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Joint Committee on the draft Financial Services Bill

Draft Financial Services Bill

Session 2010–12

Report, together with formal minutes and appendices

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The Joint Committee on the Draft Financial Services Bill

The Joint Committee on the Draft Financial Services Bill was appointed by the House of Commons on 18 July 2011 appointed by the House of Lords on 21 June 2011 with the terms of reference "to consider and report on the draft Bill by 1 December 2011." An extension was granted until 16 December 2011.

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The staff of the Joint Committee were drawn from both Houses and comprised: Chloe Mawson (Lords Clerk), Sara Howe (Commons Clerk), Nida Broughton (Economist), Stephen Seawright (Policy Analyst), Hadia Choudhury (Committee Assistant), Melanie Moore (Committee Assistant) and Michelle Edney (Committee Assistant). The Special Advisers to the Joint Committee were Professor Alistair Milne and Professor Kern Alexander.

Publications

The report of the Committee is published by The Stationery Office by Order of both Houses. All publications of the Committee are available on the intranet at:
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CONTENTS

Evidence is published online at www.parliament.uk/financialservicesbill and available for inspection at the Parliamentary Archives (020 7219 5314)

References in footnotes to the Report are as follows:
Q refers to a question in oral evidence;
Witness names without a question reference refer to written evidence.

Executive Summary

In autumn 2008, Britain's banking system came perilously close to collapse. To avert catastrophe, the Government was forced to step in with multi-billion pound bailouts. Many factors led to this crisis including failings in financial supervision and fuzzy allocation of responsibilities for preventing and managing systemic crises.

The draft Financial Services Bill is aimed at preventing such a potentially calamitous systemic failure of the financial sector occurring again. It proposes far reaching changes to the regulatory structure, replacing the tripartite system of financial regulation with a twin peaks model. Our recommendations are intended to ensure that the new regulatory authorities have the right objectives, powers and responsibilities and systems of accountability which will be essential to make them effective.

The draft Bill gives unprecedented new powers to the Bank of England. The Bank will now have substantial powers to manage the British economy not only through monetary policy but also by directly influencing risk-taking in financial markets and influencing the supply of credit. It will have access to measures impinging directly on households and businesses. This raises important issues of democratic accountability to Parliament. We make recommendations to ensure that the Treasury and Parliament will exercise more oversight of the new Financial Policy Committees' macro-prudential activities. The Bank's powers also demand a new governance structure for the Bank itself and we recommend that the Court of Directors be replaced by a Supervisory Board, some members of which would have direct experience of the financial sector. The new Board should have powers to review the performance of the new Financial Policy Committee and its chairman would be consulted on the appointment of a new Governor.

The new Financial Policy Committee should become a committee of the Bank under the new Supervisory Board, with equal status to the MPC. FPC membership must be broadened to include experts from across financial services, including insurance, and the wider economy. Bank of England staff should lose their proposed majority on the FPC to external members. Reports on major regulatory failure, like the recent report of the collapse of RBS, should be standard practice. The PRA should have an independent complaints commissioner who handles complaints against both the PRA and the FCA.

It must be clear, however, that if there is a potential banking failure, and the possibility of demands on the public finances, then it is a matter for Government. The evidence we received made clear that in the last crisis, there was confusion as to who was in charge. Our recommendations intend to remove any doubt: when there is a threat to public funds, the Governor must alert the Chancellor who must then lead the response.

No regulatory structure can completely rule out bank failure but the likelihood and potential impact can be minimised. The Independent Commission on Banking's recommendations on ring-fencing of retail banking from riskier investment banking arms should receive thorough pre-legislative scrutiny. Subject to that we recommend that legislation enacting the proposals on ring-fencing should be brought forward in the next session of Parliament, with a view to implementation at the earliest possible date. The Government should think very carefully about imposing on banks headquartered in the UK capital requirements relating to their overseas subsidiaries over and above that agreed by the international college of regulators monitoring those banks.

The financial sector, however, now extends far beyond the ranks of banks. MF Global, the recently failed US futures broker, would not have come within the regulatory perimeter as envisaged for the new Prudential Regulatory Authority. This is not acceptable. The regulatory perimeter of the PRA should be widened to cover investment firms of the size and significance of MF Global; it should be flexible with changes subject to an enhanced form of parliamentary scrutiny. The PRA's objectives in the draft Bill restrict its supervision to firms that pose a threat to the entire financial system. This is too limited—the PRA should have a secondary obligation to reduce the risk of failure of other financial firms which can burden the financial guarantee scheme, inconvenience, and potentially impose losses on, customers. The regulation of market infrastructure should sit within the PRA.

We recognise the international nature of the financial sector and the fact that the European Union imposes an increasing amount of the regulatory framework. The new regulatory structure in the UK does not mirror the EU regulatory structure and with different bodies representing the UK at different international negotiating tables there is a danger that the UK will not speak with one strong unified voice. We recommend a high level committee reporting to the Chancellor and comprising representatives from the PRA, FCA, Bank and Treasury to agree British objectives and maximise the UK's influence in EU and international negotiations.

In recent years there have been several cases of mass mis-selling of financial products, such as Payment Protection Insurance. The draft Bill establishes a new conduct of business regulator: the Financial Conduct Authority (FCA). The FCA's obligation in the Bill to promote confidence in the UK financial system could encourage it to conceal or ignore weaknesses that might disturb confidence. The FCA's objective should be to focus on promoting fair, efficient and transparent financial services markets that work well for users. The FCA should be given significant new competition powers including the power to make market investigation references to the Competition Commission and the power to hear super-complaints. Responsibility for consumer credit should be moved from the OFT to the FCA.

To complement the principle of 'caveat emptor' enshrined in the draft Bill a statutory duty should be placed on firms to treat their customers "honestly, fairly and professionally", and the FCA should ensure that companies address conflicts of interest and provide intelligible information, rather than accurate but impenetrable information that leaves customers confused. Customers have a right to know if a warning notice has been issued about a firm's product or process so the requirement for the FCA to consult before disclosing the fact should be removed from the draft Bill. We also make recommendations to ensure bank customers are made aware when, because their bank is headquartered elsewhere in the EEA, their deposits are not covered by the Financial Services Compensation Scheme.

The previous regulatory regime focused too much on backward-looking mechanistic rules and did not anticipate the evolving risks that threatened the financial system. An important aspect of the new regulatory philosophy and culture therefore will be 'judgment-led' supervision—which means being more forward-looking in anticipating the risks that threaten the regulatory objectives of financial stability, consumer protection and market integrity. Despite the Government's claim that the new regulatory approach will be based on 'judgment-led' supervision, the term is not mentioned in the draft Bill. We propose that 'judgment-led' supervision be given statutory backing.

The culture and ethics within the financial services industry also need to change. Before the 2007 crisis many banks appear to have been involved in practices that were unethical and designed to maximise remuneration regardless of risk to the bank let alone the economy. Supervisors, banks and shareholders must ensure that senior staff remuneration schemes do not lead financial institutions to take on excessive risk. The PRA and FCA should take an active interest in this area and should rigorously enforce the remuneration code. The Government and the regulators should consider increasing the share of executive remuneration that is deferred and conditional on medium term outcomes, or introducing a concept of 'strict liability' of executives and Board members for the adverse consequences of poor decisions, in order to ensure that bank executives and Boards strike a different balance between risk and return.

Draft Report of the Joint Committee on the Draft Financial Services Bill

CHAPTER 1: INTRODUCTION

1. The Financial Services Bill will reform the system of financial regulation by abolishing the tripartite system comprised of the Treasury, the Bank of England and the Financial Services Authority. This will be replaced with a new 'twin-peaks' model under which the Bank of England will be responsible for macro-prudential regulation through a new Financial Policy Committee (FPC) and micro-prudential regulation though a new subsidiary body called the Prudential Regulation Authority (PRA). In addition there will be an independent conduct of business regulator called the Financial Conduct Authority (FCA).

2. The draft Bill makes substantial and wide-ranging amendments to the Financial Services and Markets Act 2000. A consolidated version of that Act, showing all the proposed amendments, has been published by the Treasury.[1] The draft Bill also makes amendments to the Bank of England Act 1998 and the Banking Act 2009.

3. We were appointed as a Joint Committee to "consider and report on the draft Bill by 1 December 2011". Our appointment followed a motion of the House of Commons on 18 July 2011 and a motion of the House of Lords on 20 July 2011. In order to be able to give proper consideration to this large piece of draft legislation we sought, and were granted, an extension to 16 December 2011.

4. Publication of the draft Bill followed two rounds of consultation by the Treasury. An initial consultation was launched on 26 July 2010 with the publication of a document entitled '*A new approach to financial regulation: judgement, focus and stability*'. A second round was launched in February 2011 with the publication of '*A new approach to financial regulation: building a stronger system*'. We had access to the responses to these consultations as well as the responses to the Treasury's consultation following publication of the draft Bill itself.

5. The House of Commons Treasury Committee has also taken a close interest in these reforms and has published one report on preliminary consideration of the proposals[2] and one report on the accountability of the Bank of England in light of the proposals.[3] It is currently conducting an inquiry into the FCA. We have sought to keep in close contact with the House of Commons Treasury Committee throughout this inquiry in order that the two

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1 http://www.hm-treasury.gov.uk/d/consolidated_fsma050911.pdf

2 House of Commons Treasury Committee, 7th Report (2010–12) *Financial Regulation: a preliminary consideration of the Government's proposals* (HC 430-I).

3 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874).

committees complement each other's scrutiny. Two members of that committee are amongst our number.

6. Steps are already underway to give effect to the plans for reform of the regulatory structure. These steps were taken before the publication of the draft Bill. An interim FPC has begun to meet inside the Bank of England; the Bank and the FSA have held industry-wide events to explain the approach of the PRA and the FCA and appointments have been made to the positions of Chief Executive of the PRA and FCA. This formed part of the context of our considerations.

7. In September this year the final report of the Independent Commission on Banking (ICB), chaired by Sir John Vickers, was published. The ICB was appointed in 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition, and to make recommendations to the Government. The ICB made wide ranging recommendations including proposals for ring-fencing the retail activities of banks. The Government has accepted in principle the recommendations of the ICB and is committed to legislating in this parliament. Towards the end of our inquiry the Chancellor of the Exchequer announced that this Bill will not after all be used to enact the ICB recommendations on ring-fencing and higher capital requirements.[4] Given that these reforms will have a direct impact on the work of the regulatory bodies established by this legislation we have considered the draft Bill in the context of the ICB recommendations.

8. We were disappointed not to be able to consider the Government's formal response to the ICB (due to be published at approximately the same time as this report) or see any draft clauses aimed at enacting ICB recommendations. The ICB recommendations are key to reform of financial services and must be scrutinised in detail. **The ICB recommendations on ring-fencing and higher capital requirements are extremely important. Parliament must consider the substance and get the detail right in the legislation that enacts the recommendations. We urge the Treasury to confirm that legislation will be subject to pre-legislative scrutiny in parliament. The legislation enacting the ICB recommendations on ring-fencing should be brought forward during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented as soon as possible. There is a good case for allowing time to rebuild capital requirement adequacy.** (see para 185).

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4 Q 1005

CHAPTER 2: IS REFORM NECESSARY?

9. The fundamental purpose of the draft Bill is to change the structure of regulation from the tripartite system to a twin peaks model.

10. The preponderance of evidence suggested that no regulatory structure however well designed can guarantee that there will be no banking failures or crises in future. Our first starting point has been that **it is vital that legislation makes proper provision for handling crises (including the ongoing need for the lender of last resort function) and resolving bank failures—including possible restructuring of banks to make them more resoluble.**

11. This legislation addresses how the Treasury, the Bank of England and the regulatory authorities should co-ordinate in a crisis and it goes some way to clarifying who is in charge in a crisis. It also sets objectives to enable orderly firm failure. It needs to be considered alongside the Special Resolution Regime provisions in the Banking Act 2009, the Bank of England's duties as Lender of Last Resort, and the ICB recommendations for the ring-fencing of retail banking operations to make them more resoluble.

12. The financial crisis that began in 2007 had an enormous economic, social and political impact on the United Kingdom. It highlighted weaknesses with the tri-partite regulatory structure. The FSA was severely criticised for inadequate regulation and supervision of UK banks and wholesale capital markets, and for failing to contain systemic risk.

13. The lack of proper prudential supervision was only part of the problem. The run on Northern Rock in 2007 revealed major weaknesses in the process for crisis management and in particular in co-ordination and division of responsibility between the three players in the tri-partite system: the Bank, the FSA and the Treasury. As the crisis unfolded, there was disagreement about how to respond. The Rt Hon Alistair Darling MP, who was Chancellor of the Exchequer at the time, wrote in his recent autobiography that: "The whole system depended on the chairman of the FSA, the Governor of the Bank and the Chancellor seeing things in exactly the same way. The problem was that, in September 2007, we simply did not see things in the same way."[5]

14. The Northern Rock failure also revealed that there was no satisfactory resolution procedure.[6]

15. Our witnesses were also overwhelmingly of the view that the structure of financial regulation was not the determining factor in how successful a country was in avoiding or handling the crisis since 2007. Countries with unitary or twin peaks regulation experienced problems on a similar scale to those with tripartite systems like the UK. And the few countries which appear to have best handled or avoided the crisis include those with a range of different regulatory structures.

16. This evidence leads us to our second basic starting point—that **successful regulation depends more on the regulatory *culture, focus and***

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5 *Back from the Brink: 1000 days at No 11*, Alistair Darling, Atlantic Books, 2011

6 A resolution procedure is the procedure whereby the authorities seek to manage the failure of an institution in a safe and orderly way.

philosophy **than on structure.** A robust regulatory culture, focus and philosophy is essential to ensure effective handling of risk.

17. Culture, focus and philosophy do interact with the regulatory structure and the Bank of England believes that combining conduct and prudential regulation in the tripartite structure undermined focus and "directly contributed to the FSA's taking its eye off the build-up of prudential risks in a number of major institutions".[7] Lord Burns, Chairman of Santander plc, told us that the "structure created insufficient attention given to the prudential aspects of financial stability, particularly with respect to capital adequacy and liquidity management."[8]

18. As Mr Andrea Enria, Chairman of the European Banking Authority, put it "We have to acknowledge that during the crisis there were different types of construction that equally succeeded or failed in the face of the crisis."[9]

19. For example Australia, which had a twin peaks regulatory structure, weathered the crisis quite well. Dr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, believes that this was partly attributable to the fact that "… the regulatory culture in Australia may have been different from the one that prevailed in other countries … Some regulatory cultures are more comfortable than others with making use of softer powers. In Australia APRA would describe itself as being towards the end of the spectrum; that is, it would be more comfortable with using its persuasive powers and ability to put pressure on institutions to try to influence the way they behave."[10] He went on to conclude that "Both the twin peaks and unified central bank regulator models can be made to work. The most important thing is how the regulators go about their task."[11] This is supported by the experience of Canada, a country with a unified regulator like the UK Financial Services Authority, but which like Australia imposed comparatively strict bank regulations (for example higher capital requirements than in other countries and compulsory insurance for mortgages with loan-to-value ratio of more than 75%). It is their stricter regulation of banks rather than their regulatory architecture that explains why both Australia and Canada were relatively unaffected by the global crisis.

20. In many other countries the predominant philosophy amongst regulators was flawed. There was a presumption that markets are perfectly rational which led the regulators to rationalise the activities of market participants and assume that they did not pose risks. This complacency is illustrated by the IMF Global Financial Stability Report which stated in April 2006 a year before the credit crunch erupted:

> "There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient.
>
> The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks may be less vulnerable today to credit or economic shocks."[12]

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7 Bank of England written evidence

8 Q 35

9 Q 91

10 Q 104

11 Q 105

12 IMF Global Financial Stability Report, April 2006.

21. In the UK the regulatory culture established in the late 1990s was not focused on stability, probably because the UK had not had a systemic banking crisis for a generation. Also the main aim of the new structure was to create an independent monetary policy committee and the system it replaced had focussed on regulating financial services other than banking. Because nobody was anticipating a major banking crisis:

    (1) Responsibilities for preventing and managing systemic crises were not clearly allocated.

    (2) The focus was on the stability of individual firms and there was no attention paid in the legislation to the stability of the system as a whole.

    (3) The focus was on regulation (i.e. the application of rules once problems emerge, which was thought appropriate for financial products and services), rather than supervision (i.e. trying to anticipate problems before they happen, which is more appropriate for ensuring banking stability).

22. This committee was conscious of the risk of making the opposite mistake and focussing exclusively on systemic stability to the neglect of other less topical objectives of the regulatory system. The regulatory culture also failed to provide rigorous conduct regulation. In recent years there have been a number of cases of mass mis-selling of financial products to consumers. The most high profile case was the mis-selling of payment protection insurance but others include personal pensions, mortgage endowment policies and split capital investment trusts. The financial industry has had to make compensation payments of approximately £15 billion and this amount will increase considerably with much PPI compensation yet to be paid. As the FSA itself acknowledges "a new approach to conduct regulation is essential."[13]

23. The hope is that the reforms embodied in the draft Financial Services Bill address the problems with the tripartite regulatory structure by giving clear responsibility for macro- and micro- prudential regulation, making it clear who is responsible in a crisis and creating a separate expert conduct regulator.

24. **To be successful the reforms will have to change the regulatory culture and philosophy. It is through a change in culture and philosophy that the relevant authorities can best ensure both financial stability and good conduct of business. A key aspect of the cultural change needed will be a shift towards forward looking supervision as explained in paras 188–198. This will require staff with appropriate experience, approach and attitudes. A change in culture is not something that legislation can guarantee but legislation can influence the culture of a regulator by:**

    (1) setting objectives,

    (2) allocating and aligning powers and responsibilities,

    (3) establishing appropriate systems of accountability.

    These are the three themes around which this report is structured.

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[13] The FSA, *the Financial Conduct Authority: approach to regulation*, June 2011, pg 1.

Without significant changes to clarify objectives, allocate appropriate powers and create proper accountability the Bill as currently drafted will not guarantee a change in regulatory culture. This report makes recommendations to address these weaknesses.

25. It is also important to bear in mind that UK reform cannot be considered in a vacuum. The financial sector is global and crises may require a global response. This is recognised in the work of the G20, the Financial Stability Board and the EU. While shaping UK reforms, clarity is needed with regard to the UK's powers vis-a-vis Europe and beyond.

26. Our remit was to consider the Draft Financial Services Bill and therefore necessarily our recommendations are mainly directed at the Government for proposals to amend the Bill and at the regulators for how to interpret duties under the Bill. This does not mean that we think it is only the regulatory culture that need to change. The culture and ethics within the financial services industry also needs to change. Before the 2007 crisis many banks appear to have been involved in practices that were unethical and designed to maximise remuneration regardless of risk to the bank let alone the economy. Codes of ethics either did not exist or were not adhered to and were certainly not enforced. We heard some evidence that this is changing and banks are emphasising ethics to their staff in particular to discourage excessive risk taking. Developing the ethics of those working in the financial services industry is the responsibility of each firm and should be a high priority. The primary responsibility for the health of a company lies with the Board and senior management as highlighted in the very recent FSA report on the failure of the Royal Bank of Scotland.

CHAPTER 3: OBJECTIVES

27. The draft Bill creates three new bodies: the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The legislation needs to set out clearly the objectives of all three. This is essential to give each of them a clear focus; to ensure that there is no dispute about their respective responsibilities; and to provide a clear basis for their accountability to government and to parliament.

The objective of the FPC

28. The FPC is to be a macro-prudential supervisor. It will look across the financial system as a whole identifying risks to the stability of the financial system arising from excessive gearing, asset bubbles or the 'interconnectedness' of firms.

29. Under the Banking Act 2009 the Bank of England had an objective "to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom".[14] Prior to this, the Bank considered financial stability but its responsibility for this area was only spelt out in the Memorandum of Understanding between the Tripartite Authorities.[15]

30. The draft Bill makes financial stability almost exclusively the responsibility of the Bank of England and its subsidiaries by dropping the words "contribute to":

> "An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective")". [16]

31. The draft Bill further amends the Bank of England Act to establish the Financial Policy Committee whose objectives it defines as follows:

(1) "The Financial Policy Committee is to exercise its functions with a view to contributing to the achievement by the Bank of the Financial Stability Objective.

(2) The responsibility of the Committee in relation to the achievement of that objective relates primarily to the identification of, monitoring of, and taking of action to remove or reduce, systemic risks with a view to protecting and enhancing the resilience of the UK financial system.

(3) Those systemic risks include, in particular—

(i) systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector, and

(ii) unsustainable levels of leverage, debt or credit growth."[17]

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14 Banking Act 2009, Part 7, Section 238, Clause 1 (created new Section 2A in Bank of England Act)

15 Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority 1997

16 Clause 2(2)

17 Clause 3 (new Bank of England Act 1998 clause 9C)

32. The drafting in Bank of England Act new clause 9C which requires the FPC to pay attention to systemic risks including "unsustainable levels of leverage, debt or credit growth" goes on to define debt and credit growth as "debt owed by" and "lending to" "individuals in the United Kingdom and businesses carried on in the United Kingdom". We cannot see why this limit to the United Kingdom is specified. British banks faced in 2007, and could again face systemic risks as a result of lending to, or debts owed by, individuals, businesses or, indeed, governments abroad. As drafted it would appear to exclude US sub-prime lending or Greek and Italian bonds from the categories of credit and debt which the FPC is required to monitor. It is true that the clause does not prevent the FPC looking beyond UK lending and debt but it does require the FPC to start with this narrow focus. This adds to the impression that the draft Bill has been written initially as if it applied only to the UK with at best a belated recognition that banking is a global industry. **We recommend the Government reconsider the drafting of clause 3 (new Bank of England Act 1998 clause 9C(6)) to make clear the importance of monitoring the global exposure of UK banks.**

33. Before and during the 2007 crisis regulators underestimated risks that were building up. These risks were sometimes greater than the sum of their parts due to interconnectedness between firms but this was not properly understood or monitored. In order to achieve financial stability the FPC must carefully consider the interconnected nature of the system. **The reference in the FPC's objective to monitoring "systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector" is presumably intended to place a duty on the FPC to consider the interconnected nature of the market—this duty should be made more explicit.** An interim FPC has already been established and we were pleased to see that at its meeting on 16 June 2011 it observed that there are "vulnerabilities relating to the structure of the financial system itself. In particular, these related to interconnectedness in the financial system and to complex or opaque instrument structures with the potential to amplify or propagate any stresses that emerged".[18]

Defining financial stability

34. Assessing financial stability is difficult as it is nebulous and hard to quantify or define. It is not like inflation for which a numerical target can be set against which the Monetary Policy Committee's performance can be assessed. Lord Burns told us: "One of the problems is that measuring financial stability is a good deal more complex ... it is quite difficult for the Government to set an objective that is terribly precise."[19] The draft Bill leaves the term undefined.

35. Some witnesses argued there was a risk that the objective could be interpreted in an asymmetric manner. It could encourage the FPC to be overly cautious in pursuit of financial stability. Stuart Gulliver, chief executive of HSBC, said: "The way the FPC has been set up is that it is focused entirely on stability ... You could see a situation where everything

[18] Minutes of the interim FPC meeting on 16 June 2011

[19] Q 56

has been secured to such an extent that there is no risk of a failure but there is no credit going into the economy either."[20]

36. Given the difficulties involved in measuring or even defining financial stability, Stuart Gulliver and others proposed changing the objective to maintaining a stable and sustainable supply of credit.[21] Barclays argued this is a more workable objective than trying to define financial stability itself. There is a twofold rationale for this: first, that excessive credit growth leads to overleveraging, asset bubbles and ultimately a financial crisis. Barclays wrote "We cannot think of a systemic risk that has no potential impact on the 'sustainable supply of credit'.[22] Conversely, in the aftermath of a banking crisis there is a danger of inadequate credit growth or even credit contraction if banks are required to restore their capital adequacy and do so by restricting or shrinking their lending. HSBC asserted that moving to a stable supply of credit objective would remove incentives for the FPC to be excessively conservative in such circumstances.[23] Second, the advocates of maintaining a sustainable supply of credit objective argue that the MPC sets a price for credit—the interest rate—but that has little effect on the supply of credit which should therefore be made the responsibility of the FPC using macro-prudential tools. They see the roles of the two committees as symmetrical. So, just as the Treasury sets the MPC an inflation target they believe it should set the FPC a target range for credit growth. And just as the MPC has to pursue its inflation target while "having regard for the government's growth and other objectives" so the FPC would have regard for those other objectives while meeting its credit target. Indeed, Stuart Gulliver suggested that "the Treasury should be setting out what the Government's goals are for growth, employment and job creation and saying to the FPC, "Use your macro-prudential tools to ensure that you achieve the Treasury's goals."[24] Both he and Bob Diamond cited the experience of Pacific economies who actively manage the flow of credit and even its sectoral allocation using a variety of macro-prudential tools.[25]

37. The British Bankers' Association also supported this approach. Other witnesses disagreed with an objective based on ensuring a stable supply of credit. Sir Mervyn King, Governor of the Bank of England, said such an objective would be unclear. Furthermore, credit supply is affected by many factors beyond the FPC's scope:

> "That should not be the objective of the FPC, simply because I don't think they can deliver it given the sort of policy instruments that will be available. What does "sustainable supply of credit" mean? If it is zero, which is where we are now, that is certainly sustainable, but that is not desirable. The natural supply of credit will vary over the business cycle. What matters is that the committee should focus on the resilience of the financial system ... I totally accept the idea that we should be responsible for a symmetric response. It is just that I worry about a rather

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20 Q 692

21 E.g Barclays written evidence, HSBC written evidence, British Bankers' Association written evidence. Each witness suggested a slightly different version of an objective focussed on growth of credit.

22 Barclays written evidence

23 Q 692

24 Q 693

25 Q 692, Q 701

> mechanistic definition of "credit", and it certainly cannot be credit to the real economy, because that will move up and down according to many factors outside the control of the FPC."[26]

38. Sir John Gieve, former deputy governor of the Bank responsible for financial stability, also opposed the proposal: "That really would take you right into MPC territory. It would be very odd to have a separate committee charged with maintaining a sustainable supply of credit on one side and hitting an inflation target on the other, operating mainly by the regulation of credit."[27]

39. An unsustainable growth of credit is not the only potential source of financial instability. There are others including, in particular, inadequate bank capital and liquidity, the migration of exposures to maturity mismatch outside of the regulated banking sector to the wholesale financial markets and shadow banking and the network of interconnectedness revealed when Lehmans collapsed. These or other problems might trigger system wide problems even if bank credit has grown only moderately.

40. **Preventing excessive or inadequate growth of credit will be an important part of the way that the FPC meets its objective. However, it will also need flexibility to consider other factors which bear on the stability of the financial system. Moreover, it would in our view be premature to attempt to set quantitative targets for credit growth before the FPC has experience of developing and applying macro-prudential tools. So we do not recommend setting a credit based objective for the FPC.**

Financial stability and economic growth

41. As mentioned in paragraph 36, HSBC proposed that the FPC should be given an obligation mirroring that of the MPC "subject to [meeting its principal objective], to support the Government's economic objectives including those for growth and employment". The draft Bill does already require the FPC to take account of the impact of its policies on the financial sector's contribution to growth. It states that the FPC's responsibilities for contributing to the Bank's Financial Stability Objective:

> "do not require or authorise the Committee to exercise its functions in a way that would in its opinion be likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term".[28]

Several witnesses suggested that this clause should be re-drafted to put the FPC under a positive duty to support economic growth.[29]

42. It is interesting to compare the drafting of the FPC objective to the MPC objective. Compared to the MPC formulation, where growth can only be considered subject to having delivered price stability, the FPC formulation places considerably higher priority to safeguarding growth. Ultimately the FPC will not be able to take decisions to promote financial stability if it believes those decisions risk medium to long term economic growth.

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26 Q 792–794

27 Q 669

28 Clause 3 (new Bank of England Act 1998 clause 9C(4))

29 E.g. Legal and General written evidence, CBI written evidence

43. Mark Hoban MP, Financial Secretary at the Treasury, explained that the different remits of the MPC and FPC "means that it is appropriate that their objectives in relation to economic growth are formulated differently". The Treasury's position is that by meeting its primary objective of price stability the MPC will naturally support economic growth. In contrast the FPC's primary objective of protecting and enhancing the financial system could lead to decisions that have a negative impact on growth. Mr Hoban wrote: "The FPC therefore needs to strike a balance between making the financial sector safer overall without compromising sustainable economic growth in the long term."[30] The FPC's objective therefore features a stronger emphasis on growth to ensure that the FPC acts proportionately.

44. **The Government is right to require the FPC to consider the impact of its decisions on growth. But the Bill's current drafting is too strong and restrictive. The FPC is not authorised to take any actions to promote stability if it is likely to have a significant adverse effect on the financial sector's contribution to growth in the medium or long term. The Bill should be redrafted so that like the MPC, the FPC must have regard to the Government's growth and other economic objectives subject to meeting its primary responsibility of attaining financial stability.**

The role of the Treasury in interpreting the financial stability objective

45. The draft Bill provides that the Treasury will set and renew at least annually the remit of the FPC by making recommendations about how it should interpret and pursue the financial stability objective.[31] The FPC must respond to the Treasury's recommendations but in order to protect the independence of the FPC it will be able to reject the recommendations as long as it explains its reasons. The Treasury's proposals and the FPC's response must be laid before Parliament.

46. The draft Bill gives the Court of Directors of the Bank responsibility for setting the Bank's overall financial stability strategy and for renewing it every three years after consulting the FPC and the Treasury. The FPC will be required to take the strategy into account but has the right to make recommendations about it to the Court at any time.[32] This strongly reinforces the case for the Court to be replaced with a new Supervisory Board (see para 307).

47. The tools available to the FPC could allow a reversion to a level of central intervention in credit flows that has not been practised in the UK since the period of 'Competition and Credit Control' in the early 1970s. Such interventions would, for example, often affect mortgage availability and loans to households and companies. Given the wide range of possible interventions, and absence of any quantifiable target for financial stability corresponding to the inflation target for monetary stability, the FPC's decisions will be more politically controversial than those of the MPC.

48. It is right that the FPC will have the power to disagree with the Treasury's interpretation of the financial stability objective. However, the Treasury

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30 Treasury further supplementary written evidence

31 Clause 3 (new Bank of England Act 1998 clause 9D)

32 Clause 3 (new Bank of England Act 1998 clause 9A)

should have the power to override the FPC's objections otherwise the FPC would be constrained only by criticisms from the House of Commons Treasury Committee. Lord Burns said: "If there is any part of this set of proposals that concerns me, it is probably to do with the governance of the FPC in relation both to its accountability to Parliament through the Treasury and the extent to which it can be defined as 'independent'."[33]

49. We would address concerns about accountability of the FPC in two ways. We support the proposal of the Treasury Select Committee for the replacement of the Court of the Bank of England by a supervisory board to oversee the work of the Bank, and of the MPC and the FPC (see para 309). But while the supervisory board can provide independent assessment and review of the performance of the Bank, it cannot provide political oversight; that has to be exercised by either the executive or by Parliament. Therefore, in order to provide effective political accountability, **the draft Bill should be amended so that the Treasury, not the FPC, has the final say about the interpretation of the remit of the FPC. We would normally expect the Treasury and the FPC to come to an agreement about the remit and therefore we would not expect the Treasury to have to override the FPC on a regular basis. If the FPC has any objections to the annual remit issued by the Treasury it should make these public and alert the House of Commons Treasury Committee. Notwithstanding that the Treasury may have suggested matters that the FPC should regard as relevant to the Committee's understanding of the Bank's financial stability objective the Bank of England remains responsible for the entirety of that objective.**

Indicators of financial stability

50. Professor Charles Goodhart of the London School of Economics advocated that the FPC assess financial stability against published indicators (to be chosen and justified by the FPC). These indicators would help the FPC in the pursuit of its objective. Marked movements in these indicators would mandate the FPC to explain to the House of Commons Treasury Committee its response.[34] In evidence to that committee Professor Goodhart wrote:

> "Past experience suggests that there are a number of early warning indicators which tend to precede financial crises. These include the following:
>
> (1) A rate of growth of (bank) credit which is significantly faster than average, and above its normal trend relationship to nominal incomes.
>
> (2) A rate of growth of housing (and property) prices which is significantly faster than normal and above its normal trend relationship with incomes.
>
> (3) A rate of growth of leverage, among the various sectors of the economy which is significantly faster than usual and above its normal trend relationship with incomes."
>
> "I would not be dogmatic about the choice and formulation of such indicators, but I would like to suggest that you require the [FPC] to choose somewhere between two to four such presumptive indicators.

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[33] Q 53

[34] Q 258

> The idea is that when at least two of these indicators are showing a danger signal, that the expectation would be that the [FPC] should take action to counter such developments or else be prepared to explain in public to yourselves at the TSC [Treasury Select Committee] why they have not done so."[35]

51. Professor Goodhart acknowledged that his proposed indicators were only suggestions and that the FPC "might have a completely different list". He suggested that the FPC should propose its own indicators and explain the reasoning behind each indicator in a published document.[36]

52. The Chancellor of the Exchequer was cautious about defining indicators at this stage:

> "it is much more difficult in this field than it is in inflation targeting to find a single measure or set of metrics ... This is a much newer and certainly less developed area of policy making. Certainly, I would not feel confident today to say there is a set of metrics and a set of tools which I am absolutely certain is what is required to provide that macro-prudential stability."[37]

53. The House of Commons Treasury Committee recommended that the Treasury should give guidance under Clause 3 of the draft Bill to the Bank of England to adopt indicators for gauging financial stability.[38] Recognising that thinking is still developing in this area it stated that the indicators should be flexible and open to challenge and review by parliament, government, the Bank and industry. The indicators would be published and the FPC would report against them at regular intervals.

54. Given that no one claims there is a known set of indicators that will provide a sure guide to the stability of the financial system it would be wrong to prescribe any in statute. Nor is it necessary to impose an obligation on the FPC to adopt a set of indicators of its own choosing. But we can see the attraction of having indicators of financial stability. **The FPC should begin work towards developing indicators of financial stability in dialogue with the Treasury. They should be published and the FPC should report against them. The set of indicators should be flexible and subject to regular review.**

Financial stability and recourse to public funds

55. As noted above the draft Bill amends the Bank's Financial Stability Objective so that it reads:

> "An objective of the Bank shall be to protect and enhance the stability of the financial system of the United Kingdom (the "Financial Stability Objective")."[39]

56. The Chancellor told the House of Commons Treasury Committee that his definition of financial stability included not requiring taxpayers' money to support the financial industry.[40]

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35 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 107

36 Q 259

37 Q 1014

38 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 114

39 Clause 2

40 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 109

57. Despite the Chancellor's view no mention is made in the Bank's financial stability objective of avoiding recourse to public funds. The Treasury Committee concluded this should be changed.[41]

58. **We agree with the Chancellor that avoiding where possible the need for taxpayers' money to support or rescue parts of the financial services industry is a key element of financial stability. There will of course always be a possibility that public funds are called on to preserve stability but part of the objective of the FPC should be to minimise the likelihood of this happening. The FPC's objective should be amended to require it to "reduce the likelihood of recourse to public funds".** We recommend a similar amendment to the PRA's objectives in paragraph 76.

Possible conflict between the MPC and the FPC

59. How the decisions of the Financial Policy Committee and Monetary Policy Committee will interact is unclear. Influencing the amount of credit—as the FPC will do—will affect inflation. Changes in interest rates by the MPC will influence the amount of borrowing and, hence, financial stability. The Treasury admits monetary and macro-prudential policies "could move in opposite directions" but this "does not necessarily represent potential conflict between the actions of the two committees".[42]

60. In the July 2010 White Paper the Treasury gave the example of the build-up to the financial crisis, when interest rates were low—which encouraged excessive borrowing that made the financial system less stable—but inflation was on target so there was no case to increase interest rates. Had there been an FPC then it could have taken action to slow growth in banks' balance sheets and restrain borrowing. Depending on the macro-prudential tools used, such actions could have affected inflation and therefore the appropriate level of interest rates.[43]

61. The Treasury believes cross membership between the FPC and the MPC will help manage these interactions and avoid potential conflicts. The Governor and Deputy Governors for financial stability and monetary policy will sit on both the FPC and MPC.[44]

62. Furthermore, the Treasury suggests that there should be careful sequencing of meetings with the MPC being "the 'last mover', adjusting its analysis to take account of the likely impact of the most recent action taken by the FPC".[45] But it is unclear how much sequencing is needed: the FPC is scheduled only to meet every three months, while the MPC is scheduled to meet every month, meaning the MPC will have ample opportunity to respond as the last mover.

63. The Treasury said in its July 2010 consultation that further analysis on the interaction between monetary and macro-prudential policies will be needed when discussing what tools should be at the FPC's disposal.

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41 Ibid, para 115

42 HM Treasury, A new approach to financial regulation: judgment, focus and stability, July 2010, page 18.

43 Ibid

44 Ibid, para 2.47

45 HM Treasury, A new approach to financial regulation: building a stronger system, February 2011.

64. Sir Mervyn King believes that the FPC will make the job of the MPC "easier" and found unconvincing the arguments that one committee may make the other's job more difficult:

> "The virtue of the FPC is that it can remove dilemmas that the MPC might face and would be worried about. For example, the MPC was worried to some extent that the imbalances in the economy and expansion of the banking sector balance sheet was an argument for raising interest rates by more than would be justified by the need to maintain inflation close to the target, and hence steady growth. If the FPC can deal with that problem and remove the dilemma it will make the job of the MPC easier. Far and away the most likely outcome is that the existence of the FPC will make the MPC's job easier, not more difficult because there is a tension between the two."[46]

65. If there is nonetheless any potential for conflict between the FPC and the MPC the key to avoiding it is good communication and co-ordination.[47] The British Bankers' Association suggested that the ability of members of the FPC and MPC to attend briefings from the Bank staff supporting each committee should also enhance coordination; they further suggested that members of either committee should have full access to information made available to the other. Fundamentally, however, the British Bankers' Association asserted that it is for the Chancellor to use his annual remit letters to the two committees to minimise any discrepancy in policy.[48]

66. Gillian Tett, US Managing Editor of the Financial Times, told us that the coordination of monetary policy and financial regulation was key to avoiding another crisis:

> "It was clear to me back in 2005 and 2006 from the Japanese experience that the way the Bank of England and the FSA were looking at financial regulation was ridiculous, because you had monetary policy examining the water, and the FSA looking at the micro-level details of the pipes, but there was very little attempt to try to bring that together. Obviously, splitting the FPC and MPC risks creating a division, but I have some confidence that, so long as it is clearly recognised that there needs to be a lot of collaboration, overlap and a single financial brain, the new FPC will have more chance of taking a holistic oversight than the system which was in place before."[49]

67. In our view, one risk is that more importance is attached to the MPC's work than the FPC's because the former has a quantifiable inflation target whereas the latter has a more nebulous target.

68. This risk would be reduced by implementing a recommendation from the House of Commons Treasury Committee to introduce a statutory duty for the Governor to raise any conflicts between the MPC and FPC with a new Supervisory Board (these recommendations are discussed further at paragraph 309). The Treasury Committee also recommended that the Governor should indicate how the conflict will be handled. This would force any conflict to be addressed and reduce the risk of the MPC being prioritised over the FPC.

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46 Q 823

47 E.g Charles Dumas Q 25

48 BBA written evidence

49 Q 3

69. Furthermore the risk should be reduced because interpretation and pursuit of the financial stability objective will evolve through the annual dialogue between the Treasury and the FPC. Over time this process should help ensure the FPC develops a statement of the interpretation and pursuit of financial stability that is consistent with the MPC's pursuit of monetary stability.

70. **We do not expect any serious conflicts between the MPC and FPC but they may arise. Careful co-ordination and communication should minimise the risks as should the evolution of the FPC's interpretation of its objectives. On the rare occasions when the two committees might come into conflict the Governor should inform the Court—or the equivalent body if it is reformed—and the Chancellor, to explain how the conflict will be handled. Even if there is a difference of opinion the two committees must remain independently responsible for their own levers.**

Governance structure of FPC and MPC

71. There are concerns about the different governance structures for the MPC and FPC.

72. The FPC will be a committee of the Court of Directors of the Bank whereas the MPC is a committee of the Bank itself. Barclays said that: "The FPC should, like the MPC, be a committee of the Bank rather than a committee of the Court of Directors of the Bank of England. At the very least, there should be shared membership of the independent non-executive members between the Court and the FPC. Otherwise, the FPC is only accountable to the Court through the shared executive directors of the Bank."[50]

73. The Bank of England has previously suggested that the reason for this arrangement is that the MPC is entirely responsible for decisions on monetary policy whereas the FPC will have to give directions to the PRA and FCA to use macro-prudential tools and the Bank executive and Court will make decisions on other financial policy matters (such as emergency liquidity assistance, lender of last resort etc). It will be the job of the Court to keep oversight of all the financial stability policy instruments distributed across the Bank and therefore the FPC will need to recognise the authority of the Court.[51]

74. We do not find these arguments convincing. Whether it is a committee of the Bank or the Court the draft Bill requires the FPC to take account of the strategy laid down by the Court. **The governance arrangements in the draft Bill—where the FPC is a committee of the Court and the MPC is a committee of the Bank—risk giving the impression that one body is more important than the other. The FPC should be made a committee of the Bank.**

The objectives of the PRA

75. The PRA's general objective is to "promote the safety and soundness of PRA regulated persons".[52] The draft Bill currently requires the PRA to meet this objective primarily by:

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50 Barclays written evidence

51 See Paul Tucker's evidence to the House of Commons Treasury Select Committee, 28 June, Q 375.

52 Clause 5 (new Financial Services and Markets Act clause 2B(2))

> "(a) seeking to ensure that the business of PRA-authorised persons is carried on in a way which avoids adverse effect on the stability of the UK financial system, and (b) seeking to minimise the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system."[53]

76. The second part makes it clear that the PRA is not expected to be a zero-failure regulator. Firms should be allowed to fail but the PRA will be responsible for seeking to ensure that failure will not have an impact on the stability of the financial system. We agree with that. We agree too that the primary concern of the PRA when regulating firms should be to prevent firms either in the way they carry out their business or if they fail from threatening the stability of the financial system.

77. But the Bill seems to make stability of the financial system the PRA's sole concern. It appears to absolve the regulator of any concern about the "safety or soundness" of firms it supervises if their failure would not pose a threat to the stability of the financial system as whole. This is unsatisfactory. The failure of a financial firm, even if it poses no systemic financial risk, can still place a burden on the Financial Services Compensation Scheme, seriously inconvenience customers, and—should any of its products and services not be covered by the compensation scheme—result in losses for customers and thus possibly also pressure for compensation by the taxpayer. This is why the prudential safety of individual firms is widely recognised as a separate regulatory responsibility, to be pursued alongside the 'macroprudential' function of promoting the stability of the system.[54] In practice the PRA will have a 'microprudential' responsibility as a result of EU directives. Since the draft bill does not state otherwise, the PRA supervisors will inherit from the FSA the responsibility for ensuring that UK firms comply with European directives known as Capital Requirements Directive IV (CRD IV) and Solvency II.

78. **In order to align its objectives with its own activities and with international best practice, the Bill should explicitly give the PRA a microprudential objective alongside its concern with avoiding risks to the whole system. When supervising PRA regulated persons, the primary objective should remain to reduce risks to the stability of the UK financial system. The secondary objective should be to reduce potential costs of failure to the Financial Services Compensation Scheme, taxpayer funds and customers. Neither objective requires the PRA to be a zero failure regulator. The second objective will mean ensuring firms comply with rules on for example, capital adequacy, solvency and liquidity that will reduce but not eliminate the likelihood of failure.**

Should the PRA have regard to competition?

79. The PRA is not currently required to have regard to the effect of its actions on competition in the financial sector. Certain witnesses have argued that this would be desirable. For instance, the Office of Fair Trading told us:

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53 Clause 5 (new Financial Services and Markets Act clause 2B(3))

54 See for example Richard J. Herring and Jacopo Carmassi, The Structure of Cross-Sector Financial Supervision, Financial Markets, Institutions & Instruments, Volume 17, Issue 1, February 2008, pages 51–76 of David T Llewellyn, The Economic Rationale for Regulation, UK Financial Services Authority Occasional Paper number 1, 1999.
Current IMF recommendations (International Monetary Fund: "Macroprudential Policy: An Organizing Framework", March 2011) also emphasise the desirability of supporting the macroprudential policy function with rigorous microprudential regulation and supervision.

> "Although [the PRA's] work is not so closely related to the conduct of markets as that of the FCA, its actions may have significant consequences for markets. A good example would be in the setting of capital requirements differently on competing types of activities or businesses: this would tend to have consequences for barriers to entry, and hence for competition in markets ... it would, for example, encourage the PRA where it has a choice of different regulatory approaches to achieve the same financial stability outcome to select the one with the least impact on competition".[55]

80. Sir John Vickers, Chair of the Independent Commission on Banking, said that it was "very important" for the PRA to have regard to competition, although he was not sure of the best way to achieve this.[56] One reasons Sir John gives is that "prudential capital requirements can be a barrier to entry, requiring newer and/or smaller banks to hold more capital for each unit of assets, and therefore raising their costs (holding all else equal)".[57]

81. On the other hand, Stephen Hester, Chief Executive of the Royal Bank of Scotland, told us that giving the PRA a duty on competition could muddy the waters between the PRA and the OFT: "it is just simply a choice of having one or the other. Abolish the OFT and give it to the PRA, or leave it with the OFT and don't give it to the PRA".[58]

82. The FSA opposed the suggestion of a duty on the PRA to have regard to its impact on competition, stating that the benefits of competition were uncertain in practice and, in particular, that introducing extra factors into the PRA's decisions would lead to trade-offs that could dilute the PRA's focus on prudential issues.[59]

83. **Competition within the financial sector is an important part of developing a stronger, more diverse system. The actions of the PRA have the potential to affect the costs of individual firms or of particular types of institution, and affect the barriers to entry and expansion in the market. While the need to protect and promote competition in the sector should not dictate the actions of the PRA, nor detract from the clear role of the OFT in this area, we believe it is a factor that ought to be considered in the course of PRA decision making. We invite the Treasury to consider how best this duty could be included in the Bill.**

The PRA's insurance objective

84. In addition to its general objective the PRA is given an insurance objective: "Contributing to the securing of an appropriate degree of protection for

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55 Office of Fair Trading written evidence

56 Q 288

57 Independent Commission on Banking, *Final Report*, 12 September 2011, p216. The report suggests that: new banks may be required to hold more capital if their management team is less experienced and without a proven track record; that small banks may be required to hold more capital because of limited geographical or sectoral diversity; and that small banks may not be able to make use of complex risk modelling systems, and may therefore have to use a standardised approach to risk-weighting, leading to higher risk weights for some assets. Chapter 7 of the report sets out this argument in more detail.

58 Q 692

59 FSA further supplementary written evidence

those who are or may become policyholders".[60] The PRA will be responsible for the regulation of all insurers in the same way it will be responsible for all deposit takers. Mark Hoban MP, told us that this was appropriate because of the cross-over between insurance and banking, often within the same group, and the "complex on-balance sheet prudential issues" that affected both insurance and banking.[61]

85. The draft Bill sets out the PRA's insurance duties through a separate insurance objective: "contributing to the securing of an appropriate degree of protection for those who are or may become policyholders".[62] This reflects the correlation in this sector, especially in with-profits policies, between the management of risk and consumer outcomes. If our recommendations for new cross-sectoral objectives for the PRA are accepted then the need for a separate insurance objective will disappear. In case those recommendations are not accepted it is worth noting our concerns about the drafting of the PRA's insurance objective.

86. Consumer groups have suggested that the phrase "contributing to the securing of an appropriate degree of protection" does not place a sufficient responsibility on the PRA. Peter Vicary-Smith, Chief Executive of Which?, told us that the phrasing seemed to treat the consumer aspect of the PRA's with profits regulation as an "afterthought".[63] In response, Mark Hoban MP told us that the PRA objective had been defined in terms of making a contribution because the FCA's generic responsibility for consumer protection would also apply, meaning that the PRA was not solely responsible.[64]

87. The PRA also has a specific responsibility to secure "an appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under with-profits policies".[65] The term 'reasonable expectations' is problematic. It has a legislative precedent in the (now repealed) Insurance Companies Act 1982. The FSA told us that under that Act the phrase "gave rise to a lack of clarity as to how those expectations were formed, what the substance of them was, and what actions the firm (and the regulator) should take in relation to them".[66] Indeed, much of the Equitable Life litigation revolved around the problems of defining the term. The FSA has said that the concept underlying 'reasonable expectations'—but not the phrase—has since been subsumed within the FSA's Principle 6 (Treating Customers Fairly Principle) and its rules on with profits policies.[67]

88. In the context of the draft Financial Services Bill, the FSA told us that although it supported the general policy aim, reintroducing the phrase 'reasonable expectations' risked "perpetuating this lack of clarity" and would be "an unfortunate retrograde step". Sir Mervyn King warned the House of Commons Treasury Committee in June that the term was "almost impossible to define for the regulator" and risked "leaving the regulator open

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60 Clause 5(new Financial Services and Markets Act clause 2C)

61 Q 1060

62 Clause 5 (new Financial Services and Markets Act clause 2C(2))

63 Q 123

64 Treasury written evidence

65 Clause 5 (new Financial Services and Markets Act clause 3F(1))

66 FSA further supplementary written evidence

67 FSA further supplementary written evidence

to ex post judgements by others in court as to what it should and should not have done".[68] However, the Association of British Insurers told us that it was happy with the phrasing in its current form and that the phrase was "no more nebulous than this judgement-led approach".[69]

89. The Treasury has recognised the need for the FCA to advise the PRA on "matters relevant to achieving an appropriate balance between the interests of policyholders and the prudential position of the firm".[70] The FSA has stated that it will be "vitally important" for the PRA to have regard to the FCA's advice and make use of the FCA's expertise in consumer matters.[71] Under current provisions, this arrangement would be established under the memorandum of understanding governing co-ordination between the PRA and the FCA, but the Treasury has indicated it is considering "whether explicit legislative provision is necessary to ensure efficient and effective consultation".[72] The Association of British Insurers told us that conduct and prudential regulation of with-profits insurance were "completely joined at the hip" and that although the FCA should advise the PRA on these issues as a matter of course, it would be "safer" to have an explicit requirement written into the legislation.[73]

90. **There is legal uncertainty regarding the definition of the "reasonable expectations" of policyholders. Using a phrase of this kind makes it difficult for the PRA to be clear on the meaning of its duties, and near to impossible for consumers and Parliament to hold the PRA to account for its actions. The phrase has been shown to be problematic in the past: it is unwise for the Treasury to revive it in new legislation and thereby risk the same difficulties recurring. The PRA should be responsible for ensuring that with-profits consumers are treated fairly, but the Treasury must find a way to redraft the Bill to achieve this end without using the problematic phrase "reasonable expectations". The PRA should be given an explicit duty to consult the FCA, as the consumer expert, on matters affecting with-profits consumers.**

The objectives of the FCA

The FCA's strategic objective

91. As currently drafted, the FCA's strategic objective will be to "protect and enhance confidence in the UK financial system".[74] This will be complemented by three operational objectives:

- securing an appropriate degree of protection for consumers;
- protecting and enhancing the integrity of the UK financial system; and

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68 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), vol II, Q 373.

69 Q 595

70 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.56

71 FSA further supplementary written evidence

72 Ibid

73 Q 595

74 Clause 5 (new Financial Services and Markets Act clause 1B)

- promoting efficiency and choice in the market for certain types of services.[75]

92. The FCA will also have a duty to discharge its general functions in a way that promotes competition, where appropriate.[76]

93. There was some support for this formulation of the FCA's objective. For example, HSBC said that "protecting and enhancing confidence in the UK financial system must be at the heart of its regulatory approach", and that "building confidence is the only way that we will achieve empowered consumers and well functioning markets".[77]

94. However, there has also been considerable criticism of the FCA's strategic objective to promote and enhance confidence. Criticism has focussed on the danger that it could require the FCA to bolster confidence by concealing or downplaying cases of consumer detriment. Few doubted the importance of promoting confidence—as long as it was warranted. Other criticisms of the strategic objective were that it does not reflect what the FCA is actually expected to do and that the meaning is unclear.

95. The purpose of the FCA is to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.[78] The FSA was concerned that this was not reflected in the FCA's strategic objective:

> "... we are concerned that the formulation in the draft Bill, 'protecting and enhancing confidence in the UK financial system', does not adequately capture the distinctive nature of the FCA's responsibilities and that it overlaps significantly with the responsibilities of the Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC). The PRA's focus will be financial stability and the prudential soundness of individual firms—which is of course very relevant to the FCA's strategic objective. The Government's intention is that the FCA will be responsible for conduct issues in relation to consumers and markets. We therefore think it would be more appropriate for the FCA's strategic objective to be: 'promoting fair, efficient and transparent markets in financial services."[79]

96. The ICB said that the practical meaning of the strategic objective was unclear, and that:

> "The fundamental issue is to make markets work well—in terms of competition, choice, transparency and integrity. The Government should reconsider the strategic objective in order to provide greater clarity. If markets are working well, then consumers will have justified confidence in them."[80]

97. The OFT was also of the view that the strategic objective should not focus on confidence, and suggested the following wording: "making financial markets work well for their users". It thought that this would make it clear

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75 Ibid

76 Ibid

77 HSBC further supplementary written evidence

78 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 1.14

79 FSA supplementary written evidence

80 Independent Commission on Banking, *Final Report*, 12 September 2011, para 8.87

that competition is about achieving better outcomes for consumers and other users, and help ensure that the FCA will regulate in the interests of users and not market incumbents.[81]

98. The Treasury has indicated that it will revisit the FCA's strategic objective to better reflect the commitment to positive consumer outcomes while ensuring that the strategic objective remains sufficiently broad to cover the FCA's functions.[82] The objective of the FCA should not be focused on confidence. It is *justified* confidence in markets, not confidence per se that it important. Too much focus on confidence for its own sake could result in conflicts with the need to increase transparency in the market and protect consumers. The FCA's focus should instead be on making markets work well, which in turn should result in justified confidence in the market.

99. **The FCA's strategic objective should be amended to focus on promoting fair, efficient and transparent financial services markets that work well for users. This would better reflect the Treasury's intended purpose for the FCA, which is to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.**

Efficiency and choice operational objective

100. With a strategic objective that focuses on markets working well, the FCA will need to promote competition, to the extent that it benefits users of financial markets.

101. The ICB recommended replacing the FCA's efficiency and choice operational objective with "promoting effective competition". This would be in addition to the FCA's duty to discharge its general functions in a way that promotes competition.[83] The ICB suggested that as currently drafted competition appeared to play a subordinate role to the strategic and operational objectives of the FCA.

102. The FSA told us that it favoured a similar solution to that recommended by the ICB although it proposed a slightly different wording: "promote effective competition for the benefit of consumers".[84] The words "effective" and "benefit for consumers" are helpful in that they reflect the fact that actions to increase competition per se do not always result in the best outcomes for consumers.

103. **We recommend that the FCA should have a clearer role in promoting competition. To this end the FCA's operational objective of "promoting efficiency and choice" should be replaced by "promoting competition, efficiency and choice for the benefit of consumers". This will give the FCA a clear mandate in the area of competition and a clear responsibility for taking forward some of the ICB's recommendations aimed at making it easier for customers to move between retail banks and compare products.**

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81 OFT written evidence

82 Treasury written evidence

83 Independent Commission on Banking, *Final Report*, 12 September 2011, paras 8.84–8.87

84 FSA supplementary written evidence

104. If the FCA is to have a specific operational objective to promote competition, efficiency and choice for the benefit of consumers, then it is necessary to consider whether it will have appropriate competition powers and whether the right balance is struck between the FCA's competition powers and the OFT's responsibilities. This is considered in the next chapter.

The definition of consumer in the FCA's objectives

105. As part of the consumer protection objective, the draft Bill[85] defines "consumer" in broad terms, covering both retail customers and wholesale and professional investors.

106. A number of witnesses, including the FSA's panels and Consumer Focus were concerned that the FCA's broad definition of consumer does not make sufficient distinction between retail and professional consumers, and this could encourage a "one size fits all" approach to regulation.[86]

107. Several financial firms were also concerned about the broad definition of "consumer". Barclays said: "A more specific and narrower definition of 'consumer' would be helpful."[87] Lloyds Banking Group said the Bill should include reasonable provisions to ensure that regulatory approaches are proportionate to the consumer, nature of the transaction and the product type.[88]

108. Clause 5 of the draft Bill[89] requires the FCA to have regard to:

- the differing degrees of risk involved in different kinds of investment or other transaction;
- the differing degrees of experience and expertise that different consumers may have.

109. Therefore, the FCA is expected to take a differentiated approach across different types of consumer and different contexts. This is particularly important, as it is clear that the right regulatory approach will differ depending on the needs and abilities of different types of consumers. Retail customers are generally less likely to have the same level of financial expertise as professional investors. This will mean, for example, that the way product information is presented to professional investors may not be appropriate for retail customers.

110. Mark Hoban MP argued in favour of retaining a broad definition of "consumer". This was on the grounds that it ensured that the FCA could discharge both its official listing functions, and its general functions to protect those persons who use the services of certain types of service-provider which do not carry on regulated activities but do provide key services to participants in the financial system:

> "For example, as a result of the extension of the definition the FCA may also exercise its functions under that Part (as amended) to require primary information providers, when providing services to issuers of

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85 Clause 5 (new Financial Services and Markets Act clause 1C)

86 Financial Services Consumer Panel written evidence; Consumer Focus written evidence

87 Barclays written evidence

88 Lloyds Banking Group written evidence

89 Clause 5 (new Financial Services and Markets Act clause 1C)

> listed securities, to have in place back-up arrangements to minimise disruption in the event of the technical failure of the systems used to disseminate information to the market."[90]

111. **Given that the draft Bill requires the FCA to tailor its approach to different types of consumer we believe the definition of "consumer" should remain broad and not be restricted to a narrower category.**

Balancing the responsibilities of consumers and firms

112. The FCA's consumer protection objective is the same as that of the FSA: "securing an appropriate degree of protection for consumers".[91] As set out earlier, in considering what degree of protection for consumers may be appropriate, the FCA must have regard to the differing degrees of risk involved in different types of transaction, and the degrees of experience and expertise that different consumers may have. It must also have regard to (amongst other things):

> "(e) the needs that consumers may have for advice and accurate information;
>
> (f) the general principle that consumers should take responsibility for their decisions."[92]

113. The consumer responsibility principle is also repeated under the regulatory principles[93] to be applied by both regulators, and which also include principles covering regulatory efficiency, proportionality and transparency.

114. Consumer groups objected to the consumer responsibility principle on the basis that not enough responsibility is placed on firms to ensure their products are "appropriate for the consumer in terms of meeting their needs, accessibility and reasonable value for money".[94] They fear that firms will continue "providing reams of documents for each product as a means of discharging disclosure requirements, in the hope that thereafter responsibility is transferred to consumers, as they 'should have read' these documents".[95]

115. Consumer understanding and financial literacy is also a problem. According to Consumer Focus, 5.2 million UK adults lack basic financial literacy, and some standard text accompanying loans requires PhD level education to understand. [96]

116. Professor Niamh Moloney of the LSE expressed the need for caution in applying the concept of consumer responsibility in the current environment:

> "A combination of very limited investor ability to decode complex and detailed disclosures and to assess conflict of interest risk, largely unrestricted product development and duplication, and significant conflict of interest risk in the structure of the commission-based distribution sector, make the investor vulnerable to mis-selling.

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90 Letter from the Financial Secretary to the Treasury to Peter Lilley MP, 3 October 2011

91 Clause 5 (new Financial Services and Markets Act clause 1C)

92 Ibid

93 Clause 5 (new Financial Services and Markets Act clause 3B)

94 Consumer Focus written evidence

95 Ibid

96 Ibid

> In this environment, and combined with the state's withdrawal from welfare provision, the notion of consumers being able 'to take responsibility for their decisions' (Bill, clause 3B(c)) must be treated as a very limited concept. The state owes households very significant responsibility to ensure that their 'decisions' are made in an environment in which significant efforts are made by the regulator to make the investment environment as free of structural failures as possible. Much remains to be done on this front."[97]

117. As a solution, the Financial Services Consumer Panel suggested the consumer responsibility objective should be balanced by giving firms an explicit fiduciary duty towards their clients. The Consumer Panel said that:

> "A fiduciary is someone who has undertaken to act for and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. Fiduciary duty implies a stricter standard of behaviour than the comparable duty of care at common law. The fiduciary has a duty not to be in a situation where personal interests and fiduciary duty conflict, a duty not to be in a situation where his fiduciary duty conflicts with another fiduciary duty, and a duty not to profit from his fiduciary position without express knowledge and consent. A fiduciary cannot have a conflict of interest."[98]

118. However, some firms did not think that a fiduciary duty on firms would be appropriate, particularly given the broad definition of "consumer" that encompasses both retail and wholesale consumers. For example, Lloyds said of a fiduciary duty that:

> "Given the broad definition of consumer in the Bill, its inclusion in an overarching statement could have unsuitable impacts on for example counterparty interactions, removing responsibility for counterparties of equal knowledge or status for their own decisions and actions."[99]

119. The FSA said that it supported a principle on the responsibility of firms:

> "... we would welcome a general principle that a regulated firm should act 'honestly, fairly and professionally' in accordance with the best interests of its consumer when carrying on regulated activities".[100]

120. Consumer Focus, Which? and Citizens Advice suggested deleting the current consumer responsibility principle. They argued that if it is "considered essential that the FCA must have regard to the behaviour of consumers when it is pursuing its consumer protection objective" then the FCA's duty to have regard to the needs that consumers have for advice and accurate information and the duty to have regard to the consumer responsibility principle should be replaced with:

> "(e) the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented;
>
> (f) the general principle that consumers are responsible for acting reasonably in their dealings with financial services providers and their intermediaries;

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97 Professor Niamh Moloney written evidence

98 Financial Services Consumer Panel written evidence

99 Lloyds Banking Group written evidence

100 FSA further supplementary written evidence

> (g) the general principle that firms will ensure, so far as is reasonable, the appropriateness of each product to the needs of the consumer."[101]

121. When asked if the consumer responsibility principle should be balanced by one for firms, Mark Hoban MP highlighted the principle in the draft Bill that senior management have responsibilities in relation to compliance with requirements imposed by or under the Financial Services and Markets Act.[102] When asked if firms have a duty to go beyond their technical legal responsibilities, Mark Hoban MP said: "It is in the interests of firms to ensure that consumers do understand the products that they are buying because it then minimises the risk of problems further down the track."[103] However, previous cases of mis-selling on a large scale—such as payment protection insurance, personal pension plans and mortgage endowment policies—indicate that it has not always been in firms' interests to ensure that consumers fully understand what they are buying.

122. We are especially concerned about problems caused by conflicts of interest, where the interests of a firm or adviser are not aligned with the best interests of its customers. An example is where an adviser receives commission from a product provider for recommending a particular product, regardless of whether it is suitable let alone the best product for a customer's needs. This is an area which the FSA has recognised as a problem and taken action: the FSA's Retail Distribution Review concluded that advisers who offer independent advice must do so free from any restrictions or biases, such as being paid by commission.[104]

123. We agree with Mark Hoban MP that financial capability needs to be improved[105], but financial education is a long-term process, and we are unlikely to see improvements in the short-term.

124. In connection with the consumer responsibility principle, Mark Hoban MP also said that:

> "... we are very keen—and in the operational objective it refers to 'appropriate' consumer protection—to make sure that this is a differentiated regime and that different consumers are dealt with in different ways. The needs of a consumer buying a pension policy are very different perhaps from the needs of a consumer buying a car insurance policy. We need to make sure that those steps are in place to give consumers proper protection. That does mean, and it is set out in the Bill, thinking about these areas of how much consumer knowledge it is reasonable to expect, how complex a product is and things like that. The Bill does get the balance right, but it is an area that I continue to focus on."[106]

125. We agree that the FCA will need to take a differentiated approach, as is currently reflected in the requirement for it to have regard to differing degrees of risk involved in different kinds of investment and transactions, and differing degrees of experience and expertise that different consumers may

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[101] Citizens Advice, Consumer Focus and Which? written evidence

[102] Clause 5 (new Financial Services and Markets Act section 3B (1)(d)); QQ 1063–1064

[103] Q 1071

[104] See http://www.fsa.gov.uk/Pages/About/What/rdr/charging/index.shtml for more details

[105] Q 1071

[106] Q 1072

have. However, we are not convinced that this is sufficient to reflect the fact that in some cases, where products are very complex, and consumer understanding very limited, it will not be reasonable to expect consumers to take on a significant degree of responsibility for decisions without a corresponding responsibility on firms to ensure that products are appropriate and consumers understand enough to make well-informed choices.

126. **We recommend that the consumer responsibility principle be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers. The FCA should be empowered to hold firms to account for this and ensure companies address conflicts of interest and the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented.**

127. This is important because provision of information alone will not significantly improve consumers' ability to make well-informed decisions. The information needs to be easily understandable and accessible.

128. **Clearly, the actions firms should be expected to take will depend on context and circumstances. For example, the way information is presented to retail consumers is likely to be different from that appropriate for a professional investor.**

CHAPTER 4: RESPONSIBILITIES AND POWERS

129. It is important to ensure that each body will have the necessary powers and duties to fulfil its objectives.

Responsibilities and powers during a crisis

130. The draft Bill reforms the respective roles of the Bank and the Treasury at times of crisis. The FPC will have a role in promoting stability to avoid crises, the PRA will have a role in anticipating any crisis by adequately preparing the resolvability of firms but once a crisis occurs the decisions will be made between the Governor and the Chancellor. The June White Paper described the roles of the different authorities in a financial crisis:

> "The Bank of England will be responsible for identifying potential crises, developing contingency plans, and implementing them where necessary, including through the special resolution regime. The Chancellor of the Exchequer will be responsible for all decisions in a crisis involving public funds or liabilities."[107]

131. This is reflected in the draft Bill which states that:

> "(1) Where it appears to the Bank of England—
>
> (a) that there is a material risk of circumstances within any of the following cases arising,[108] or
>
> (b) that such circumstances have arisen but no previous notification under this section has been given,
>
> (2) the Bank must immediately notify the Treasury."[109]

132. Clause 43 requires a Memorandum of Understanding (MoU) between the Treasury, the Bank of England and the PRA as to how they intend to co-ordinate the discharge of their functions in a financial crisis. A draft of the MoU was initially promised to aid pre-legislative scrutiny but publication has been postponed until after our deadline to report.

133. A key part of the MoU will define "material risk" of circumstances arising that could reasonably be expected to lead to the use of public funds. It will also explain how the Bank will notify the Treasury, what information the notification will contain, arrangements for keeping the Chancellor abreast of developments and the process of developing options to manage any risk to public funds.[110]

134. The House of Commons Treasury Committee recommended that material risk be defined in the draft Bill: "Definition is crucial—it determines what notice the Treasury will receive and therefore how much time it will have to prepare for a crisis and consider alternative causes of action."[111] That Committee was also concerned that material risk may become apparent too

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[107] HM Treasury, A new approach to financial regulation: the blueprint for reform, par 2.42

[108] The cases referred to are specified later in the clause and include when the Secretary of State might reasonably be expected to regard it as appropriate to provide financial assistance to a financial institution.

[109] Clause 42

[110] Treasury supplementary written evidence

[111] House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 165.

late. It recommended that the draft Bill "also require the Bank to give the Chancellor an early warning of the possibility that a notification of a material risk to public funds may need to be given, and full information about the circumstances".[112]

135. We are concerned that there is no duty for the authorities to co-ordinate in a crisis explicitly stated in the draft Bill. There is a requirement simply for an MoU. In other words, a duty to co-ordinate the exercise of functions in a crisis is imposed by requiring an MoU rather than by a duty in primary legislation.

136. We also share the Treasury Committee's concern about how much is being left to an MoU which will not be subject to parliamentary approval. The definition of material risk should be provided in a document of a legislative nature, subject to scrutiny by Parliament. The definition will determine whether or not an early warning system, as proposed by the Treasury Select Committee, is needed. If the bar is set sufficiently low for the material risk trigger no such early warning system would be needed.

137. The fact that the MoU may be revised from time to time is also of concern. There would be nothing to place any constraint on how it could be revised should it prove inconvenient. Those liable to be affected by it could therefore never be sure that it would be applied in the form in which it has been previously published.

138. Although it is intended that the MoU will define material risk it is not clear that the Treasury's view of what is a material risk is relevant: the duty in clause 42(1) is triggered simply by the Bank considering that there is a material risk.

139. Our final concern is that the draft Bill suggests there may be circumstances when a material risk has arisen but the Treasury is not notified (see sub-section (b) of clause 42).

140. **The powers and responsibilities of the Bank of England and the Treasury during a crisis are key. They should be carefully reviewed in light of the concerns we have raised. A duty for these bodies to co-ordinate in a crisis should be on the face of the Bill. The definition of the term "material risk" should be subject to parliamentary approval and not left to a Memorandum of Understanding. The Bill should also make it clear that there are no circumstances where it is permissible for the Bank not to notify the Treasury as soon as material risk to public funds becomes clear.**

141. In addition to its recommendations on material risk the House of Commons Treasury Committee recommended that the Chancellor should have statutory responsibility for a crisis after the formal notification of a material risk to public funds and that notification would automatically trigger a "discrete power for the Chancellor to direct the Bank". The Chancellor would be able to choose to use this power at any point after receiving an early warning of material risk to public funds.[113]

142. It is sensible that the Chancellor should have the power to direct the Bank at times of crisis. The Chancellor is ultimately accountable for the handling of a

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[112] Ibid, para 166

[113] Ibid, para 166

crisis and he should have powers commensurate with that accountability. The Bank of England Act 1946 does already provide such a power stating that the Treasury "may from time to time give such directions to the Bank as, after consultation with the Governor of the Bank, they think necessary in the public interest".[114] No Chancellor has ever used this power because of the effect it would have on confidence in the financial system. Alistair Darling was tempted to use the power in 2007 but decided that "a public row between myself and Mervyn would have been disastrous".[115] An automatic trigger of a power to direct the Bank might lessen the risk that using the power would provoke a crisis of confidence.

143. **The Bill should be amended so as automatically to give the Chancellor power to direct the Bank after a formal warning of a material risk to public funds. At this stage ultimate responsibility rests with the Chancellor.**

Powers and duties of the FPC

144. In pursuit of its objective the FPC will need specific powers to identify, monitor, and take action to remove or reduce, systemic risks.

Powers to identify and monitor systemic risks

145. The FPC has a duty to police the PRA's regulatory perimeter and make recommendations to the Treasury if changes are needed. The draft Bill gives the Bank of England—and by extension the FPC—the power to require that the PRA or FCA provide it with information that the two bodies hold or are empowered to demand from the firms they regulate.[116] However, the Bank wants to be able to collect information directly from firms outside the regulatory perimeter. Sir Mervyn King explained:

> "Under the proposals as they stand ... the FPC's ability to obtain information relies on the extent of regulators' own powers. These are relatively extensive in relation to UK-regulated firms. But the FPC's objectives and responsibilities are wider. In particular, the FPC has to make recommendations to the Treasury about the regulatory perimeter and for that it must be able to obtain information from those over whom the PRA and the FCA may have no authority. Put another way, the PRA has authority over banks, but the FPC needs the ability to find out about shadow banks."[117]

146. The PRA does have some powers to gather information from firms outside the regulatory perimeter. A 2010 amendment to the Financial Services and Markets Act gives the FSA,[118] (and by virtue of the draft Bill the PRA) the power to demand specific information to a specified timetable from certain classes of people outside the regulatory perimeter. These include anyone involved in running an "investment fund" as long as the information might be "relevant to the stability of one or more aspects of the UK financial

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114 Bank of England Act 1946, Clause 4

115 *Back from the Brink: 1000 days at No 11*, Alistair Darling, Atlantic Books, 2011, pg 57–58

116 Clause 3 (new Bank of England Act 1998 clause 9U)

117 Bank of England further supplementary written evidence

118 Financial Services and Markets Act, Section 165A

system".[119] But in addition the Treasury may by order extend the category as widely as it chooses—if the Treasury is convinced that the activities the information concerns meet the stricter test that they "pose, or would be likely to pose, a serious threat to the stability of the UK financial system". [120]

147. Sir Mervyn King proposed an amendment that would give the FPC a wider power to collect information from outside of the regulatory perimeter (the drafting of the amendment would also enable it to collect information from within the regulatory perimeter).[121] He proposed that the FPC should have a power to gather information from any "person where the Bank considers that the activities carried on by that person, or the way in which those activities (or any part of them) are carried on, are or might be relevant to one or more aspects of the UK financial system".[122] The FPC would therefore not only have the power to gather information from more or less any person, unlike the restricted categories set for the PRA, but would also be able to do so without meeting any test of the activities presenting a "serious threat" to financial stability. Safeguards are important—a wide power to collect information from an unspecified group of unregulated businesses could be considered draconian.

148. **We are sympathetic to the need for the FPC to have powers to collect information from those outside the regulatory perimeter. In fact the FPC will normally be able to obtain the information it needs through the PRA but sometimes this might cause delay. The FPC should be given a reserve power if it thinks that requesting the information indirectly through the PRA could cause delay or have adverse consequences.**

Powers needed to remove or reduce systemic risks

149. In pursuing macro-prudential policy the FPC will have the following levers:

(i) public pronouncements and warnings to raise awareness of issues which may lead to market-led solutions;

(ii) influencing macro-prudential policy in Europe and internationally;

(iii) making recommendations to bodies other than the PRA and the FCA, including about the regulatory perimeter to the Treasury;

(iv) a broad power to make recommendations about anything it believes relevant for financial stability to the PRA and FCA. This will be supported by a statutory requirement for the PRA and FCA to either comply with the recommendation as soon as practicable or explain in writing to the FPC why it has not done so; and

(v) the power to direct the two regulators where explicitly provided for in secondary legislation subject to Parliamentary approval.[123]

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[119] Financial Services and Markets Act, Section 165C (1)

[120] Financial Services and Markets Act, Section 165A

[121] Bank of England further supplementary written evidence

[122] Ibid

[123] HM Treasury, A new approach to financial regulation: building a stronger system, February 2011, pg 23

150. The macro-prudential tools are not specified in the draft Bill. They will be granted via secondary legislation.

151. Under the ICB proposals retail banking would be ring-fenced from riskier investment banking activities. The ICB report stated:

> "A ring-fence of this kind would also have the benefit that ring-fenced banks would be more straightforward than some existing banking structures and thus easier to manage, monitor and regulate. Further, macro-prudential regulation could be more precisely targeted on ring-fenced banks than on existing banking structures."[124]

152. Some macro-prudential tools will involve adjusting capital ratios which the ICB proposes to increase sharply above internationally agreed Basel III ratios. The ICB has recommended that large retail banks should hold equity capital of at least 10% of risk-weighted assets, compared to 7% in Basel III. Furthermore, a leverage ratio—which makes no adjustment to assets for risk—should be at least 3% for all banks.[125]

153. Under Basel III the 7% equity capital ratio has two components: 4.5% is the absolute hard minimum plus an additional 2.5% which is the capital conservation buffer. If a bank holds capital of between 4.5% and 7% supervisors will restrict dividends and bonuses to preserve capital.[126] As most bankers do not want anyone meddling with bonuses and dividends it is expected that in normal times they will want to keep equity capital above 7%. But if equity capital falls below 4.5%—the hard minimum requirement—this "would make a bank non-viable", according to the ICB, which risks the bank being put into resolution. The Commission's final report explained:

> "If a bank is put into resolution, losses fall first on equity; after the equity is wiped out further losses fall on loss-absorbing debt including non-equity capital. The resolution authorities may write down or convert loss-absorbing debt sufficiently to 'create' new equity, so the bank is re-capitalised. They will also have other options (which will include putting the bank into an insolvency process)."[127]

154. The effectiveness of capital adequacy requirements has been questioned. For example, capital adequacy requirements may not constrain credit expansion during an upswing as banks will find it relatively easy to acquire additional capital and therefore would not prevent lending excesses and asset price bubbles of the type seen before the 2007 financial crisis. This underlines the importance of ensuring the FPC has access to a wide range of tools and sufficient expertise to make informed judgements about the appropriate tools to use (see para 325). It will be correspondingly important to give Parliament a proper chance to scrutinise the instruments that grant the FPC macroprudential tools (see para 315) and to undertake detailed pre-legislative scrutiny of the legislation that will be brought forward to enact the ICB recommendations (see para 8).

Power of direction

155. The FPC will have a broad power to make recommendations about anything it believes relevant for financial stability to the PRA and FCA. The PRA and

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[124] Independent Commission on Banking, Final Report, September 2011, pg 35

[125] Ibid, pg 30 & 93

[126] Ibid, pg 87

[127] Ibid

FCA have either to comply with the recommendation or publicly explain why they will not.

156. For a narrower range of pre-specified macro-prudential tools the FPC will have the stronger power to direct the PRA and FCA to implement them. The PRA and FCA must comply with these directions. But the exact timing and means of compliance is up to the PRA and FCA. The FPC can only recommend, not order, the timing and means. For example, one possibility is that the FPC could have the power to direct the PRA to raise banks' capital ratios to a minimum of X%, recommending this be done within three months. The PRA would have to increase capital ratios to X% but may choose to do this over six months, not the recommended three, as long as they explain why.

157. The Bank believes a stronger power of direction would be better. Sir Mervyn King said:

> "I think this a missed opportunity. It was the intention of the new framework that the FPC should be able to impose requirements on systemic stability grounds, and for this purpose it is very difficult, in my view, to justify limiting its power to specify timing and means. On many occasions the precise implementation of FPC directions can be left to the micro-prudential supervisor. But in other cases a key element of the FPC's policy position will be about when or how a particular tool is to be used and, in some areas, there is likely to be a premium on pre-emptive, targeted and well-timed action."[128]

158. Sir Mervyn suggested an amendment to allow the FPC to "require or recommend its provisions to be implemented by specified means or within a specified period".[129]

159. The Financial Services Authority supported this amendment:

> "The FSA is supportive of the concept, as laid out by the Bank of England, that the FPC can direct the PRA or the FCA both as to means and timing. However, it is important that this is restricted to the powers to direct rather than recommend. We would, accordingly, support the Bank of England's suggested amendment."[130]

160. Related to this is the issue that the PRA or FCA may have to make a new rule in order to implement a macro-prudential tool. Like the FSA, the PRA and FCA will normally be expected to publish cost-benefit analyses of draft new rules and hold consultations before implementing them. In these circumstances the regulators would need flexibility on timing in order to consult. The draft Bill allows for the Treasury to "exclude or modify any procedural requirement that would otherwise apply under FSMA 2000"[131] including consultation. The requirements would be disapplied in the Order granting the FPC the power to direct over a certain macro-prudential tool. It is important that this should happen no more often than absolutely necessary.

161. **Where the FPC is to be given the power to direct the PRA and FCA to implement a macro-prudential tool it should also be given the power**

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[128] Bank of England further supplementary written evidence

[129] Bank of England further supplementary written evidence

[130] FSA further supplementary written evidence

[131] Clause 3 (new Bank of England Act 1998 clause 9H)

to direct the regulators as to the timing and means of implementing that tool. The FPC should use this power where the timing and means of implementation are likely to have a significant impact on the effectiveness of the tool. If these circumstances do not exist the decisions about timing and means are better left to the regulators—the PRA and FCA—who hold the expert knowledge.

Power for the FPC to set UK macro-prudential rules

162. The European Commission's proposals for Capital Requirements Directive IV are intended to implement the Basel III accord: a set of minimum capital requirements drawn up by a committee of central banks from major economies around the world. Basel III does not restrict a country's ability to impose higher capital requirements than the minima specified. The Treasury and Bank of England are concerned that the current draft of the Directive contains important differences from Basel III that would restrict how much the UK could raise capital requirements over and above the new 7% ratio of equity capital to assets.[132] They fear it may prevent Britain imposing a 10% minimum on large British retail banks, which has been recommended by the ICB or limit the scope for implementing countercyclical capital requirements.

163. In May, Sir Mervyn King said:

> "Under the current proposed Capital Requirements Regulation maximum harmonisation would not only limit the countercyclical buffers that could be imposed, but would also limit the number of instruments at the ESRB's disposal. In certain situations such a toolkit could be too weak or too restricted to prevent a build-up of excessive risk and leverage. It would be peculiar if one European body inadvertently prevented another from carrying out its remit."[133]

164. Andrea Enria told us that since May, the draft directive has been amended to remove ceilings on the capital requirements member states can impose:

> "I agree with him [Sir Mervyn King] that having a ceiling on the possibility of raising the counter-cyclical buffers, as he mentioned, would have been a mistake, and I am glad that the Commission removed this from the proposal that they put on the table at the end of July."[134]

165. Andrea Enria added that the directive now provided enough flexibility for the UK to introduce the higher capital requirements recommended by the Independent Commission on Banking. However, he went on to say:

> "My point of view is that whenever you have requirements to go higher than the European level, which are bound to create a sort of redistribution of capital liquidity or whatever else in a group [cross-border bank], there needs to be scrutiny to make sure this does not

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[132] The 7% figure comes from adding the 4.5% absolute minimum and 2.5% capital conservation buffer. A bank has to hold 4.5% at all times. If a bank doesn't hold the additional 2.5% capital conservation buffer there will be restrictions on bonuses and dividends. No banker would want such restrictions, which makes the 7% figure almost mandatory.

[133] Hearing on the European Systemic Risk Board before the Committee on Economic and Monetary Affairs of the European Parliament, Introductory Statement by Mervyn King, 1st Vice Chair of the ESRB, Brussels, 02 May 2011.

[134] Q 66

> jeopardise the single market, that it does not de facto create barriers for business across borders and does not jeopardise or hamper the integration of the financial market in Europe. There needs to be an element of scrutiny, but the flexibility is there."[135]

166. We believe that Andrea Enria's claim that the regulation will allow the UK flexibility to implement the ICB's recommended capital requirements is contradicted by his admission that it will be subject to EU scrutiny. Asked if he meant that any increase in UK capital requirements would need clearance at a European level Andrea Enria appeared to say 'yes'—despite not liking the word 'clearance':

> "'Clearance' is perhaps a strong word. There needs to be a process through which these are discussed at European tables, co-ordinated with other authorities, and, yes, also subject to some sort of review."[136]

167. Despite the July amendments to the directive, Sir Mervyn King remains concerned. In November he told us:

> "The Commission's current proposals still want to impose maximum harmonisation. I am completely baffled as to why they want to do it ... The Commission takes the view that some of the things we want to achieve by implementation of the proposals of the Vickers Commission, or macro-prudential regulation through the Financial Policy Committee of the Bank, could be done through what is known as Pillar 2 of the capital requirement. Again, that seems rather bizarre to us, because it is clear from the legal basis of Pillar 2 that this is for individual institutions, but clearly that is not macro-prudential. Macro-prudential is something that applies to all banks, and that is naturally Pillar 1. I cannot see any reason why anyone should object to a country using Pillar 1 to have higher capital requirements."[137]

168. Sir Mervyn King also disputed Andrea Enria's concerns about capital redistribution if one country unilaterally increases its capital requirements:

> "That is false. There is no fixed lump of capital allocated across a particular group. If supervisors say that more capital is required, the bank can obtain it. I don't think that holds any water at all. To take the example of HSBC in this country ... for quite a long time it has had a high capital ratio, often higher than many of its competitors. No one has argued that somehow it is unfair and wrong for HSBC to have a higher capital ratio and therefore it is attracting business because it looks a more sound or strong bank. That is what we want banks to do. It is very peculiar that this argument should be used ..."[138]

We concur with this analysis and find Mr Enria's justification for setting an upper limit on capital requirements unconvincing.

169. Asked how confident he was, on a scale of one to ten, that the European consultations would deliver British authorities the flexibility they need, Lord Turner answered:

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[135] Q 80

[136] Q 81

[137] Q 769

[138] Q 774

> "Five. We made a clear point of view that, in principle, there should not be maximum harmonisation. There should be harmonisation of minimum standards with national regulators able to go above. What we have is a set of complex flexibilities achieved through pillar 2. We have continued to argue this case that this is not the appropriate way. The Government are continuing to do it."[139]

170. The Chancellor told us:

> "We are reasonably confident that the directive will give us the scope to run the kind of regime that is appropriate for a very large wholesale financial centre, which other EU member states do not have. But it is a fight we will be having over this winter."[140]

171. The current draft of the Capital Requirements Directive IV appears to allow member state authorities to take into account "structural variables and the exposure of the banking sector to any other risk factors related to risks to financial stability".[141]

172. **We welcome the language in the proposed Capital Requirements Directive IV that appears to allow member state authorities to take into account "structural variables and the exposure of the banking sector to any other risk factors related to risks to financial stability". Nevertheless, the Government must continue to push for the removal of all restrictions on the ability of member states to raise their capital requirements above internationally agreed minima. Such freedom to impose higher capital requirements is essential given the large size of Britain's banking sector relative to its economy.**

173. There is also an essential need to be able to run capital down in a crisis. Simply raising capital requirements without allowing capital to be used as a loss absorbing buffer, often results in contraction of assets and a reduction in credit. Stuart Gulliver explained:

> "What you would be looking for is counter-cyclical measures, so the FPC would probably be recommending to the PRA that banks run down their capital buffers at this time ... you don't even get to the point of deciding, "Is it okay to lend and will this person repay me?" if your capital ratios keep going higher and higher, because in essence you are de-leveraging your banking system."[142]

174. This is equally a problem for insurance companies under the new European Solvency II regime as it is for banks.

175. **The FPC and the PRA should consider carefully what actions they will take with regard to capitalisation and liquidity requirements in the event of another crisis and must consider to what extent they are currently constrained by European regulation and how far this represents a threat to the UK's ability to respond to any financial crisis. Where they assess that they are constrained by European regulation they should report this to the Treasury and to the**

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139 Q 933

140 Q 1040

141 Capital Requirements Directive IV, recital 58.

142 Q 700

committee that we recommend at para 305 as being responsible for co-ordinating international representation on these type of issues.

Powers and responsibilities of the PRA

Powers in respect of firms headquartered outside the UK

176. Many of the firms which the PRA will regulate will be headquartered outside the UK. The PRA's supervisory approach will be based on the principle that all banks, both UK and overseas, operating in the UK "should be subject to the same prudential requirements. The PRA's focus will be on the impact which a firm's failure might have on the stability of the UK financial system, regardless of the location of its ultimate parent and legal form."[143]

177. The PRA's powers over international banks will be determined by the legal form which a bank takes in the UK:

- Subsidiaries of overseas banks—the PRA's prudential powers will be the same as for a UK headquartered bank. The PRA will need to assess the UK firm's links with its parent company and the viability of the group as a whole, so supervision of overseas activities will be relevant. The PRA would expect to be on the college of regulators of the parent firm. International firms that carry out investment banking business in the UK will be particularly hard for the PRA to regulate. It may be difficult to ensure orderly resolvability of the subsidiaries of international investment banks given the interconnectedness of their business with their operation elsewhere. The PRA will have to work with the supervisory college to maximise cross-border co-ordination.

- Branches of overseas banks—EEA headquartered banks have the right to passport branches into the UK. During the crisis, EU law provided inadequate safeguards for EEA host state authorities to ensure that the branch operations of EEA banks were complying with EU prudential regulatory requirements. This was a particular problem for UK authorities in overseeing the UK branch operations of Icelandic banks where the Icelandic authorities had failed to ensure they were complying with EU capital and liquidity requirements. We therefore welcome the proposal within CRD IV that affords host state supervisory authorities with significant oversight powers to require all EEA branches to report to them periodically on their activities in the host member states and to demonstrate that their UK branch operations comply with EU prudential regulatory standards. However, EU bank insolvency law remains firmly anchored to the principle of home country control, which makes it impossible to resolve an EEA branch in the UK separately from the rest of the firm.

178. The PRA's powers to supervise the UK operations of EEA branches are therefore limited but will be strengthened under proposals contained in CRD IV. In 2010 it was calculated that these branches held around £2 trillion of assets in the UK. The PRA will "seek to influence, through collaboration and in a supportive manner, the supervisory approach of the home state at group level". It will "wherever possible" obtain evidence that home regulators have

[143] Bank of England & FSA (2011) *The Bank of England, Prudential Regulation Authority—Our approach to banking supervision*, Box 4, Page 16

sound resolution plans.[144] **For all major banks with significant branches in the UK the PRA should be on the college of supervisors for that bank.**

179. In reality the PRA's main power will be to make public its limited role in regulating these firms and to work with the FCA to ensure that consumers understand that deposits in passported banks are not covered by the Financial Services Compensation Scheme. The PRA has said that where it does not have much information "it will make that understood publicly so that there is no misunderstanding about what it can do and so that it is clear to depositors that they are not protected by the home state regime".[145]

180. **Even though the PRA may under CRD IV gain limited powers to oversee the UK operations of EEA firms these will remain ultimately the responsibility of their home state regulator. The PRA and the FCA should seek to ensure that the public understand when a banking group is not subject to UK prudential regulation. Where deposits are not covered by the Financial Services Compensation Scheme the regulators should require banks to make this clear with prominent warnings in branches and on websites. The regulators should work with consumer groups to plan how best to get this message heard and understood.**

181. There is a further way that the PRA's powers will be limited in respect of firms operating in the UK and the EEA. The Bank of England and FSA state that the establishment of the new European Supervisory Authorities and the European Banking Authority "provides an opportunity for the PRA to influence further the supervision of incoming EEA branches".[146] This is true and in para 305 we set out how we hope the UK regulators will maximise their influence at a European level. However, the European Supervisory Authorities will also have powers to direct the PRA (and the FCA) to act in certain circumstances. For example, the European Supervisory Authorities will be able to direct the PRA and the FCA if there is a disagreement between two of the EEA regulators in respect of a firm operating in both their countries. So for example if the UK and German regulators disagreed about the requirement that should apply to a bank headquartered in Germany but passported here, or a bank headquartered here but passported in Germany, then either the UK regulator or the German regulator could refer the issue to the European Banking Authority for mediation. The European Banking Authority would then have discretion to mediate and in some circumstances to issue a binding decision on the national regulators. There are different interpretations as to when the EBA could issue a binding decision.

182. **The PRA will be under a duty to co-ordinate with international regulators.[147] This is an immensely important duty given the international dimension of many of the firms whose failure could impact on the stability of the UK financial system. In order that the PRA can be effectively held to account for its duty to co-ordinate with**

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144 Ibid, pg 16

145 Ibid

146 Ibid

147 New Financial Services and Markets Act clause 354B,

international regulators we recommend a further duty to report on its work in this area.

The impact of ICB recommendations on the PRA's responsibilities

183. It is hoped that the PRA's approach of enabling orderly firm-failure will be aided by the ICB's recommendations on ring-fencing the retail operations of banks. The Banking Act 2009 provided a resolution regime for UK deposit-taking banks/building societies along with an enhanced financial compensation scheme. This addressed the Northern Rock problem where a medium-sized—mainly deposit-taking—bank failed and the UK authorities (rather than rely on an inadequate insolvency law regime) guaranteed all of Northern Rock's deposits and later nationalised it. However, after the Banking Act 2009 was adopted, Andrew Bailey, Deputy Chief Executive-designate of the PRA, stated that the Act still could not handle the failure or resolution of a too-big-to-fail universal UK bank.[148] The Banking Act 2009 worked well with Bradford and Bingley and Dunfermline Building Society; but it was recognised as being inadequate to handle the resolution of Barclays, Lloyds or RBS etc.

184. In order to avoid a 'no-failure' regime for too-big-to-fail universal banks, the ICB proposes to regulate the structure of the universal banks with ring-fencing and an enhanced regulatory capital charge. Ideally, the PRA would apply the ICB recommendations so that the Banking Act's 2009 resolution regime could be applied to allow an insolvent too-big-to-fail universal bank to fail without imposing a direct cost on taxpayers. We think that ring-fencing retail banking is a necessary step but whether it will be sufficient to address the too-big-to-fail issue remains to be seen. If it does not prove sufficient then the Bank of England will still need to be ready to step in and support banks as Lender of Last Resort in order to protect the stability of the financial system.

185. The ICB recommended that the ring fencing proposals should be put in place soon but it recognised that its recommendations on additional capital requirements would take longer to prepare for and therefore suggested that they should be implemented no slower than Basel III (so no later than 2019). HSBC said that meeting the ICB's capital requirements across the group, not just in the UK, would require the issuance of bonds to finance the purchase of gilts which could lead to an estimated annual carrying cost of US$2.1 billion after tax.[149] The Treasury has now confirmed that this draft Bill will not be the vehicle for those changes. **The ICB recommendations are key to the work of the regulators established by the draft Financial Services Bill. For example, without the ICB reforms it will be harder for the PRA to meet its objective of minimising the impact of firm failure. The legislation enacting the ICB recommendations on ring-fencing should be introduced into parliament during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented speedily. By contrast there is a good case for allowing banks to build up capital over time. Furthermore, the Government should think carefully about imposing on banks**

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148 Andrew Bailey, the Financial Crisis Reform Agenda, speech at the Annual International Banking Conference, 13 July 2010.

149 Q 761

headquartered in the UK capital requirements relating to their overseas subsidiaries over and above that agreed by the international college of regulators monitoring those banks.

186. Once in place, the ICB's recommendations on ring-fencing the retail operations of banks will place considerable additional responsibilities on the PRA which will have to supervise the ring fence. How this will work will be a matter for separate legislation but it is worth flagging-up a concern Sir Mervyn King raised about whether that legislation will give the PRA a role in defining the ring fence:

> "Our strong view is that as far as possible this should be done in legislation and not left to the regulator. I say that because the difficulty that will arise with this approach is that the banks and their lawyers will have enormous amounts of money, time and resources to come up with all kinds of clever ways to try to get round the rules set out in legislation. Unless those rules are pretty clear the regulator will be chasing the banks round in a circle and will come under enormous pressure."[150]

> "As little as possible should be left to the regulator. They will already have an enormous job in making judgments about the riskiness of the balance sheets of banks. I would rather the efforts and resources of the PRA be devoted to judging the risks which banks are taking on their balance sheets than a perpetual legal game of trying to define the ring fence."[151]

187. **It should be for Parliament to define the ring-fence for retail banking. The definition may need adjusting from time to time and therefore should not be enshrined in primary legislation. Instead it should be set out in secondary legislation so it can be more easily reviewed and adjusted. It should not be left to the Bank or the regulators to define the ring-fence.**

Empowering the PRA to conduct judgement-led supervision

188. The Treasury intends that the approach of the two new regulatory bodies will be "judgement-led". The Chancellor sees this as one of the key objectives of the reforms:

> "If I was to point to one principle behind the entire change we are making, it is that we would wish to emphasise more than was the case in the past the role of judgment on what is going to keep our system safe, competitive and prosperous."[152]

189. Although ministers and regulators have been very vocal about the importance of the new judgement-led approach, the term is not referred to or defined in the legislation and no specific powers are given.

190. Hector Sants offered a helpful explanation of judgement-led supervision:

> "All regulation has an element of judgment. The question is the degree to which that judgment is based on hard, observable facts as opposed to

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[150] Q 761

[151] Q 762

[152] Q 1009

> the degree to which it is based on a view as to what might happen in the future.
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> The central proposition is in relation to the way the FSA was working pre the crisis. For the record, we are now working in an entirely different way ... Pre the crisis, the FSA was only intervening on observable facts: i.e. after the fact. The premise of the new approach is to say, "If we think something might go wrong in the future, even if the bank or the institution has a different view to us, then we would intervene to put in mitigants, capital or liquidity or to dissuade them from taking that action." Forward-looking is the key phrase, rather than judgment."[153]

191. The FSA already has, and exercises, powers that allow it to place different requirements on different firms depending on an assessment of the risks they pose. For example, the FSA can vary the permission a particular firm has to carry on a regulated activity. This power can be used to limit the activities the firm carries on or to require a firm to do, or not to do, a particular thing. So if the FSA told a particular firm to hold a certain level of capital and that firm did not comply, then the FSA has the power to remove or restrict the firm's permission or require it to comply on the basis of an assessment of risk. The key difference is that the PRA and FCA will be expected to use these powers in a more forward looking way.

192. The Bank of England is concerned that the Financial Services and Markets Act framework will constrain judgement-led supervision. When we visited the Bank on 21 November (see Appendix 5) Sir Mervyn King told us that the Act was designed to be a piece of compliance regulation and that it will be a real challenge to amend it to become a piece of legislation which promotes judgement-led supervision.

193. Paul Tucker, Deputy Governor (Financial Stability) of the Bank of England, suggested introducing a duty on the PRA to supervise. This would be different from the FSMA duty to ensure compliance with the rule book. Schedule 1ZB of the draft Bill places a duty on the PRA to maintain arrangements designed to enable it to determine whether persons it regulates are complying with relevant requirements. The Bank would like to see this amended to place a duty on the PRA to maintain arrangements that allow it to supervise firms. Paul Tucker suggested this would be key to empowering the Bank to make judgement based decisions. In para 78 we recommended that the objectives of the PRA be amended to distinguish between its two distinct duties of monitoring individual firms to contribute to system wide safety and monitoring individual firms to ensure that they have robust prudential plans in place. The FSMA duties are still relevant to the second objective of prudential regulation of individual firms. Thus the duty on the PRA could be to maintain arrangements allowing it to (a) determine whether a person it regulates complies with relevant requirement; and (b) monitor and where appropriate intervene in the actions of regulated persons in order to avert systemic financial risk.

194. Key to the regulators' approach are the threshold conditions contained in Schedule 6 of the Financial Services and Markets Act. These set out what firms must do to become, and remain, authorised. The Bank told us "Together with the regulator's statutory objectives, the threshold conditions

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[153] Q 934

form the basis on which the regulator will determine and enforce its supervisory judgments." The Financial Services and Markets Act applies a single set of criteria to all firms. The Bank believes the current criteria are too general and will not allow supervisors to use judgement to assess prudential risks. The Bank therefore proposes that the threshold conditions be amended so that banking institutions and designated investment firms on the one hand, and insurers on the other hand, should be subject to threshold conditions designed specifically for their type of business.[154]

195. The Bank's proposed amendment to threshold conditions would represent a very significant change in the authorisations process for firms. It is arguable that such a significant change should be consulted upon. If such changes were put in place then there would be complicated questions to address such as whether the authorisations of all existing firms would need to be reviewed in light of the new, and significantly different, threshold conditions. There may also be risks to being too specific about the threshold conditions for each type of business in primary legislation given that flexibility may be helpful. Nevertheless it is clearly important that the threshold conditions embody all the things that the PRA might want to take into account when deciding whether to authorise a firm. An authoritative list of all the things the PRA will consider during the authorisation process would be a useful tool for supervisors.

196. **Forward looking supervision is a desirable aim. Mechanical enforcement of rules should not be the objective of the regulators. We agree with the Bank of England that more needs to be done to ensure the PRA has the legal power to supervise using forward looking judgement. As a first step the Bill should be amended to place a duty on the PRA to supervise firms. The Treasury should then consider how to enshrine in the legislation the concept of forward looking supervision. In particular, the threshold conditions which set out what firms must do to become and remain authorised should be carefully reviewed to ensure that they embody all the things that the PRA may wish to consider in a forward looking regime.**

197. **There has been concern and uncertainty about what forward looking supervision might mean for firms. Once established, the new regulators should provide clarity on this issue. A less predictable approach means that regulators will have greater discretion and it is therefore important that attention is paid to the proportionality principle.**

198. Forward looking supervision does not sit easily with the moves within the European Union towards a more rules based and harmonised approach to financial regulation. CRD IV and Solvency II will both create more regulations in this area and a single EU rulebook, achieved through binding technical standards issued by the ESAs, should not limit the necessary discretion of UK regulators to move away from compliance towards judgement. This is a risk to the forward looking approach and it should be kept under review. **The new committee which we propose be established to agree objectives and maximise the UK's influence in EU and international negotiations (see para 305) should have as an objective ensuring that the European rulebook does not limit the**

[154] Bank of England further supplementary written evidence

necessary discretion of the UK supervisory authorities to achieve forward looking regulation.

Attracting the right staff

199. Forward looking supervision is a key cultural change for the regulators and it will require a different approach and skillset. Effective judgment led regulation will require intellectual capability, an understanding of the complexities of financial markets and a willingness and confidence to challenge senior staff within firms. The lack of senior, experienced regulatory staff able to exercise judgment in an increasingly complex financial services market may constrain a shift in this direction.

200. Several witnesses suggested that the regulators would need to offer substantially better pay and conditions to attract the quality of staff needed. There is a considerable asymmetry between the pay and conditions of those who work in the financial services industry and those who regulate it. Highly skilled individuals with knowledge of the system are likely to be attracted by jobs which pay considerably more than the regulators. Sir Mervyn King stated that this was not always the case and that some very good people were attracted to a public service career specialising as a regulator. [155]

201. **The PRA and the FCA will need to attract staff with the appropriate approach and experience if the required cultural change is to be realised. There is considerable debate, which we cannot resolve, about how this can be achieved within the financial constraints of public sector bodies. The PRA and the FCA should publish practical plans that explain how they will ensure that they have staff with suitable skills and how they will develop careers for financial regulators in the public service. They should report against progress in this area in their annual reports.**

Designation of PRA activities

202. The draft Bill does not define the activities to be regulated by the PRA. Instead it provides for this designation to be made through secondary legislation.[156] The FPC will be responsible for monitoring the regulatory perimeter, with input from the PRA and FCA, and for recommending changes to the Treasury.[157]

203. The Treasury has signalled that at least initially firms carrying out the following activities will be regulated by the PRA:

- accepting deposits
- carrying out contracts of insurance
- investment firms authorised to deal in investments as principal on their own account

204. The wide variety of business conducted in the financial sector has complicated the question of where to set the outer limits of the PRA's regulatory perimeter. For example, the FSA and the Bank of England

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[155] Q 846

[156] Clause 6 (new Financial Services and Markets Act clause 22A)

[157] FSA further supplementary written evidence

indicated that they were considering suggesting that the eventual definition of PRA activities be amended to ensure the PRA could "regulate all firms posing potentially significant risks to the financial system because their activities are in substance analogous to deposit-taking".[158] In a later submission the FSA noted that it was important that the PRA's "perimeter is not defined by the concept of deposit taking and insurance" and that the definition of regulatory activities could change in the future as progress was made on defining the broad and varied issue of shadow banking.[159]

205. The PRA should have a role in supervising shadow banking activity. Gillian Tett pointed to a body of opinion that "argues that by focusing so heavily on the Basel rules for banks the FSB is encouraging this flight of activity into the shadow banks". She therefore asserted that "Everything will depend on whether the FPC and PRA not merely monitor the shadow banking world but are enabled to step in and impose some form of control on that."[160]

206. Most shadow banking takes place in investment firms of one type or another. It is envisaged that, at least initially, the PRA will be given the power to supervise investment firms authorised to deal in investments as principal on their own account but the PRA will develop additional criteria for designation. These criteria are likely to include: the size of a firm; the substitutability of its services; the complexity of its activities; and its interconnectedness with the financial system and any PRA-supervised companies within its group.[161] The definition of investment firms "authorised to deal in investments as principal on their own account" together with the additional criteria the PRA will apply means that only investment firms *likely* to pose sufficient risk to the stability of the financial system will be inside the PRA's regulatory perimeter. The Bank has stated that it is envisaged that this will be a very small number.[162] There will be significant areas of shadow banking activity that will not be supervised by the PRA under current proposals.

207. The detailed definition of investment firms subject to PRA supervision is likely only to cover the very biggest investment firms operating in the UK. We understand that it is unlikely to encompass firms the significance of the UK arm of MF Global, the US futures broker that has very recently gone into administration. This cannot be right. The collapse of MF Global could affect the stability of the wholesale markets and this is just the type of firm with the PRA should be supervising. The Former Chief Executive of MF Global told a US Congressional committee that he simply did not know where $1.2billion of customers' money had gone. Such firms have tentacles across the system and should not be left to the FCA to regulate. A group of small firms can be 'systemic as a herd' of which the most obvious example in the recent crisis was the US money market industry.

208. There is a strong case for suggesting that any firm that engages in "rehypothecation" of client money and assets should be subject to PRA

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158 Bank of England and FSA, The Bank of England, Prudential Regulation Authority: Our approach to banking supervision, May 2011, p8 (Box 2).

159 FSA further supplementary written evidence

160 Q 13

161 Bank of England and FSA, The Bank of England, Prudential Regulation Authority: Our approach to banking supervision, May 2011, p8 (Box 2).

162 Ibid, para 21

supervision. Rehypothecation involves a commercial agreement between a firm and client that assets and monies the firm holds in trust for the client can be "on lent" or used in other ways by the firm in its investment activities. The practice can be repeated many times, creating complex webs of counterparty links. MF Global engaged in rehypothecation and this was a significant issue in the Lehman's case. Rehypothecation can pose similar systemic risks to deposit taking.

209. **The PRA's regulatory perimeter should be broader. We would expect firms of the significance of MF Global, and firms engaging in rehypothecation of client money and assets, to be supervised by the PRA.**

210. Paul Tucker and Hector Sants called for a more comprehensive regime for the PRA's powers in relation to the regulation of holding companies for UK banks and insurers.[163] They noted that the Financial Services and Markets Act gives the FSA only indirect powers over unregulated holding companies of banks, restricted to approving changes of control and limitations on intra-group exposures, and that this meant "supervision of groups headed by an unregulated parent is less effective than for those headed by a regulated firm". They argued that the current restrictions on the regulator's powers were only partially improved by the provisions of the draft Bill,[164] and that in consequence:

> "Although the UK prudential regulator is regarded, under the key international agreements such as the Basel Concordat, as the consolidated prudential supervisor of groups headquartered in the UK, its capacity to deliver varies according to the precise organisational structure of each international banking (and insurance) group".[165]

211. **We are persuaded that there is cause for concern in the area of regulation of holding companies, and recommend that the Treasury examine how it can provide the PRA with more comprehensive powers to ensure a consistent regulatory approach**.

212. Each financial crisis is different from that which preceded it and it is difficult to anticipate where a crisis could arise.[166] In consequence, it is vital that the new regulatory structure starts with a broad regulatory perimeter and is nimble enough to be able to identify areas of new risk and then extend its reach to police them as necessary.

213. **It is right that the designation of PRA regulated activities is left to secondary legislation. The financial landscape develops quickly and any definition fixed in primary legislation could soon become redundant or inadequate. The secondary legislation approach will allow a quicker response if the regulatory perimeter needs to be changed in order to accommodate a new area of risk. Nevertheless, given that the initial designation of PRA regulated activities is a key factor in understanding the intentions and scope of the Bill, a draft of the Order must be available when the Bill is introduced into parliament.**

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163 Bank of England further supplementary written evidence

164 Clause 24 (new Financial; Services and Markets Act clause 192A)

165 Bank of England further supplementary written evidence

166 See, for example, Q 4 (Charles Dumas) and Q 39 (Lord Burns)

214. The initial order designating PRA-regulated activities, as well as subsequent orders which bring an activity within PRA regulation or move it out of PRA regulation, will be subject to the 28-day affirmative procedure, meaning that the order will be made before it is laid before Parliament and will cease to have effect unless it is approved by both Houses of Parliament within a set period.[167] The House of Lords Delegated Powers and Regulatory Reform Committee noted that "it is usual nowadays for the 28-day affirmative procedure to apply only where there is urgency". It suggested there is a case for amending the Bill to provide for draft affirmative procedure (whereby the order is not made until it has been approved by both Houses) in these cases.[168] We think there is a case to go further than this. The designation of PRA activities is complex and important and needs careful scrutiny. There should be an enhanced form of scrutiny of these orders.

215. Within the last Session there have been two bills containing an enhanced affirmative procedure allowing greater scrutiny of secondary legislation: the Localism Act and the Public Bodies Act. These provide useful examples of how the draft Bill could be amended to ensure enhanced scrutiny of orders designating PRA regulated activities.

216. Section 11 of the Public Bodies Act provides that the Minister may lay a draft order and accompanying Explanatory Memorandum before Parliament. The Act sets out the information that the Explanatory Memorandum must present. From the day on which the draft order is laid, a 30-day period starts ticking. Within this period, the Act provides that either House may decide that an enhanced affirmative procedure should apply to the draft order. This can be triggered in one of two ways: by resolution of either House, or on the recommendation of a committee of either House charged with reporting on the draft order. If the 30-day period lapses without either House or a Committee triggering the application of an enhanced affirmative procedure, then the draft order may be approved by a resolution of each House once a further 10 days have elapsed (creating a 40-day scrutiny period in total). If however the enhanced affirmative procedure is triggered, then a further 30-day period must be allowed to lapse (creating a 60-day scrutiny period in total). The Act provides that where the enhanced affirmative procedure has been applied, the Minister "must have regard to (a) any representations, (b) any resolution of either House of Parliament, and (c) any recommendations of a committee of either House of Parliament charged with reporting on the draft order, made during the 60-day period". Once the 60-day period has lapsed, the draft order may be approved by a resolution of each House of Parliament, or, if the Minister wishes to make material changes to the order, a revised draft order and accompanying statement summarising the changes proposed may be laid before Parliament. No further scrutiny period applies before the revised draft order may be approved by a resolution of each House but any material changes to the draft are subject to scrutiny.

217. **The procedures for orders designating PRA activities should be amended to provide for an enhanced affirmative procedure in non-urgent cases, retaining the made affirmative procedure for urgent cases only. We appreciate that there will be instances where fast action is required, but it is not appropriate for the 28-day procedure**

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[167] Clause 6 (new Financial Services and Markets Act clause 22A)

[168] See appendix 8

to be applied as a matter of routine. The enhanced affirmative procedure should be modelled on that contained in Section 11 of the Public Bodies Act.

Responsibility for considering the ethics and remuneration structures of firms

218. One factor behind banks taking on huge amounts of risk in the run-up to the crisis was the link between management remuneration and returns on equity. This created incentives to keep capital low—which meant banks had less capital to absorb losses when trouble struck—and boost profits through excessive leverage. Sir Mervyn King told the House of Commons Treasury Committee: "I think that the incentives that have been created by linking compensation to the rate of return on equity is clearly a distortion because it gives an incentive built in to raise leverage ... I have never understood why people thought it was a sensible idea to base compensation in these institutions on the return on equity."[169]

219. Robert Jenkins, a member of the interim FPC, said: "Over the last 10 to 15 years it [return on equity] has helped to make many bankers rich and loyal shareholders poor. Moreover it prompts banks to fight to keep loss absorbing capital low. This makes their enterprises vulnerable and our financial system fragile."[170]

220. After the financial crisis erupted the Financial Services Authority introduced a Remuneration Code for senior staff at financial institutions. A revised version came into force earlier this year. The regulatory structure outlined in the draft Bill will not change the Remuneration Code and enforcement will largely be undertaken by the PRA who "will be responsible for ensuring that the remuneration policies ... are aligned with effective risk management and that they do not provide incentives for excessive risk-taking".[171] The FCA will also enforce the Remuneration Code with firms covered by the Code but not regulated by the PRA.

221. Among the Remuneration Code's measures, at least half of variable remuneration should consist of shares rather than cash. The shares awarded in pay packets have to be retained for specified periods. Andrew Proctor, Global Head of Government and Regulatory Affairs at Deutsche Bank, said: "The balance between cash and stock for bonuses has significantly changed in favour of stock ... The deferral periods are now extended out to about five years, typically. The claw-back provisions are much tougher than they have ever been before, either for malice or misconduct or because the profits upon which the bonus decision was made turn out to be illusory. Finally, there is a far greater emphasis on indicators of good and bad behaviour being reflected directly in the bonus decision."[172]

222. In certain cases, supervisors can demand individual contracts be redrafted if they create incentives to excessive risk-taking. Sally Dewar, formerly of the

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[169] House of Commons Treasury Committee, 7th Report (2010–12) *Financial Regulation: a preliminary consideration of the Government's proposals* (HC 430-II), Q 786

[170] Speech by Robert Jenkins at the CFA Institute: Fourth Annual European Investment Conference, Paris, 2 November 2011

[171] Bank of England and Financial Services Authority, *The Bank of England, Prudential Regulation Authority—Our approach to banking supervision*, May 2011

[172] QQ 879–880

FSA and Managing Director for International Regulatory Risk at JP Morgan, said: "The regulator has the authority to rip up a contract."[173]

223. Other factors could also help prevent bankers and traders building-up excessive risks that occurred in the run-up to the financial crisis. Shareholders of banks and other financial institutions should play a more active role in monitoring directors and senior employees' remuneration schemes to ensure they do not encourage excessive risk-taking. In its recent report on the failure of RBS the FSA suggested that the remuneration arrangements of executives and non-executive directors might be changed so that a significant proportion of remuneration is deferred and forfeited in the event of failure. Regulations of this form have already been introduced for executive directors: they could be strengthened by increasing both the proportion of pay deferred and the period of deferral.[174]

224. The three investment banks who spoke to us—Deutsche, Goldman Sachs and JP Morgan—all stressed the importance of ethical codes at their organisations which could help discourage staff from activities that lead to excessive risk-taking. However, Mr Proctor of Deutsche admitted ethical codes may not have been clearly expressed in the past: "The articulation of them has become clearer. I would think that at bottom they have not changed, but there is a much clearer articulation and expression of them."[175]

225. Supervisors, banks and shareholders must ensure that senior staff remuneration schemes do not lead financial institutions to take on excessive risk. The PRA and FCA should take an active interest in this area and should rigorously enforce the remuneration code. **The Government should consider the FSA's recommendations on changing the remuneration arrangements for executives and non-executive directors, or introducing a concept of 'strict liability' of executives and Board members for the adverse consequences of poor decisions, in order to ensure that bank executives and Boards strike a different balance between risk and return. Amendments could be brought forward to this Bill.**

Responsibility for markets

226. Under the current proposals, the FCA will have a role in markets regulation, under its objective to protect and enhance the integrity of the UK financial system. In pursuing this objective, the FCA will be concerned with the soundness and resilience of the trading infrastructure; the integrity of the financial markets, including the reliability of their price formation process; combating market abuse; and addressing the extent to which the UK financial system may be used for the purposes of financial crime.[176]

227. More specifically, the FCA will be responsible for the conduct and prudential regulation of recognised investment exchanges (RIEs)[177]. However, the Bank of England will regulate settlement systems and clearing houses[178].

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[173] Q 886

[174] The FSA, the Failure of the Royal Bank of Scotland: FSA Board Report, December 2011

[175] Q 881

[176] Clause 5 (new Financial Services and Markets Act clause 1D)

[177] A recognised investment exchange is an investment exchange which is recognised by the FSA. Investment exchanges allow securities to be traded. An example is the London Stock Exchange.

228. The FSA is particularly concerned about the need for the FCA to be involved in regulation of settlement systems and clearing houses, which will be within the Bank of England's remit:

> "Under the Government's proposals the Bank of England will become responsible for supervising the providers of systemically important infrastructure (central counterparty clearing houses and settlement systems). However, we consider that the new legislation should explicitly recognise the role of the FCA in the conduct of business supervision of these entities. This would put the FCA on the same footing as its key EU counterparts (who share supervision of clearing and settlement with their national central banks/prudential regulators) and make it a fully credible participant in discussions on this area in the European Supervision and Markets Authority. A model of shared supervisory responsibility would also reflect the likely implementation in many Member States of the European Markets Infrastructure Regulation currently being negotiated, under which Member States will be responsible for designating one or more authorities to carry out the authorisation and supervision of clearing houses."[179]

229. The FSA acknowledged "the argument that co-ordination between the PRA and the FCA would be simplified if the PRA (rather than the BoE itself) was also responsible for the prudential oversight of clearing and settlement organisations. We recognise, however, that this would require a further reorganisation of the current BoE structure and thus is probably not justified at this stage. However, in our view there would be merit in ensuring that the legislation is sufficiently flexible to allow for such a change in future, without the need for primary legislation."[180]

230. Market infrastructure—exchanges, listing authorities, clearing houses, and settlement institutions—are central to competition in securities markets. If the FCA is to have a central role on competition, then it will have a significant role in the regulation of financial markets. At the same time the Bank and PRA will have a critical role in terms of clearing, payments and settlement (with regard to prudential systemic risk). It will therefore be important to ensure good coordination mechanisms.

231. **For consistency of regulation, there is a strong rationale for keeping regulation of market infrastructure together. Given the PRA's role in regulating prudentially significant firms, we recommend that the regulation of market infrastructure should sit within the PRA. As is the case for other PRA-regulated firms, the FCA will have an important role in regulating market infrastructure with respect to conduct issues, and it is important that the legislation makes this clear. Appropriate coordination mechanisms between the two regulators will be required.**

232. There is a gap in resolution arrangements for market infrastructure firms.[181] These are not covered by the provision of the Banking Act 2009.

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178 Clearing houses provide clearing services, which are activities from the time a commitment is made for a transaction until it is settled. A transaction is settled when the agreed payments and delivery of securities have been made.

179 FSA written evidence

180 Ibid

181 Professor Julia Black written evidence

Professor Black, The London School of Economics and Political Science said that "resolution powers should be extended to cope with the failure of a CMI [critical market infrastructure] institution".[182]

233. **We are concerned by the gap in resolution arrangements for market infrastructure firms that may be of systemic importance. The Treasury should take action to ensure that this gap is closed.**

Information from auditors

234. The PRA and FCA will have a power to require firms to provide information and data in specific forms. It is however important to consider whether other bodies should have a duty to bring certain types of information to the attention of the regulators. Legislation already affords legal protection to auditors who provide confidential opinions on banking clients to supervisors in the interests of better supervision.[183] The practice of regular meetings between auditors and supervisors of banks fell into disuse prior to the banking crisis. In 2006 there was not a single meeting between the FSA and the external auditors of either Northern Rock (PwC) or HBoS (KPMG), and only one meeting between the auditor of RBS (Deloitte) and the FSA. In 2007 there was only one FSA/auditors meeting with each bank auditor. All three banks were bailed out by the taxpayer. The FSA told the House of Lords Economic Affairs Committee: "The regular practice of auditor-supervisor meetings fell away gradually following the transition from the Bank of England to the FSA as banking supervisor."[184]

235. The House of Lords Economic Affairs Committee earlier this year suggested a statutory obligation for bank auditors and supervisors to set up an effective working relationship. That Committee suggested that this could take the form of a "mandatory quarterly meeting, at the highest appropriate level, between the supervisory authority and the external auditor of each bank whose failure might, in the view of the supervisory authority, pose a systemic risk. There might be a further requirement for either side to initiate a meeting between the regular quarterly meetings should information come to light which might warrant such a meeting". [185]

236. **The PRA will be better able to identify risks building up in individual firms if it established an effective working relationship with bank auditors. The draft Bill should be amended to place a statutory duty on the PRA to meet regularly with bank auditors. The Treasury should consider whether any complementary duties can and should be placed on auditors for example to draw certain risks to the attention of regulators.**

Quality of information held by firms

237. It is important to ensure that firms collect, hold and analyse information in a way that allows them and the regulator to understand the risks they are

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[182] Ibid

[183] Financial Services and Markets Act, Section 342.

[184] House of Lords Economic Affairs Committee, 2nd Report (2010–2011): Auditors—Market concentration and their role, par 160 (HL Paper 119-I))

[185] Ibid, para 164

exposed to. This was not happening in the run up to the 2007 crisis. Intellect, a trade body for UK technology industry, made this point:

> "Banks failed to collate and interpret risk data of suitable quality so that they could identify the risk that they were holding across their disparate operations.
>
> Regulators were ill-equipped to interpret the sheer quantity of sub-standard risk data being received from banks and turn it into actionable information"[186]

238. It is worrying to consider that under data reporting rules regulators may end up with a mass of data that they do not have the ability to interpret. The current FSA rule book has a whole section dedicated to reporting requirements and moves in the EU to agree a common reporting directive are likely to increase the information to be reported on a regular basis. Sir Mervyn King suggested that "Rather than burdening the banks with a massive data reporting requirement, we should make it clear to them, "We think you ought to know the answers to the following questions, and from time to time we will want to know the data, too, but do not send it to us until we ask for it."[187] To an extent this already happens. Andrew Bailey added "From time to time we do it now. I do it in running supervision. We say, "We want this by close of business tomorrow." Sometimes I get protests from chief executives of banks and I say to them, "Look, I'm not asking you for anything you should not have yourself to run your business."'[188]

239. Whether or not the regulators rely on regular reporting or more ad hoc requests for information they need to be sure that financial firms themselves have robust standards for recording information. Poor quality information about exposures and counterparties directly contributes to systemic risk. Intellect suggested that "Banks need to undertake significant internal changes to reform their ability to collate accurate risk data, and to improve access for regulators to it so that they can adequately perform their supervisory and financial stability objectives". Improved information standards will not only help auditors, they will allow company boards to make better decisions.

240. The USA has led the way on this issue. The Dodd-Frank Act created the Office for Financial Research which was given responsibility for monitoring of systemic financial risks and, in order to undertake this task, has been given powers for the setting of data standards for the industry. In order to allow effective monitoring of systemic financial risk, the Dodd-Frank Act also requires that OTC derivative contracts are recorded in trade repositories, a step that requires standardisation of reporting across the industry.

241. Gillian Tett told us that the Office for Financial Research is an important step because it would "force banks to have a much more proactive and timely system of reporting activity ... In an ideal world I would be putting money into trying to create some kind of international system for reporting bank positions and capital flows".[189]

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[186] Intellect written evidence

[187] Q 841

[188] Q 841

[189] Q 6

242. Improved industry-wide standards for the recording of data could help achieve stability of the UK financial system. Amongst other advantages it would allow the Regulators to shift away from the routine collection and processing of regulatory returns, information which may be little relevance to financial stability, and instead request more limited and more relevant data when the need arises.[190]

243. **The Bill should be amended to place a duty on the Bank of England (or its subsidiary the PRA) to develop information standards for the UK financial services industry and to report regularly on progress in improving these information standards in order to support financial stability.**

Powers and responsibilities of the FCA

Responsibility for consumer credit

244. The OFT currently has responsibility for regulating consumer credit under the Consumer Credit Act. As part of this, the OFT is the licensing authority and main enforcement body for regulated consumer credit (including personal loans, credit card lending and the provision of goods and services on credit as well as related activities such as debt collection and debt management).

245. The Government has consulted on transferring responsibility for consumer credit from the OFT to the FCA, but has not yet announced its final decision.[191] In the consultation, the Government set out its preference to transfer consumer credit to the FCA within a regime based on the Financial Services and Markets Act.

246. Consumer groups have supported the transfer to the FCA, on the grounds of increased clarity for consumers. Martin Lewis told us "the fact that a bank account is regulated by the FSA when in credit but probably by the OFT when it is overdrawn because it is consumer credit is just nonsense."[192] However, opinion is divided as to whether if this transfer takes place consumer credit should be covered by the Consumer Credit Act, or re-written to fit with the Financial Services and Markets Act.

247. The Consumer Credit Association is very concerned by the potential transfer of responsibility to the FCA, because it believes that such a move would "very significantly increase the regulatory cost/load of running a credit business in the UK (probably by at least a factor of five)". This is based on the fact that "the two regimes (FSA and OFT) operate at quite different cost levels. FSA spends c. £500 million per year to regulate c.25,000 firms. OFT spends c.£20m-£30m per year supervising c.96,000 traders."[193]

248. The Consumer Credit Association also believes that unsecured credit is different from products such as insurance and mortgages. It said that for unsecured credit, the risks to consumers and the complexity of the products

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[190] The desire to adopt such a conditional approach to data gathering was expressed by both Sir Mervyn King and PRA chief-executive designate Andrew Bailey in their evidence to the committee.

[191] http://www.hm-treasury.gov.uk/consult_consumer_credit.htm

[192] Q 122

[193] Consumer Credit Association written evidence

is low.[194] Other industry bodies such as the BBA also took the view that care will be required given that considerations for Consumer Credit Act regulated lending must be different to that for savings, insurance and mortgages.[195]

249. There are however strong arguments for transferring consumer credit to the FCA, which will have a brief to protect consumers. The FCA's responsibilities for authorising firms would allow it to consider carefully the business model of firms planning to offer consumer credit and consider at a very early stage whether that model is likely to cause detriment to consumers. The FCA will have important new powers to ban products that do not meet minimum standards or should not be sold to certain categories of consumers (see next section).

250. **We welcome the Government's decision to look at whether consumer credit should be moved to the FCA. Consumer credit products may pose different problems to other financial products, and it is important that the way in which they are regulated is proportionate, taking into account costs to firms and potential benefits to consumers. However, given the potential for consumer detriment in the case of some types of credit products, there are significant benefits in transferring consumer credit to the FCA, to ensure clarity of responsibilities, and to ensure that the FCA is better able to identify and deal with consumer issues across the financial services market.**

Responsibility for pensions

251. Pension regulation is split between the FSA, which supervises personal pensions, and the Pensions Regulator which focuses on occupational pension schemes.

In written evidence, Martin Wheatley, Chief Executive-designate of the FCA, explained the FCA's role under the new regime;

> "Our responsibility is looking at the sales and marketing of pensions. The Pensions Regulator oversees the occupational pension scheme ... We have separate but complementary objectives. We will have to work very closely together with the Pensions Regulator to make sure that we both share knowledge and experience. If there are joined issues that need to be addressed, we will have to address those joined issues."[196]

Consumer protection powers

252. In the wake of previous scandals, such as payment protection insurance, it is clear that improvements need to be made in the area of consumer protection. The FCA will have three main new powers, not previously available to the FSA, in the area of conduct regulation:

> **Early publication of disciplinary action**: Where a warning notice in relation to a proposed disciplinary action has been issued, the FCA will have the power to publish the fact.[197]

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[194] Consumer Credit Association written evidence

[195] BBA written evidence

[196] Q 1002

[197] Schedule 8, paragraph 24

Financial promotions power: Regulating financial promotion is already part of the FSA's remit. The draft Bill proposes to give the FCA a new power to direct a firm to withdraw or amend misleading financial promotions with immediate effect and to publish the fact that it has done so.[198]

Product intervention power: The FCA will have existing powers to take action if it identifies an issue with a product, for example, mandating minimum product standards or restricting sales to certain classes of customer. However, in addition to this, the Treasury has proposed that the FCA should have the power to make temporary product intervention rules for a period of up to 12 months with immediate effect. The FCA will be required to publish and consult on a set of principles governing the circumstances when it will use the new product intervention power.[199]

253. These are powerful new tools. There is concern among some sectors of industry that some of the new powers unfairly disadvantage them.

Early publication of disciplinary action

254. Early publication of disciplinary action is common practice amongst regulators of other sectors. Consumer Focus said that:

> "In energy markets, Ofgem announces on its website when it is investigating firms for breaches to the licence.[200] It also openly reports after nine months what has happened to the investigation. Equally, the Advertising Standards Authority (ASA) publishes on its website when a complaint has been made that they are investigating. OFCOM also announces which firms it is investigating. We see no reason why financial services firms should be granted greater dispensation from public disclosure as will still be the case in the draft Bill."[201]

255. Nevertheless the industry argues that this power could cause reputational damage to firms that are subsequently found not to be in breach of rules. AXA said that the power was "contrary to … the principle that an individual is innocent until proven guilty".[202]

256. The Government said that it has taken these concerns into account in designing the power. In particular it has proposed a series of safeguards:[203]

- The regulator will have the opportunity to consider the case for publication on a case-by-case basis, rather than being required to publish;
- The regulator must consult the person to whom the notice is given before making any disclosure;
- The FCA may not publish if in its opinion, it would be unfair to the person against whom action is being taken, if it would be prejudicial to

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198 FSMA new section 137P

199 FSMA new section 138

200 Ofgem, Enforcement Guidelines on Complaints and Investigations, 232/07

201 Consumer Focus written evidence

202 AXA written evidence

203 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.109–2.110

the interests of consumers, or if it would be detrimental to financial stability.[204]

257. These safeguards may significantly reduce the effectiveness of the power to publish early warnings of disciplinary action. The FSA considers that the requirement to consult "will seriously undermine the effectiveness of this power" to the point that it is likely to be of little use. It is concerned that most individuals and firms will object to warning notices, resulting in "satellite litigation" with firms and individuals seeking injunctions through the courts to restrain the authorities from making matters public.[205]

258. Given the powers of regulators in other sectors, and indeed, the process in criminal and civil proceedings, we see no reason why financial services firms should be granted greater dispensation from public disclosure. Requiring the FCA to consult could seriously undermine the effectiveness of this new power. The fact that the FCA will not be publishing the warning notice itself, but only the fact that it has issued one, and the fact that it will need to take into account a number of considerations in deciding what to publish should provide sufficient safeguards. **We recommend that the requirement to consult before disclosing the fact that a warning notice has been issued should be removed from the draft Bill. However, we do think it important that the FCA has the discretion to weigh the relevant factors and decide which set of interests listed in the Bill (fairness, potential to be prejudicial and potential for detriment to financial stability) are best served by disclosing or not disclosing that a warning notice has been issued. We also think that the FCA should be required to publish guidance as to how it will exercise its discretion in respect of disclosing that a warning notice has been issued. This will provide some degree of certainty to firms over how the FCA will treat different cases.**

Trusted consumer products

259. Complex products combined with a lack of financial literacy is a significant problem in financial markets. In para 126, we recommended that the FCA should have regard to the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented. If the FCA is diligent about this duty then it should make progress in helping consumers understand the products they are buying. There is however more that could be done.

260. Consumer Focus proposed a Trusted Products Board[206] to "set common standards for a suite of mass market financial services consumer products". Consumer Focus suggested that the Board could be funded by the financial services industry. It could have active industry participation but an independent Chairman and board. Its objective would be to agree:

- A suite of mass market consumer products which would be defined by a set of common minimum standards—of design, governance and management
- The specific common standards for each identified product

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[204] Schedule 8, Part 6, notice procedures

[205] FSA, written evidence

[206] Consumer Focus written evidence

- Common terms to describe products and define what is included in the product price, so products could be compared and consumers could shop around and compare like with like
- A logo or kitemark which providers of qualifying products could license and use for products which met the agreed minimum standards
- To monitor the market and identify and ban any emerging additional product features on products which otherwise met minimum standards if the Trusted Products Board considered they could cause consumer detriment
- To keep under review changing consumer needs and the changing financial services environment and (a) add new products to the suite of trusted products as required and (b) modify or remove items from the suite of existing approved products

261. A system along these lines, that would help retail consumers easily identify simple low-cost financial products, could have significant benefits. Stakeholder Pensions provide something of a precedent. It could make it easier for consumers to compare products and increase the incentives on firms to deliver value for money. It would also be necessary to indicate categories of people for whom these products would and would not be suitable.

262. However, it would not be right for the regulator to undertake itself or authorise others to select and endorse specific products or types of products. To do so would raise all sorts of issues of legal liability in the event that such products failed or were mis-sold or mis-bought. The FCA could certainly not brand some products as "trustworthy" while still authorising firms to market products refused that label.

263. **A system of identifying and certifying simple, low cost financial products is an attractive idea. This is not a role that the regulator should take on but it is something the voluntary sector itself may be well placed to do. The FCA should be prepared to help the voluntary sector in these endeavours by providing information on products and their costs.** We welcome the Government's announcement that a new steering group made up of Government, industry, trade and consumer body representatives has been set up to consider hot to bring simple products to market and to report back to the Treasury.[207]

Competition powers

264. Having considered the role of competition in the FCA's objectives at para 99, it is necessary to consider the division of responsibilities and powers between the OFT and the FCA.

265. In the UK, the OFT is the main competition authority. Its responsibilities include:

- applying and enforcing competition law, for example, on anti-competitive agreements and abuse of a dominant position.
- conducting "first phase" markets investigations, which involves looking at whether market features prevent, restrict or distort competition. If the

[207] http://www.hm-treasury.gov.uk/press_116_11.htm

OFT has reasonable grounds to suspect that this is the case, it can make a market investigation reference to the Competition Commission (CC).[208] If the CC finds that there are adverse effects on competition, it can impose remedies.

- conducting "first phase" investigations to determine whether a merger results or may be expected to result in a substantial lessening of competition. If the OFT finds that this is the case, it must refer the merger to the CC, which conducts the "second phase" of the investigation, and if required, imposes remedies.
- investigating super-complaints. Designated consumer bodies can make super-complaints to the OFT in situations where a feature, or combination of features, of a market appears to be significantly harming the interests of consumers. The OFT has a duty to respond to a super-complaint within 90 days.

266. In some regulated sectors, (such as telecoms, water, aviation, energy), the sector regulator has concurrent powers with the OFT. This means they have powers alongside the OFT to apply and enforce competition law[209], and can refer markets directly to the Competition Commission.[210] They can also investigate super-complaints. They do not however have a role in merger investigations, which are the responsibility of the OFT and Competition Commission.

267. Under the proposals in the draft Bill, the OFT will remain the lead regulator on competition issues in financial markets, with responsibilities for making market investigation references to the Competition Commission, and for applying and enforcing competition law. The FCA will have the power to make an "enhanced referral" to the OFT[211] where it has identified a possible competition issue that may benefit from technical competition expertise or require recourse to powers under competition law. Specifically, the draft Bill states that:

> "The FCA may ask the Office of Fair Trading (the OFT) to consider whether any feature, or combination of features, of a market in the United Kingdom for financial services may prevent, restrict or distort competition in connection with the supply or acquisition of any financial services in the United Kingdom or a part of the United Kingdom."[212]

268. The OFT will have a statutory duty to respond to a referral within 90 days. The OFT would also be able to carry out competition scrutiny of the PRA and FCA.[213]

269. The Government has decided not to give the FCA concurrent competition powers as "it did not consider that these delivered the desired outcomes."[214] It also summarised views given in response to its consultation:

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[208] In the case of both markets investigations and mergers, the OFT can seek undertakings from firms in lieu of the reference to the CC.

[209] Specifically, they have powers to investigate possible infringements of the prohibitions in Chapters I and II of the Competition Act 1998 and Articles 101 and 102 of the Treaty on the Functioning of the European Union in the UK (against anti-competitive agreements and abuse of a dominance position)

[210] Specifically, they have powers to make market investigation references under section 131 of the Enterprise Act 2002 where sectoral markets appear to be displaying anti-competitive features.

[211] Clause 37 (new Financial Services and Markets Act clause 354D)

[212] Ibid

[213] FSMA new sections 140A to 140H

> "... many industry respondents were concerned that the proposal for limited concurrency would lead to confusion, duplication or increased burdens. Some industry respondents highlighted the differences between financial services and other sectors where concurrency is in operation, and expressed scepticism about the economic regulator model."[215]

270. The FSA expressed the concern that the current proposals may create an overlap in responsibilities between the OFT and FCA. It wants the FCA to have the following powers and functions alongside its proposed operational objective to promote effective competition for the benefit of consumers:

    - An explicit function to keep financial services markets under review.
    - A function/power, for the FCA, instead of the OFT, to refer financial services markets directly to the Competition Commission, for investigation, where it suspects market features are preventing, restricting or distorting competition. This is known as a 'Market Investigation Reference power'. This should also allow the FCA to agree certain undertakings—e.g. including divestment—with firms in lieu of a reference.
    - Consumer organisations should be able to make super-complaints to the FCA rather than the OFT on aspects of the operation of financial services markets which are harming consumers."[216]

271. The FSA argued that had it had these powers it would have better been able to deal with issues such as payment protection insurance. [217] Consumer groups have also argued that the FCA should be able to investigate super-complaints.[218]

272. The FSA's proposal differs from that of other sector regulators in two ways. First, other sector regulators have concurrent powers alongside the OFT, rather than powers to the exclusion of the OFT. Secondly, other sector regulators have Competition Act powers alongside the OFT; the FSA does not want Competition Act powers (which would allow it to look at anti-competitive agreements and abuse of a dominant position), as "the OFT already possesses both legal and economic expertise in this area and is, therefore, best placed to carry out this function." [219]

273. There are concerns about any strengthening of the FCA's competition objectives because of the potential duplication with the OFT, as well as the lack of competition expertise in the FCA. Set against this, the FCA will have strong expertise in financial markets, which will make it well-placed to identify potential competition issues, and their impact on the market. For example, account number portability, which the ICB said should be re-evaluated as an option in the future, has implications for the technical data systems used by industry, which the FCA would be well-placed to investigate. This makes it desirable for the FCA to have an objective that

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214 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.114

215 Ibid, para 2.113

216 FSA supplementary written evidence

217 Ibid

218 Financial Services Consumer Panel written evidence, Which? written evidence, Citizens Advice written evidence, Consumer Focus written evidence.

219 FSA supplementary written evidence

explicitly focuses on competition, as well as powers that allow it to achieve this objective. It could be argued that it would be difficult for the FCA to achieve objectives of promoting competition with its powers limited to OFT referrals. If the FCA were to take on further competition powers, it would need to increase its competition expertise in terms of staffing, and the relationship with the competition authorities will need to be carefully considered.

274. The OFT does not think that the FCA should have a formal concurrent power to make market investigation references to the OFT for the following reasons:

- "The risks of inconsistent use of these tools across the competition regime which lead to greater uncertainty for business, and the likelihood of financial business pressing for 'special treatment' within the competition regime;
- The need for the FCA to develop a skillset that the FSA currently does not possess around competition assessments—and the parallel risk of then creating a duplicative set of skills in different public authorities;
- The fragmentation of roles weakening the ability of the competition regime to support the Government in tackling strong vested interests and the usual problems of overlaps, or, more likely, gaps in action;
- The risk, as with other sector regulators, that the tool is used by neither the FCA nor the OFT; and
- Partly as a result of these, the likely withdrawal by the OFT from working on the markets covered by the FCA leaving the 'sectoral' body to conduct these activities. We see this risk as especially important. One specific consequence of this would be that external assessment of the impact of the FCA's own rules on competition—despite their potential significance themselves as a barrier to entry, for example would be diminished. In short would the FCA ever be capable of carrying out thorough independent analysis of its own rulebook from a competition perspective as part of a market study?"[220]

275. The OFT's concerns apply to the option of giving the FCA concurrent powers, rather than the FSA's preference for powers to be taken away from the OFT and given to the FCA. However, to a greater or lesser extent, some of these concerns will also be relevant to the FSA's preferred option. For example, the withdrawal of the OFT from working on financial markets and consequent lack of independent competition scrutiny of the FCA's rules is clearly a greater risk if the OFT's powers in this area are taken away altogether.

276. Competition expertise is also important in building a case. The OFT does have significant experience in investigating competition issues in financial markets. In recent years, it has conducted reviews on personal current accounts, barriers to entry, expansion and exit in retail banking, payment protection insurance (following a super-complaint), and the HBOS and Lloyds merger (prior to the acquisition). However, the competition regime in financial services markets has arguably not delivered significant improvements in recent years. The ICB report concluded that "most of the

[220] Office of Fair Trading written evidence

competition problems highlighted in 2000 by the Cruickshank report into competition in UK banking remain".[221]

277. The Government has recently consulted on changes to the UK competition regime. The consultation includes a proposal to merge the competition functions of the OFT and Competition Commission to create a Competition and Markets Authority (CMA), The outcome of this consultation will affect how the future FCA may interact with the competition authorities.

278. In commenting on the consultation, the OFT highlighted that there were concerns that sector regulators have not made sufficient use of competition powers, and that it may be undesirable to further fragment UK competition powers:

> "... the Government's own consultation on the creation of the CMA recognises the paucity of MIRs [market investigation references] that have been made by the relevant sectoral regulators to date, and proposes ways to streamline and better coordinate the use of those powers, with the CMA playing a more central role. One of the concerns is that such sectoral regulators have a natural tendency to use their own narrower tools and that the development of a strong set of cross-economy precedents around the use of competition powers is weakened. The OFT also considers that the rationale for the merger of the OFT and CC is inconsistent with further fragmentation in the application of UK competition powers. In its consultation, the Government referred to the benefits of the merger including providing for the more flexible use of resource between, for example, the two phases of the market investigation regime, and the benefits of creating a single more powerful advocate for competition in the UK, Europe and internationally. Providing the FCA with competition powers would appear to be inconsistent with both objectives."[222]

279. **The Government should review its decision on the FCA's competition powers. The FCA should be given concurrent powers alongside the OFT to make market investigation references to the CC. The FCA will need greater competition powers to achieve its recommended objective than is currently set out in the draft Bill.**

280. We note that the Government is consulting on a proposal for a "clear, transparent and fair process, led by the regulator, for dealing with situations where conduct risks have crystallised and are causing mass consumer detriment." However, whereas the proposed process focuses on "mass consumer detriment", triggering a super-complaint is based on the lower threshold of situations "where a feature, or combination of features, of a market appears to be significantly harming the interests of consumers". We therefore do not think that the proposed process for mass detriment cases on its own provides a sufficient avenue for consumer issues to be brought to the attention of the FCA. **We also recommend that designated consumer bodies should be able to make super-complaints to the FCA, as well as the OFT.**

281. It is appropriate for the FCA to have concurrent powers in this area, as in some situations, the OFT may be best-placed to investigate super-complaints

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[221] ICB final report, para 6.7

[222] Office of Fair Trading written evidence

and conduct market studies, for example, where the issues involve cross-market problems that may not all fall within the FCA's remit (particularly consumer credit) or if the issue relates to effects on competition of rules imposed by the FCA itself, for example, as part of its prudential regulation responsibilities.

282. The OFT may also be better placed to take in lead in cases where it is unclear whether the right solution will be a market investigation reference to the CC or action under the Competition Act. The FCA would not have action under the Competition Act as an option as it would not have powers in this area.

283. If this recommendation is accepted, there will be a need for coordination between the FCA and the competition authorities, as well as a need for the FCA to increase its access to competition expertise. Proposals such as tasking the new CMA with acting as a central resource for sector regulators on competition issues, considered as part of the Government consultation on reforming the competition regime, may be of benefit in aiding coordination and ensuring that the FCA has access to competition expertise.

PRA and FCA duty to co-ordinate

284. The draft Bill places a duty on the PRA and the FCA to ensure co-ordinated exercise of specific functions.[223] It also requires them to prepare and maintain a Memorandum of Understanding which describes how they intend to comply with the duty. The MOU will be subject to annual review and the draft Bill requires the PRA and the FCA to include in their annual reports an account of how they have coordinated during the year.[224] When considering matters of common regulatory interest both regulators must consider the first two regulatory principles to which they are both subject. These are:

(a) the need to use the resources of each regulator in the most efficient and economic way;

(b) the principle that a burden or restriction which is imposed on a person should be proportionate to the benefits what are expected to result.

285. It is expected that there will be around 1700 dual-regulated firms and there is concern amongst those firms that dual-regulation will be a considerable burden. The Association of British Insurers stated that close co-ordination between the PRA and FCA will be key to ensuring that the new structure operates effectively.[225] AEGON highlighted industry concern that the authorisation and approvals for dual-regulated firms may prove unnecessarily burdensome.[226] Suggestions to reduce the burden on dual-regulated firms included developing shared services and a single point of contact for handling tasks such as authorisation of firms and individuals; variations of permissions; collection of all fees and levies etc. The Building Societies Association, Association of British Credit Unions and the Institute of Financial Planning all supported a single point of contact as necessary for small firms to negotiate the regulatory system.[227] Another suggestion was that there should be a single rule book for dual regulated firms.

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[223] Clause 5 (new Financial Services and Markets Act clause 3D)

[224] Schedule 3 (para 10 of new FSMA Schedule 1B and para 19 of new FSMA Schedule 1ZB)

[225] ABI written evidence

[226] AEGON written evidence

[227] QQ 487–8

286. Martin Wheatley said that while the two regulators would work to minimise the burden on dual-regulated firms in terms of information reporting it was inevitable that two separate regulators would have two separate rule books and two separate systems for making contact:

> "Our presumption is that we will start with a single rule book from the point of the legal creation of the two organisations, but the reality is that we will be two separate organisations, with two separate sets of objectives operating to two different lines of accountability. Over time it is going to become quite clear that the industry is dealing with two quite separate regulators. While we can try to manage that initially, a single point of contact does not really work if you have two regulators with two different sets of interests."[228]

287. He did however provide assurance that the two regulators would share information:

> "We have created effectively legal gateways where information given to one of the regulators will be made available to the other. It should not be the case that firms will have to give essentially the same set of information twice."[229]

288. Hector Sants stated that:

> "The FSA is currently considering with the Bank of England how best to develop and set out those regulatory provisions which will apply to dual-regulated firms. An interim solution agreed between the FSA and the Bank is to carry over the FSA's existing rulebook past the regulatory cutover period and to badge each provision in the Handbook so that firms can readily identify which provisions will be the responsibility of the PRA and which that of the FCA. Thereafter, the PRA and the FCA will jointly consider how best to present the provisions for which they are separately responsible."

289. It is important that firms regulated by both the PRA and FCA are not subject to considerably higher costs or considerably more bureaucracy.

290. The Treasury's position is that it should be for the regulators themselves to develop plans for operational coordination and for parliament to hold them to account for doing so effectively. To prescribe methods of co-ordination in legislation "would be inflexible and unnecessarily prescriptive, removing from the framework the capacity for regulators to learn, develop and improve".[230]

291. **The PRA and FCA must co-ordinate as far as possible to minimise the burden on dual-regulated firms. We welcome the assurances that information given to one regulator will be shared with the other so that the same information will not have to be given twice. While a joint rule book and a single point of contact may not be possible, the two bodies should consider other methods of reducing the burden. A draft of the Memorandum of Understanding on co-ordination**

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[228] Q 915

[229] Q 998

[230] HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.136

between the PRA and FCA must be available when the Bill is introduced into parliament.

292. For some specific functions, such as authorisations, the PRA will lead but will seek the consent of the FCA. However, the draft Bill provides that the PRA alone is responsible for approving individuals performing significant influence functions in dual-regulated firms. It is expected that the PRA would consult the FCA under the general duty to consult. The FSA expressed concern that the PRA will have to consult the FCA but not seek its consent for approved persons:

> "The Netherlands operates a 'twin peaks' system, with an authorisations regime similar to that proposed by the draft Bill for approved persons in that while it confers the decision-making power on one regulator, there is a requirement to consult the other regulator. In a high profile case, the two Dutch regulators were unable to agree on whether the Chief Financial Officer of a firm was fit and proper to hold his post. This disagreement reached the press, and the Dutch Finance Ministry was unable to resolve the regulators' competing views. As a result, the Dutch Government commissioned a report, which led to a recognition that it was unrealistic for two different agencies with differing objectives to agree in all cases where significant regulatory decisions (for example authorisations) were to be made. This has led to a proposal for new legislation giving one regulator the lead in authorisations, but giving the other the right to veto the authorisation".[231]

293. The future senior management of the FCA therefore feel strongly that the draft Bill should—in line with the arrangements for authorisation of firms—require the FCA's consent to the approval by the PRA of any persons holding significant influence in a dual-regulated firm.[232] We have considerable sympathy with this argument. If the FCA is to be able to effectively regulate the conduct of firms it must have a say over whether the people running those firms are fit and proper.

294. **The draft Bill should be amended so that the FCA will have to give its consent before the PRA approves any persons holding significant influence in a dual-regulated firm.**

Influencing EU and international decisions

295. The Treasury, the Bank, the PRA and the FCA will each have separate responsibilities for representing UK interests abroad. The Treasury will continue to represent UK interests in G20, G7 and other international forums. The Bank of England is represented on several G20 and G7 bodies, including the Financial Stability Board. The PRA and FCA will have different responsibilities for representing the UK on the new European Supervisory Authorities (see para 298 below).

296. Given the importance of financial services to the UK economy, it is important that the UK plays a leading role in these organisations. There is however a risk that the UK does not speak with one voice on the international stage and that one body has to represent the UK's position on a subject where it is not the competent national expert. These risks are

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[231] FSA written evidence

[232] FSA written evidence

particularly apparent when considering how the UK regulatory structure will map onto the European regulatory structure.

297. At the top of the new European framework is the European Systemic Risk Board (ESRB). This is a new body that is responsible for macro-prudential oversight of the EU financial system. It will assess, and propose recommendations to reduce, systemic risks in the financial sector. Its remit is therefore very similar to the FPC although it will only have an advisory capacity. Below the ESRB is a system of European financial supervisors, consisting of three European Supervisory Authorities (ESAs). The ESAs are tasked with: harmonising and coordinating the work of Member States' national regulatory bodies; drafting and implementing technical regulatory standards; and mediating between national supervisors where conflicts arise.

298. The ESAs' regulatory responsibilities are divided along subject areas (banks, insurance and securities), while the new UK regulatory bodies will instead be split into prudential and conduct regulation across all subject areas. The two structures are therefore quite different. This difference means it is not simple to ensure that the right people represent the UK on each of the ESAs. Each Member State has one voting seat on each ESA. The draft Bill provides that the PRA will hold the UK's voting seat on the European Banking Authority and European Insurance and Occupational Pensions Authority. The FCA will represent the UK's interests on European Securities and Markets Authority. There will therefore be substantial areas of the ESAs' work which are not the primary responsibility of the institution that holds the voting seat. When this occurs, effective cooperation between the regulatory authorities will be crucial to ensure that the UK's views are best represented.

299. The difference in structure between the UK and European regulatory authorities is a cause of significant concern for some. Barclays stated that "The proposals seem to largely ignore the evolution of a new EU regulatory regime".[233] Sharon Bowles MEP, Chair of the European Parliament Economic and Monetary Affairs Committee, points out that the FCA will be responsible for only about half of ESMA's remit, "leaving the UK views on substantial and relevant issues essentially unrepresented".[234] However, Andrea Enria told us that he did not envisage any difficulties with the differences in the EU and UK regulatory architectures "We have a lot of different institutional architectures across Europe. There are other countries with a twin-peak type of construction, others which are sectoral and others which are still fully integrated. We need to have a European setting that works together with different national settings".[235]

300. The Government is seeking to ensure that the UK's representation on the international stage is as strong as possible by using the draft Bill to ensure that the relevant bodies co-ordinate. Clause 44 requires the Treasury, the Bank of England, the FCA and the PRA to prepare and maintain an MOU describing how they intend to co-ordinate the exercise of their relevant functions so far as they relate to membership of, or relations with, the European Supervisory Authorities,[236] EU institutions and other international organisations.

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233 Barclays written evidence

234 FSA reform threatens influence in Brussels, Financial Times, 5 October 2010.

235 Q 90

236 The European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

301. Subsection (4) requires the MOU to be made with a view to ensuring that:
    - the UK authorities agree consistent objectives in relation to matters of common interest
    - they exercise their relevant functions in a way that is likely to advance those objectives
    - they exercise their relevant functions in a way that is consistent and effective.
302. Subsection (5) requires the MOU to make particular provision on the following points:
    - which authorities are members of which international organisations
    - which authority will represent the UK at certain international organisations
    - what procedures the authorities will follow in agreeing consistent objectives
    - how the authorities will consult each other
303. Hector Sants stated that it is "vitally important ... that Government take the lead in focusing on these financial regulation issues and co-ordinate all other bodies to ensure that you are seeking to influence across the whole spectrum of the various arenas and fora where decisions are made. Effective intervention has to be a fully co-ordinated event between Government and individual authorities. There is an argument for ensuring that Government are doing that. Whether the right place for that is in a Bill is a matter for the Government and Parliament".[237]
304. The CBI suggested the establishment of an executive level international coordination committee, directly accountable to Boards of the regulatory bodies and ultimately to the Treasury.[238] This proposal was supported by Nationwide[239] and Fidelity International.[240]
305. **We strongly support proposals for an international regulatory committee. To be really useful it would need to go wider than just representatives of the FCA and PRA. We suggest that the international co-ordination Memorandum of Understanding establishes a committee responsible for ensuring the UK authorities agree consistent objectives and exercise their functions in a way that is effective. This committee should report to the Chancellor and include representatives of the PRA, the FCA, the Bank and the Treasury. The Treasury should chair this committee.**

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[237] Q 935

[238] CBI written evidence

[239] Nationwide written evidence

[240] Fidelity International written evidence

CHAPTER 5: ACCOUNTABILITY, TRANSPARENCY AND ENGAGEMENT

306. The financial services industry is going to be subject to more intensive supervision than ever before. There are good reasons for this but it is important that the wide remits and powerful tools the new regulatory bodies are being granted are paired with increased transparency, strong governance and clear lines of accountability.

Governance of the Bank

307. The governance structures within the Bank of England have recently been the subject of a detailed report by the House of Commons Treasury Committee.[241] That committee concluded that the role of the Court of the Bank of England needed to be substantially enhanced. It suggested replacing the Court with a new smaller supervisory board with expert members. The new Board would have new responsibilities including conducting ex-post reviews of the Bank's performance in the prudential and monetary fields. The Board would have the responsibilities that the draft Bill gives the Court for setting the Bank's financial stability strategy. It would have sight of all the papers considered by the MPC and FPC and the Chairman of the Board would observe MPC and FPC meetings.

308. The Treasury Committee recommended that the new Board would be responsible for responding to requests for information by Parliament and that it should take a more open approach than the Court.

309. **The evidence we received in the course of our inquiry indicated that the House of Commons Treasury Committee was right to conclude that the governance structures within the Bank need considerable strengthening. Our recommendations about the role of the FPC add weight to this. We support the idea that the Court should be replaced by a Supervisory Board with expert members some of whom should have experience in prudential policy. The new Supervisory Board would be empowered to scrutinise work of its sub-committees and conduct retrospective reviews of decisions taken by the FPC. The reforms in the draft Bill give the Bank significant new powers in macro- and micro- prudential policy. These powers must be paired with reforms to ensure that clear accountability processes are in place. In addition we recommend that the Chairman of the Supervisory Board should be consulted over the appointment of the Governor.**

Scrutiny of macro-prudential tools

310. The FPC will be given its key instruments, the macro-prudential tools, in secondary legislation. The FPC's toolkit will be largely untested. Some of the tools being considered will put considerable new burdens on banks and other firms. Some may be different from the tools being deployed in other countries. It is of utmost importance that Parliament has a proper chance to

[241] House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874).

consider the impact of each tool in some detail before a decision is made about whether to grant the tool to the FPC.

311. Normally, Parliament will be asked to grant each macro-prudential tool through approval of a draft affirmative instrument or, in urgent cases, the 28-day "made affirmative" procedure. The made affirmative procedure involves less parliamentary control. The tool could be used the day it is laid before Parliament and therefore before any scrutiny has taken place. If however approval does not follow within 28 days of the instrument being laid, it would be withdrawn. The Government views the made affirmative procedure as a last resort believing it will "rarely—if ever—need to be used".[242]

312. The Treasury Committee noted that approval of draft affirmative instruments in the House of Commons would normally only require a 90-minute debate in a General Committee and a decision without a debate in the House. It recommended that it should have sight of the text of draft orders two months before they are laid in order to report to the House of Commons in time to inform debate. It also recommended a requirement that debates on orders prescribing macro-prudential measures be held on the floor of the House of Commons, free of the 90-minute restriction.[243]

313. We agree that there should be a system of enhanced parliamentary scrutiny of these important tools. This should apply in both Houses. In para 217 we recommended an enhanced procedure for scrutinising the statutory instruments that will define the PRA's regulatory perimeter. This procedure was based on section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument.

314. We are attracted to a similar procedure for the statutory instruments containing macro-prudential tools. The role given to designated committees of both Houses would allow the Treasury Committee and the appropriate committee in the Lords to bring expertise to bear and trigger the enhanced procedure only if necessary. The enhanced procedure would place a duty on the Minister to consider the reports of each committee and make material changes to the Order if those reports persuade him change is necessary.

315. **The macro-prudential tools to be used by the FPC are of considerable importance. Some of the tools being considered will have a direct effect on the economic circumstances of constituents. Parliament must have an opportunity properly to scrutinise these powers. On the other hand there must be flexibility to grant the FPC new tools quickly in rare and urgent circumstances. In non-urgent cases we recommend that the tools be subject to an enhanced affirmative procedure similar to that set out in Section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument.**

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[242] HM Treasury, A new approach to financial regulation: building a stronger system, February 2011, para 2.75.

[243] House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 119

316. Once Parliament has granted the FPC the power to use a specific macro-prudential tool, it will have that tool at its disposal indefinitely unless the Government decides to lay an order revoking it. The British Bankers' Association suggested that there should be sunset clauses attached to each instrument so that Parliament regularly reviews the FPC's toolkit.[244] Review would be informed by the FPC's reports on its use of macro-prudential tools which we recommend be included in its bi-annual Financial Stability Reports (see para 319). **All statutory instruments aimed at granting macro-prudential tools to the FPC should contain a sunset clause of one parliament. This will allow ongoing parliamentary scrutiny of the FPC's toolkit.**

Transparency of the FPC

317. For the industry, consumer groups and Parliament to be able to understand and scrutinise the work of the FPC it will need to operate in an open and transparent manner. The arrangements proposed in the draft Bill are similar to the arrangements for the MPC. The FPC will publish bi-annual Financial Stability Reports and will release detailed minutes of its quarterly meetings at which it will discuss the state of financial stability and decide how to deploy macro-prudential tools.

318. However, the FPC is a committee of the Court which has shown worrying signs of a lack of transparency by refusing to provide the Treasury Committee with minutes of Court meetings relating to the financial crisis. We hope the FPC takes a more open approach to requests for information.[245]

319. We welcome the publication of detailed minutes and voting records for the FPC's quarterly meetings. The bi-annual Financial Stability Reports should assess the state of financial stability against the early warning indicators which we endorsed at para 53, and report the effectiveness of macro-prudential tools deployed.

Membership of the FPC

320. The majority of the FPC will be Bank of England executives—the Governor, three Deputy Governors (including the chief executive of the PRA) and two others from within the Bank. Four external members will be appointed by the Chancellor. The FCA chief executive will be a member and there will also be a non-voting representative of the Treasury.[246]

321. This contrasts with the PRA and FCA boards which will both have a majority of non-executive directors. The House of Commons Treasury Committee recommended that the FPC have a majority of members from outside the Bank. It argued that this would help minimise the risk of "group think". The Treasury Committee wrote: "The role of external members on the Bank's Committees will be crucial to the success of the proposals ... We would expect that external members will not always agree with the internal Bank executives, but we believe that there should be room for such creative

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[244] British Bankers' Association written evidence

[245] Treasury Select Committee, Correspondence between Treasury Committee and Court of the Bank of England, 31 October 2011

[246] Clause 3 (new Bank of England Act 1998 clause 9B) and HM Treasury, *A new approach to financial regulation: building a stronger system*, February 2011, para 2.76–2.80

tension. Whatever the precise numbers, the external members of both the FPC and MPC should be in the majority".[247]

322. Together the four external members of the FPC are expected to "have recent and relevant financial sector experience, including expertise in non-bank areas such as insurance".[248] Legal and General suggested a specific requirement that the Treasury must satisfy itself that the membership of the FPC as a whole has a sufficient breadth of knowledge or experience across the banking, insurance and investment management sectors.[249] The Association of British Insurers said there should be a requirement that one of the external members has insurance expertise.[250]

323. It may however be hard to recruit people of the right calibre and experience to sit on the FPC. Experience of working in the industry will be crucial but potential conflicts of interest could bar many with jobs in the industry from serving on the FPC. Professor Charles Goodhart said:

> "One of the difficulties is that getting the right external people on to the FPC may be more difficult than for the MPC. You want people who are expert in commercial and financial affairs. If they are on the FPC they really cannot do anything else, whereas in the MPC the experts who have been appointed—and I agree are primarily needed—are basically academic economists who can serve on the MPC without difficulty. Getting the right kind of commercially savvy people on to the FPC is going to be very much harder".[251]

324. Although little can probably be done about salary differentials between the FPC and the City, the Treasury Committee urged the Bank to continue what it described as a flexible interpretation of its code of conduct on FPC appointments:

> "There is a risk that the code of conduct for members of the FPC may prevent or discourage the appointment of experienced industry practitioners whose membership would be of benefit. We have heard evidence that the interpretation of the FPC code of conduct has, to date, been flexible. We welcome this, but fear that there is still a risk that the rules are too tight and may prevent suitable candidates even being considered for appointment. The same concerns apply in the case of the MPC. We recommend that the Bank change its emphasis so that the appointment of industry practitioners becomes easier. This will put more onus on the committees, led by their chairmen, themselves to deal with any conflicts of interest as they arise. In order to do so they should follow best practice of private sector boards".[252]

325. **FPC membership must include experts from across the financial services industry including insurance and the wider economy. The draft Bill should be amended so that there are a majority of non-**

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247 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 101–104

248 HM Treasury, A new approach to financial regulation: the blueprint for reform, par 2.19, June 2011

249 Legal & General written evidence

250 Q 559

251 Q 262

252 House of Commons Treasury Committee, 21st Report (2010–12) *Accountability of the Bank of England* (HC 874), para 91

executives on the FPC. The interpretation of the FPC code of conduct should not prevent individuals with current and recent industry experience from sitting on the FPC but the FPC should develop clear protocols for dealing with conflicts of interest as they arise.

Accountability and engagement of the PRA and the FCA

Transparency

326. We expect that committees of both Houses will want regularly to engage with the new regulators. In order for Parliament to hold the regulators to account they will have to operate in a transparent manner. We welcome the fact that the PRA and FCA will be subject to NAO audit.

327. We also hope that both bodies will publish Board agendas and minutes. The FSA currently publishes a summary of its board minutes (with commercially sensitive information removed). In evidence to the Treasury Committee, Lord Turner said that:

> "You could require that FCA board minutes, to a much greater extent than at the moment, where they deal with a direct public policy issue, are published and set out clearly the arguments for and against, in the way that the MPC minutes or the FPC minutes do".[253]

328. **We recommend that the draft Bill be amended to require the FCA to publish Board & Panel minutes and agendas, where possible and appropriate. Where the FCA board has considered an issue of public policy the minutes should set out clearly the arguments for and against the policy.**

329. The PRA board meetings will largely concern discussions of individual companies. This may mean that a great deal of material would be redacted before publication. Nonetheless the PRA should publish those parts of Board agendas and minutes that are not commercially sensitive so as to give an indication of the nature of its work.

330. Section 348 of the Financial Services and Markets Act relates to "Restrictions on disclosure of confidential information by [the FSA]". That section will be re-enacted in the draft Bill and restricts considerably what information the PRA and FCA will be able to disclose. This could impact on the information available to Parliament and the information available to firms and consumers. The Government is constrained in its ability to amend section 348 as it enacts EU law but witnesses suggested that the UK had gold-plated the relevant directives.[254] Consumer groups called on the Treasury to undertake a review of section 348 in order to identify areas where the regulators can be more transparent.[255] Mark Hoban MP told us that the Treasury is currently looking at the issue.[256] **We look forward to the outcome of the Treasury's review on section 348 of the Financial Services and Markets Act. This section should not be retained as currently drafted. Neither regulator should be unnecessarily**

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253 Oral evidence taken before the Treasury Select Committee on 1 November 2011, Q 116 (HC 1574-ii—inquiry into the Financial Conduct Authority)

254 Which? written evidence

255 Which? written evidence

256 Q 1074

restricted from disclosing information. Section 348 should be amended to make it as unrestrictive as is possible within the confines of EU law.

Engaging with the industry and consumers

331. Sections 9 and 10 of the Financial Services and Markets Act 2000 require the FSA to establish practitioner and consumer panels to represent the interest groups affected by its activities. The FSA has also voluntarily established a third panel, for smaller business practitioners.

332. Under the draft Bill, the FCA will retain the FSA's duties to establish practitioner and consumer panels, will be statutorily obliged to also establish a smaller business practitioner panel and will also retain the FSA's duty to consider representations made by its statutory panels.[257] However, although the draft Bill places the PRA under a duty to establish arrangements for engaging with practitioners (and, potentially, other persons affected by the PRA), it says only that such arrangements "may include the establishment of such panels as the PRA thinks fit". It does not further specify how the PRA should fulfil this duty.[258]

333. Several witnesses suggested that the draft Bill should require the Bank to establish a PRA practitioner panel.[259] Deloitte argued that a permanent practitioner panel would be preferable to ad-hoc consultation as the panel would build-up knowledge of the PRA's approach.[260] The Financial Services Practitioner Panel also argued that panels were preferable on the basis that they provided regular input.[261]

334. The Bank of England made clear that it does not intend to establish a practitioner panel for the PRA. It described the FSA's panels as "essentially legacies of the old self-regulatory arrangements that preceded FSMA".[262] Sir Mervyn King told us that although the Bank intended to *consult* industry, it was not *accountable* to industry.[263] He explained that the Bank was "opposed to statutory practitioner panels but not consultation"[264] and that its intention was to consult widely "with a different group of people each time", tailored to the issue in hand, rather than relying on the fixed membership of a statutory panel.[265] Hector Sants echoed this but further argued that the existence of statutory panels would "create the perception of a relationship which undermines the independence of judgment of the regulator".[266]

335. The draft Bill does not place a duty on the PRA to engage directly with consumers, although it is required to consult with the FCA on matters that may have an adverse effect on FCA objectives. The Government has stated

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257 Clause 5 (new FSMA clauses 1H, 1I, 1J, 1L and 1M)

258 Clause 5 (new FSMA clause 2J)

259 E.g Deloitte written evidence, Financial Services Practitioner Panel written evidence, AgeUK written evidence.

260 Deloitte written evidence

261 Financial Services Practitioner Panel written evidence.

262 Bank of England written evidence

263 Q 782

264 Q 781

265 Q 782

266 Q 948

that this is because the PRA's remit of prudential issues does not require direct consumer consultation, and it is more appropriate for the PRA to consult directly with the FCA on such issues.[267] Hector Sants told us that "if it was necessary to have a consumer input then we would definitely seek it".[268] Nevertheless, Mr Adam Philips, Chairman of the Financial Services Consumer Panel, suggested that certain areas of the PRA's remit (such as mortgages and insurance) would benefit from consumer interest input into decision-making.[269] He argued that without a consumer panel there would be "a significant weakening of the quality of input into [PRA] decisions".[270]

336. **While we consider that it is vital for the PRA to consult with practitioners, and as far as necessary, consumers, we believe it is right that the PRA should not be obliged by legislation to establish panels on the same model as the FCA. In particular, we are concerned that an obligation to create such panels could lead to regulatory capture. However, in the absence of panels it is even more important for the PRA to demonstrate that it is undertaking fair and adequate consultation. We are concerned that there is not yet clarity on how the PRA intends to go about this. We recommend that details of the proposed consultation arrangements are made available for consideration alongside scrutiny of the Bill in Parliament. The PRA should, in addition to its duty to publish details of consultation arrangements, also have a duty to report annually on its consultation activities.**

337. If statutory panels are not appointed, it is even more important for the PRA's Board to include individuals with the appropriate expertise to properly assess the PRA's work in relation to the sectors it regulates. The draft Bill provides for the governing body of the PRA to include a Chair (the Governor of the Bank of England), the PRA chief executive (the Bank's Deputy Governor for prudential regulation), the Bank's Deputy Governor for Financial Stability, and the Chief Executive of the FCA. The draft Bill also states that the majority of the members of the governing body must be non-executive members, and provides for the appointment of further members by the Bank, with the approval of the Treasury.[271] The Government noted that respondents from the insurance sector to its June 2011 consultation had called for insurance expertise to be explicitly represented on the PRA Board:

> "The PRA board must provide a robust challenge to the executive. The legislative requirement for a non-executive majority on the board will help, but it is essential that the board has the right balance of expertise, and the Government expects that the Bank will ensure that this is the case".[272]

338. **The PRA Board must have a balance of expertise reflecting the sectors regulated by the PRA. The draft Bill should make particular**

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[267] HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.78

[268] Q 949

[269] Q 458

[270] Q 448

[271] Schedule 3 (new FSMA Schedule 1ZB)

[272] HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.69

provision for at least one member of the Board to have specialist expertise in the area of insurance. The distinct nature of the insurance role of the PRA has been explicitly recognised through an entire separate objective—it only follows that the prescribed membership of the Board should reflect this responsibility.

Dealing with complaints

339. The Financial Services and Markets Act requires the FSA to have an internal complaints procedure and also to make arrangements for the investigation of eligible complaints arising in connection with the exercise of, or failure to exercise, any of its non-legislative functions.[273] The FSA fulfilled the latter requirement by establishing the independent Office of the Complaints Commissioner (OCC), where complainants dissatisfied with the outcome of the internal procedure can pursue their grievance.

340. The draft Bill imposes requirements on both the PRA and the FCA to establish complaints schemes.[274] However, although the FCA investigator is required to be independent and have his appointment approved by the Treasury (as is the case for the OCC at present), the PRA is required neither to appoint from outside the Bank, nor to have the appointment approved by the Treasury. The draft Bill does however state that the investigator must be free at all times to act independently of the PRA.[275] The Government has stated that "the complaints scheme deals with operational matters (rather than regulatory judgements), and for the scheme to be run by the Bank is consistent with the PRA's position within the Bank of England group".[276]

341. The OCC argued that the complaints scheme for both regulators should be totally independent, with no connection to the regulators or the Bank.[277] In the OCC's view this is particularly important first because the FCA and PRA will have legal immunity for issues relating to negligence, etc.[278] and secondly because the regulators may struggle to adapt to the new regulatory culture, with a risk of "failing to maintain adequate records, and not explaining the rationale behind decisions [that] will leave the PRA open to claims of bias, lack of integrity or negligence".[279]

342. We also heard arguments in favour of a single complaints commissioner shared by the FCA and PRA. The Investment Management Association believed this was necessary to prevent complaints involving coordination between the PRA and FCA from falling between two stools.[280] The single complaints system model was also supported by the Financial Services Practitioner Panel.[281] The OCC told us that separate complaints mechanisms would not only "involve more cost"[282] but could also make complaints harder to resolve:

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273 Financial Services and Markets Act 2000, Schedule 1, paragraph 7.

274 Schedule 3, Part 1 (new FSMA Schedule 1ZA and new FSMA Schedule 1ZB)

275 Schedule 3, Part 1 (new FSMA Schedule 1ZB)

276 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.71

277 Office of the Complaints Commissioner written evidence.

278 Q 460

279 Office of the Complaints Commissioner written evidence.

280 Investment Management Association written evidence

281 Q 460

282 Q 452

> "if you have a complaint, for example, against the FCA, they may use as a partial explanation the policy of the PRA, who would have a different Complaints Commissioner, not truly independent ... if the FCA use, as part of their cover for what they did or did not do, a policy of the PRA, who in turn may blame the FPC, I can see there being problems".[283]

343. **Given the shift in regulatory architecture and culture, it is vitally important for the new regulatory bodies to have effective, independent complaints systems. The arrangements in the draft Bill do not provide for a sufficiently independent system at the PRA. We believe that the PRA should, mirroring arrangements under the current system, have an independent complaints commissioner whose appointment must be confirmed by the Treasury. In order to ensure that complaints concerning co-ordination between the PRA and FCA are properly handled and resolved, we recommend a single complaints commissioner and system covering both the FCA and the PRA.**

Appealing regulatory decisions

344. Judgement-led supervision will mean a more intense and invasive regulatory approach. The new product intervention powers are significant new tools. An increase in the regulatory powers must be balanced with a clear route for appeal and review.

345. The draft Bill allows regulated firms to appeal PRA or FCA decisions at Tribunal (a collection of specialist judicial bodies with responsibility for deciding disputes in particular areas of law). The Financial Services and Markets Act specifies that, for the purposes of its provisions, "tribunal" means the Upper Tribunal, the body that otherwise considers appeals against rulings by the First-Tier Tribunal.[284]

346. In certain cases the draft Bill limits the actions available to the Tribunal. A distinction is made between disciplinary matters or those involving specific third party rights,[285] and other cases, generally "supervisory action taken in pursuance of wider public-policy aims such as consumer protection",[286] (for example, a decision by the PRA to vary a person's permission to carry on regulated activities). In the latter set of cases, if the Tribunal chooses not to uphold the decision of the regulator it will not usually be able to substitute its own opinion. It will instead be limited to referring the decision back to the regulator with a direction to reconsider.[287] The draft Bill does not place a duty on the regulator to explain its reasons if it does not accept the decision of the Tribunal.

347. The British Bankers' Association raised concerns that this limitation would lead to a "potentially toothless review process", representing a serious erosion of firms' rights to an independent review of contested decisions.[288]

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283 Q 450

284 Financial Services and Markets Act section 417(1)

285 Specifically, those set out in FSMA section 393(11) regarding the right of a third party to appeal to tribunal if he alleges that a copy of a regulator's decision notice ought to have been made available to him, but was not.

286 Explanatory notes to the draft Bill, paragraph 218.

287 Clause 20 (new FSMA clauses (6) and (6A)

288 British Banking Association written evidence.

The Government has stated that the arrangements provide an appropriate balance between the rights of those affected by supervisory decisions and the fact that, in line with the principal of judgement based regulation, "the regulators are best placed to determine the nature of the regulatory action which should be taken".[289] This view was echoed by Hector Sants, discussing the PRA:

> "Asking another set of individuals who are not technical experts in that area to second-guess the judgment, as opposed to the process, would to some degree be contradictory to the basic intent of the proposition ... We just need to think through the whole philosophy of what we have tried to do here and go back to the core question: do you want the regulator only to make decisions on observed facts so that it can defend itself to the Court, or do you want it to be brave and ask the question, "I don't like that business model, it might fail in the future and I will challenge the bank's management as to whether it should persist with that business model"?"[290]

348. **We acknowledge the concerns that in certain cases the Upper Tribunal will be confined to referring contested decisions back to the regulators, rather than substituting its own opinion. However, we believe that the PRA or FCA, as the regulators, will remain better placed to reach an informed judgement. Allowing the Tribunal to substitute its own opinion for that of the regulator would undermine the principle of judgement-based regulation.**

Reports on regulatory failure

349. There is always a possibility that either of the regulators may fail to meet their objectives. It is important that if and when this happens there is a thorough investigation to ascertain why the failures occurred and what lessons can be learnt from them. The value of such a report is demonstrated by the very recently published report by the FSA on the failure of RBS. **It should be standard practice to publish a report after major regulatory failure.**

350. The draft Bill includes requirements for both the FCA and the PRA to investigate and report on regulatory failures. There are however concerns about the criteria set out to trigger an investigation and how the FCA should balance the requirement to report on regulatory failure with the requirements to enforce regulatory action against firms associated with the event where the regulator is said to have failed.

351. The FCA must carry out an investigation where two triggers have been met:

- that, in the assessment of the FCA, there has been an adverse impact on any of its objectives; and
- that regulatory failure has been a possible contributing factor.[291]

352. The first trigger would include events that:

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289 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.66

290 Q 953

291 HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.131

- indicated a significant failure to secure an appropriate degree of protection for consumers;
- had or could have had a significant adverse effect on the integrity of the UK financial system;
- had or could have had a significant adverse effect on efficiency and choice in the market for the services;
- caused or could have caused a significant restriction in competition in the provision of those services.[292]

353. The PRA must carry out an investigation where the following triggers have been met:
    - where public funds have been provided to or in respect of certain persons and where this may not have occurred but for regulatory failure; or
    - where serious damage has been caused to the values underpinning the PRA's objectives and this might not have occurred but for regulatory failure.[293]
354. The second trigger would include events that:
    - had or could have had a significant adverse effect on the safety or soundness of one or more other PRA-authorised persons, or
    - related to a PRA-authorised person and indicated a significant failure to secure an appropriate degree of protection for policyholders (in the case of PRA-regulated insurance contracts).[294]
355. For both the PRA and FCA, the regulators must assess whether triggers have been met. In addition, the Treasury can direct the regulators to carry out an investigation if it considers that the triggers have been met or where it considers that an investigation is in the public interest.[295]
356. The FSA raised some specific issues relating to how the requirement to produce regulatory failure reports will work in practice. Its main concerns centred around two areas: the objectivity of triggers, and how regulatory failure inquiries will fit with ongoing enforcement action.
357. The FSA thought that it was inappropriate for the regulators themselves to decide if triggers for a report on their own failure had been met. It also was unsure how the FCA triggers relating to its efficiency and choice objective and to impacts on competition would work in practice, particularly as they could be used by firms to challenge product intervention powers. The FSA also asserted that there is a lack of clarity about the thresholds for triggering the reports. It suggested some objective triggers, such as a particular level of redress paid as a result of mis-selling or a certain scale of levy made by the Financial Services Compensation Scheme.[296]

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[292] Clause 51

[293] HM Treasury, A new approach to financial regulation: the blueprint for reform, June 2011, Cm 8308, para 2.73

[294] Clause 52

[295] Clauses 51, 52 and 54

[296] FSA supplementary written evidence

358. **There are some advantages to have an objective set of triggers for regulatory failure inquiries, to ensure clarity and increase accountability. However, these would be very difficult to define. It is important to note that even if the FCA or PRA does not think the threshold for an inquiry has been met, the Treasury will, under the proposals, be able to direct the regulators to undertake an inquiry. Given this, we do not think that the Bill needs to contain more specific objective triggers.**

359. Early reports on regulatory failure would have benefits in terms of understanding why failures occurred and taking steps to reduce the probability of such events in the future. However, there could be conflicts with the need to avoid prejudicing potential enforcement action against firms and individuals. If the regulatory failure took place in respect of an investigation of a particular action of a particular firm, and that investigation is ongoing when the report on regulatory failure is ready, then publishing the report could pre-empt the related enforcement action. In addition, dealing with both a regulatory report and enforcement action at the same time could have operational implications, with a risk of inconsistency and duplication if separate teams were used. The FSA said that in light of its previous experience, including preparing the report on the failure of RBS, pursuing enforcement action and producing a report at the same time "would involve considerable difficulties from both a legal and operational standpoint".[297] The FSA added that the RBS report had involved a "very lengthy and difficult debate" and a long discussion about the use of the FSA's powers to collect information and what usage that information could be used for.[298] The FSA has suggested that clear political guidance is needed on how to balance reports on regulatory failure and enforcement action.

360. There is some flexibility in the draft Bill as to how an investigation on regulatory failure should be conducted. Specifically, Clause 55 states that it is for the regulator to decide how to carry out an investigation, subject to certain provisions:

> "55 Conduct of investigation
>
> (1) Where a regulator is required by section 51 or 52 or under section 54 to carry out an investigation, it is for the regulator to decide how it is to be carried out, but this is subject to the following provisions.
>
> (2) The Treasury may, by a direction to the regulator, control
>
> a) the scope of the investigation;
>
> b) the period during which the investigation is to be carried out;
>
> c) the conduct of the investigation;
>
> d) the making of reports.
>
> (3) A direction may, in particular
>
> a) confine the investigation to particular matters;
>
> b) extend the investigation to additional matters;

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[297] FSA written evidence

[298] Q 995

c) require the regulator to postpone the start of an investigation until a specified time or until a further direction;

d) require the regulator to discontinue the investigation or to take only such steps as are specified in the direction;

e) require the regulator to make such interim reports as are so specified." [299]

361. Under the draft Bill, the Treasury can therefore direct the regulator as to the timing of the investigation, as well as other matters. However, at the moment, neither the Treasury nor the regulator is explicitly required to consider the impact of regulatory failure investigations on other regulatory activity, including enforcement action.

362. **The Treasury should be required to consider impacts on other regulatory activity, including enforcement activity, when making directors to the regulator on the conduct of investigations into regulatory failure. We also recommend that the regulator should be required to consider the impacts on other regulatory activity, including enforcement activity, when deciding how to conduct a regulatory failure investigation.**

[299] Clause 55

CHAPTER 6: CONCLUSIONS AND RECOMMENDATIONS

363. The following is a list of the conclusions and recommendations that appear in the report. Their place in the main text is indicated in the reference at the end of each paragraph.

Introduction

364. The ICB recommendations on ring-fencing and higher capital requirements are extremely important. Parliament must consider the substance and get the detail right in the legislation that enacts the recommendations. We urge the Treasury to confirm that legislation will be subject to pre-legislative scrutiny in parliament. The legislation enacting the ICB recommendations on ring-fencing should be brought forward during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented as soon as possible. There is a good case for allowing time to rebuild capital requirement adequacy. (para 8)

Is reform necessary?

365. It is vital that legislation makes proper provision for handling crises (including the ongoing need for the lender of last resort function) and resolving bank failures—including possible restructuring of banks to make them more resoluble. (para 10)

366. Successful regulation depends more on the regulatory *culture, focus and philosophy* than on structure. (para 16)

367. To be successful the reforms will have to change the regulatory culture and philosophy. It is through a change in culture and philosophy that the relevant authorities can best ensure both financial stability and good conduct of business. A key aspect of the cultural change needed will be a shift towards forward looking supervision. This will require staff with appropriate experience, approach and attitudes. A change in culture is not something that legislation can guarantee but legislation can influence the culture of a regulator by:

(1) setting objectives,

(2) allocating and aligning powers and responsibilities,

(3) establishing appropriate systems of accountability.

Without significant changes to clarify objectives, allocate appropriate powers and create proper accountability the Bill as currently drafted will not guarantee a change in regulatory culture. This report makes recommendations to address these weaknesses. (para 24)

Objectives

The objective of the FPC

368. We recommend the Government reconsider the drafting of clause 3 (new Bank of England Act 1998 clause 9C(6)) to make clear the importance of monitoring the global exposure of UK banks. (para 32)

369. The reference in the FPC's objective to monitoring "systemic risks attributable to structural features of financial markets or to the distribution of risk within the financial sector" is presumably intended to place a duty on the FPC to consider the interconnected nature of the market—this duty should be made more explicit. (para 33)

Defining financial stability

370. Preventing excessive or inadequate growth of credit will be an important part of the way that the FPC meets its objective. However, it will also need flexibility to consider other factors which bear on the stability of the financial system. Moreover, it would in our view be premature to attempt to set quantitative targets for credit growth before the FPC has experience of developing and applying macro-prudential tools. So we do not recommend setting a credit based objective for the FPC. (para 40)

Financial stability and economic growth

371. The Government is right to require the FPC to consider the impact of its decisions on growth. But the Bill's current drafting is too strong and restrictive. The FPC is not authorised to take any actions to promote stability if it is likely to have a significant adverse effect on the financial sector's contribution to growth in the medium or long term. The Bill should be redrafted so that like the MPC, the FPC must have regard to the Government's growth and other economic objectives subject to meeting its primary responsibility of attaining financial stability. (para 44)

The role of the Treasury in interpreting the financial stability objective

372. The draft Bill should be amended so that the Treasury, not the FPC, have the final say about the remit of the FPC. We would normally expect the Treasury and the FPC to come to an agreement about the remit and therefore we would not expect the Treasury to have to override the FPC on a regular basis. If the FPC has any objections to the annual remit issued by the Treasury it should make these public and alert the House of Commons Treasury Committee. Notwithstanding that the Treasury may suggest matters that the FPC should regard as relevant to the Committee's understanding of the Bank's financial stability objective the Bank of England will remain responsible for the entirety of that objective. (para 49)

Indicators of financial stability

373. The FPC should begin work towards developing indicators of financial stability in dialogue with the Treasury. They should be published and the FPC should report against them. The set of indicators should be flexible and subject to regular review. (para 54)

Financial stability and recourse to public funds

374. We agree with the Chancellor that avoiding where possible the need for taxpayers' money to support or rescue parts of the financial services industry is a key element of financial stability. There will of course always be a possibility that public funds are called on to preserve stability but part of the objective of the FPC should be to minimise the likelihood of this happening.

The FPC's objective should be amended to require it to "reduce the likelihood of recourse to public funds". (para 58)

Possible conflict between the MPC and the FPC

375. We do not expect any serious conflicts between the MPC and FPC but they may arise. Careful co-ordination and communication should minimise the risks as should the evolution of the FPC's interpretation of its objectives. In the rare occasions when the two committees come into conflict the Governor should inform the Court—or the equivalent body if it is reformed—and the Chancellor, to explain how the conflict will be handled. Even if there is a difference of opinion the two committees must remain independently responsible for their own levers. (para 70)

Governance structure of FPC and MPC

376. The governance arrangements in the draft Bill—where the FPC is a committee of the Court and the MPC is a committee of the Bank—risk giving the impression that one body is more important than the other. The FPC should be made a committee of the Bank. (para 74)

The objectives of the PRA

377. In order to align its objectives with its own activities and with international best practice, the Bill should explicitly give the PRA a microprudential objective alongside its concern with avoiding risks to the whole system. When supervising PRA regulated persons, the primary objective should remain to reduce risks to the stability of the UK financial system. The secondary objective should be to reduce potential costs of failure to the Financial Services Compensation Scheme, taxpayer funds and customers. Neither objective requires the PRA to be a zero failure regulator. The second objective will mean ensuring firms comply with rules on for example, capital adequacy, solvency and liquidity that will reduce but not eliminate the likelihood of failure. (para 78)

Should the PRA have regard to competition?

378. Competition within the financial sector is an important part of developing a stronger, more diverse system. The actions of the PRA have the potential to affect the costs of individual firms or of particular types of institution, and affect the barriers to entry and expansion in the market. While the need to protect and promote competition in the sector should not dictate the actions of the PRA, nor detract from the clear role of the OFT in this area, we believe it is a factor that ought to be considered in the course of PRA decision making. We invite the Treasury to consider how best this duty could be included in the Bill. (para 83)

The PRA's insurance objective

379. There is legal uncertainty regarding the definition of the "reasonable expectations" of policyholders. Using a phrase of this kind makes it difficult for the PRA to be clear on the meaning of its duties, and near to impossible for consumers and Parliament to hold the PRA to account for its actions. The phrase has been shown to be problematic in the past: it is unwise for the Treasury to revive it in new legislation and thereby risk the same difficulties

recurring. The PRA should be responsible for ensuring that with-profits consumers are treated fairly, but the Treasury must find a way to redraft the Bill to achieve this end without using the problematic phrase "reasonable expectations". The PRA should be given an explicit duty to consult the FCA, as the consumer expert, on matters affecting with-profits consumers. (para 90)

Objectives of the FCA

The FCA's strategic objective

380. The FCA's strategic objective should be amended to focus on promoting fair, efficient and transparent financial services markets that work well for users. This would better reflect the Treasury's intended purpose for the FCA, which is to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants. (para 99)

Efficiency and choice operational objective

381. We recommend that the FCA should have a clearer role in promoting competition. To this end the FCA's operational objective of "promoting efficiency and choice" should be replaced by "promoting competition, efficiency and choice for the benefit of consumers". This will give the FCA a clear mandate in the area of competition and a clear responsibility for taking forward some of the ICB's recommendations aimed at making it easier for customers to move between retail banks and compare products. (para 103)

The definition of consumer in the FCA's objectives

382. Given that the draft Bill requires the FCA to tailor its approach to different types of consumer we believe the definition of "consumer" should remain broad and not be restricted to a narrower category. (para 111)

Balancing the responsibilities of consumers and firms

383. We recommend that the consumer responsibility principle be complemented by an amendment to the draft Bill to place a clear responsibility on firms to act honestly, fairly and professionally in the best interests of their customers. The FCA should be empowered to hold firms to account for this and ensure companies address conflicts of interest and the needs that consumers may have for advice and information that is timely, accurate, intelligible to them and appropriately presented. (para 126)

384. Clearly, the actions firms should be expected to take will depend on context and circumstances. For example, the way information is presented to retail consumers is likely to be different from that appropriate for a professional investor. (para 128)

Responsibilities and powers

Responsibilities and powers during a crisis

385. The powers and responsibilities of the Bank of England and the Treasury during a crisis are key. They should be carefully reviewed in light of the concerns we have raised. A duty for these bodies to co-ordinate in a crisis

should be on the face of the Bill. The definition of the term "material risk" should be subject to parliamentary approval and not left to a Memorandum of Understanding. The Bill should also make it clear that there are no circumstances where it is permissible for the Bank not to notify the Treasury as soon as material risk to public funds becomes clear. (para 140)

386. The Bill should be amended so as automatically to give the Chancellor power to direct the Bank after a formal warning of a material risk to public funds. At this stage ultimate responsibility rests with the Chancellor. (para 143)

Powers and duties of the FPC

Powers to identify and monitor systemic risks

387. We are sympathetic to the need for the FPC to have powers to collect information from those outside the regulatory perimeter. In fact the FPC will normally be able to obtain the information it needs through the PRA but sometimes this might cause delay. The FPC should be given a reserve power if it thinks that requesting the information directly through the PRA could cause delay or have adverse consequences. (para 148)

Power of direction

388. Where the FPC is to be given the power to direct the PRA and FCA to implement a macro-prudential tool it should also be given the power to direct the regulators as to the timing and means of implementing that tool. The FPC should use this power where the timing and means of implementation are likely to have a significant impact on the effectiveness of the tool. If these circumstances do not exist the decisions about timing and means are better left to the regulators—the PRA and FCA—who hold the expert knowledge. (para 161)

Power for the FPC to set UK macro-prudential rules

389. We welcome the language in the proposed Capital Requirements Directive IV that appears to allow member state authorities to take into account "structural variables and the exposure of the banking sector to any other risk factors related to risks to financial stability". Nevertheless, the Government must continue to push for the removal of all restrictions on the ability of member states to raise their capital requirements above internationally agreed minima. Such freedom to impose higher capital requirements is essential given the large size of Britain's banking sector relative to its economy. (para 172)

390. The FPC and the PRA should consider carefully what actions they will take with regard to capitalisation and liquidity requirements in the event of another crisis and must consider to what extent they are currently constrained by European regulation and how far this represents a threat to the UK's ability to respond to any financial crisis. Where they assess that they are constrained by European regulation they should report this to the Treasury and to the committee that we recommend as being responsible for co-ordinating international representation on these type of issues. (para 175)

Powers and responsibilities of the PRA

Powers in respect of firms headquartered outside the UK

391. For all major banks with significant branches in the UK the PRA should be on the college of supervisors for that bank. (para 178)

392. Even though the PRA may under CRD IV gain limited powers to oversee the UK operations of EEA firms these will remain ultimately the responsibility of their home state regulator. The PRA and the FCA should seek to ensure that the public understand when a banking group is not subject to UK prudential regulation. Where deposits are not covered by the Financial Services Compensation Scheme the regulators should require banks to make this clear with prominent warnings in branches and on websites. The regulators should work with consumer groups to plan how best to get this message heard and understood. (para 180)

393. The PRA will be under a duty to co-ordinate with international regulators.[300] This is an immensely important duty given the international dimension of many of the firms whose failure could impact on the stability of the UK financial system. In order that the PRA can be effectively held to account for its duty to co-ordinate with international regulators we recommend a further duty to report on its work in this area. (para 182)

The impact of ICB recommendations on the PRA's responsibilities

394. The ICB recommendations are key to the work of the regulators established by the draft Financial Services Bill. For example, without the ICB reforms it will be harder for the PRA to meet its objective of minimising the impact of firm failure. The legislation enacting the ICB recommendations on ring-fencing should be introduced into parliament during the 2012–13 Session in order to give banks a clear framework to work to. The ring-fence should be implemented speedily. By contrast there is a good case for allowing banks to build up capital over time. Furthermore, the Government should think carefully about imposing on banks headquartered in the UK capital requirements relating to their overseas subsidiaries over and above that agreed by the international college of regulators. (para 185)

395. It should be for Parliament to define the ring-fence for retail banking. The definition may need adjusting from time to time and therefore should not be enshrined in primary legislation. Instead it should be set out in secondary legislation so it can be more easily reviewed and adjusted. It should not be left to the Bank or the regulators to define the ring-fence. (para 187)

Empowering the PRA to conduct judgement-led supervision

396. Forward looking supervision is a desirable aim. Mechanical enforcement of rules should not be the objective of the regulators. We agree with the Bank of England that more needs to be done to ensure the PRA has the legal power to supervise using forward looking judgement. As a first step the Bill should be amended to place a duty on the PRA to supervise firms. The Treasury should then consider how to enshrine in the legislation the concept of forward looking supervision. In particular, the threshold conditions which set out what firms must do to become and remain authorised should be carefully

[300] Consolidated FSMA clause 354B

reviewed to ensure that they embody all the things that the PRA may wish to consider in a forward looking regime. (para 196)

397. There has been concern and uncertainty about what forward looking supervision might mean for firms. Once established, the new regulators should provide clarity on this issue. A less predictable approach means that regulators will have greater discretion and it is therefore important that attention is paid to the proportionality principle. (para 197)

398. The new committee which we proposed be established to agree objectives and maximise the UK's influence in EU and international negotiations should have as an objective ensuring that the European rulebook does not limit the necessary discretion of the UK supervisory authorities to achieve forward looking regulation. (para 198)

Attracting the right staff

399. The PRA and the FCA will need to attract staff with the appropriate approach and experience if the required cultural change is to be realised. There is considerable debate, which we cannot resolve, about how this can be achieved within the financial constraints of public sector bodies. The PRA and the FCA should publish practical plans that explain how they will ensure that they have staff with suitable skills and how they will develop careers for financial regulators in the public service. They should report against progress in this area in their annual reports. (para 201)

Designation of PRA activities

400. The PRA's regulatory perimeter should be broader. We should expect firms of the significance of MF Global, and firms engaging in rehypothecation of client money and assets, to be supervised by the PRA. (para 209)

401. We are persuaded that there is cause for concern in the area of regulation of holding companies, and recommend that the Treasury examine how it can provide the PRA with more comprehensive powers to ensure a consistent regulatory approach. (para 211)

402. It is right that the designation of PRA regulated activities is left to secondary legislation. The financial landscape develops quickly and any definition fixed in primary legislation could soon become redundant or inadequate. The secondary legislation approach will allow a quicker response if the regulatory perimeter needs to be changed in order to accommodate a new area of risk. Nevertheless, given that the initial designation of PRA regulated activities is a key factor in understanding the intentions and scope of the Bill, a draft of the Order must be available when the Bill is introduced into parliament. (para 213)

403. The procedures for orders designating PRA activities should be amended to provide for an enhanced affirmative procedure in non-urgent cases, retaining the made affirmative procedure for urgent cases only. We appreciate that there will be instances where fast action is required, but it is not appropriate for the 28-day procedure to be applied as a matter of routine. The enhanced affirmative procedure should be modelled on that contained in Section 11 of the Public Bodies Act. (para 217)

Responsibility for considering the ethics and remuneration structures of firms

404. The Government should consider the FSA's recommendations on changing the remuneration arrangements for executives and non-executive directions, or introducing a concept of 'strict liability' of executives and Board members for the adverse consequences of poor decisions, in order to ensure that bank executives and Boards strike a different balance between risk and return. Amendments could be brought forward to this Bill. (para 225)

Responsibility for markets

405. For consistency of regulation, there is a strong rationale for keeping regulation of market infrastructure together. Given the PRA's role in regulating prudentially significant firms, we recommend that the regulation of market infrastructure should sit within the PRA. As is the case for other PRA-regulated firms, the FCA will have an important role in regulating market infrastructure with the respect to conduct issues, and it is important that the legislation makes this clear. Appropriate coordination mechanisms between the two regulators will be required. (para 231)

406. We are concerned by the gap in resolution arrangements for market infrastructure firms that may be of systemic importance. The Treasury should take action to ensure that this gap is closed. (para 233)

Information from auditors

407. The PRA will be better able to identify risks building up in individual firms if it established an effective working relationship with bank auditors. The draft Bill should be amended to place a statutory duty on the PRA to meet regularly with bank auditors. The Treasury should consider whether any complementary duties can and should be placed on auditors for example to draw certain risks to the attention of regulators. (para 236)

Quality of information held by firms

408. The Bill should be amended to place a duty on the Bank of England (or its subsidiary the PRA) to develop information standards for the UK financial services industry and to report regularly on progress in improving these information standards in order to support financial stability. (para 243)

Powers and responsibilities of the FCA

Responsibility for consumer credit

409. We welcome the Government's decision to look at whether consumer credit should be moved to the FCA. Consumer credit products may pose different problems to other financial products, and it is important that the way in which they are regulated is proportionate, taking into account costs to firms and potential benefits to consumers. However, given the potential for consumer detriment in the case of some types of credit products, there are significant benefits in transferring consumer credit to the FCA, to ensure clarity of responsibilities, and to ensure that the FCA is better able to identify and deal with consumer issues across the financial services market. (para 250)

Early publication of disciplinary action

410. We recommend that the requirement to consult before disclosing the fact that a warning notice has been issued should be removed from the draft Bill. However, we do think it important that the FCA has the discretion to weigh the relevant factors and decide which set of interests listed in the Bill (fairness, potential to be prejudicial and potential for detriment to financial stability) are best served by disclosing or not disclosing that a warning notice has been issued. We also think that the FCA should be required to publish guidance as to how it will exercise its discretion in respect of disclosing that a warning notice has been issued. This will provide some degree of certainty to firms over how the FCA will treat different cases. (para 258)

Trusted consumer products

411. A system of identifying and certifying simple, low cost financial products is an attractive idea. This is not a role that the regulator should take on but it is something the voluntary sector itself may be well placed to do. The FCA should be prepared to help the voluntary sector in these endeavours by providing information on products and their costs. (para 263)

Competition powers

412. The Government should review its decision on the FCA's competition powers. The FCA should be given concurrent powers alongside the OFT to make market investigation references to the CC. The FCA will need greater competition powers to achieve its recommended objective than is currently set out in the draft Bill. (para 279)

413. We also recommend that designated consumer bodies should be able to make super-complaints to the FCA, as well as the OFT. (para 280)

PRA and FCA duty to co-ordinate

414. The PRA and FCA must co-ordinate as far as possible to minimise the burden on dual-regulated firms. We welcome the assurances that information given to one regulator will be shared with the other so that the same information will not have to be given twice. While a joint rule book and a single point of contact may not be possible, the two bodies should consider other methods of reducing the burden. A draft of the Memorandum of Understanding on co-ordination between the PRA and FCA must be available when the Bill is introduced into parliament. (para 291)

415. The draft Bill should be amended so that the FCA will have to give its consent before the PRA approves any persons holding significant influence in a dual-regulated firm. (para 294)

Influencing EU and international decisions

416. We strongly support proposals for an international regulatory committee. To be really useful it would need to go wider than just representatives of the FCA and PRA. We suggest that the international co-ordination Memorandum of Understanding establishes a committee responsible for ensuring the UK authorities agree consistent objectives and exercise their functions in a way that is effective. This committee should report to the Chancellor and include representatives of the PRA, the FCA, the Bank and the Treasury. The Treasury should chair this committee. (para 305)

Accountability, transparency and engagement

Governance of the Bank

417. The evidence we received in the course of our inquiry indicated that the House of Commons Treasury Committee was right to conclude that the governance structures within the Bank need considerable strengthening. Our recommendations about the role of the FPC add weight to this. We support the idea that the Court should be replaced by a Supervisory Board with expert members some of whom should have experience in prudential policy. The new Supervisory Board would be empowered to scrutinise work of its sub-committees and conduct retrospective reviews of decisions taken by the FPC. The reforms in the draft Bill give the Bank significant new powers in macro- and micro- prudential policy. These powers must be paired with reforms to ensure that clear accountability processes are in place. In addition we recommend that the Chairman of the Supervisory Board should be consulted over the appointment of the Governor. (para 309)

Scrutiny of macro-prudential tools

418. The macro-prudential tools to be used by the FPC are of considerable importance. Some of the tools being considered will have a direct effect on the economic circumstances of constituents. Parliament must have an opportunity properly to scrutinise these powers. On the other hand there must be flexibility to grant the FPC new tools quickly in rare and urgent circumstances. In non-urgent cases we recommend that the tools be subject to an enhanced affirmative procedure similar to that set out in Section 11 of the Public Bodies Act 2011. This would provide for consideration by the relevant select committees in both Houses and where appropriate would place a duty on the Treasury to consider those committees' recommendations before laying the final instrument. (para 315)

419. All statutory instruments aimed at granting macro-prudential tools to the FPC should contain a sunset clause of one parliament. This will allow ongoing parliamentary scrutiny of the FPC's toolkit. (para 316)

Membership of the FPC

420. FPC membership must include experts from across the financial services industry including insurance and the wider economy. The draft Bill should be amended so that there are a majority of non-executives on the FPC. The interpretation of the FPC code of conduct should not prevent individuals with current and recent industry experience from sitting on the FPC but the FPC should develop clear protocols for dealing with conflicts of interest as they arise. (para 325)

Accountability and engagement of the PRA and the FCA

Transparency

421. We recommend that the draft Bill be amended to require the FCA to publish Board & Panel minutes and agendas, where possible and appropriate. Where the FCA board has considered an issue of public policy the minutes should set out clearly the arguments for and against the policy. (para 328)

422. We look forward to the outcome of the Treasury's review on section 348 of the Financial Services and Markets Act. This section should not be retained as currently drafted. Neither regulator should be unnecessarily restricted from disclosing information. Section 348 should be amended to make it as unrestrictive as is possible within the confines of EU law. (para 330)

Engaging with the industry and consumers

423. While we consider that it is vital for the PRA to consult with practitioners, and as far as necessary, consumers, we believe it is right that the PRA should not be obliged by legislation to establish panels on the same model as the FCA. In particular, we are concerned that an obligation to create such panels could lead to regulatory capture. However, in the absence of panels it is even more important for the PRA to demonstrate that it is undertaking fair and adequate consultation. We are concerned that there is not yet clarity on how the PRA intends to go about this. We recommend that details of the proposed consultation arrangements are made available for consideration alongside scrutiny of the Bill in Parliament. The PRA should, in addition to its duty to publish details of consultation arrangements, also have a duty to report annually on its consultation activities. (para 336)

424. The PRA Board must have a balance of expertise reflecting the sectors regulated by the PRA. The draft Bill should make particular provision for at least one member of the Board to have specialist expertise in the area of insurance. The distinct nature of the insurance role of the PRA has been explicitly recognised through an entire separate objective—it only follows that the prescribed membership of the Board should reflect this responsibility. (para 338)

Dealing with complaints

425. Given the shift in regulatory architecture and culture, it is vitally important for the new regulatory bodies to have effective, independent complaint systems. The arrangements in the draft Bill do not provide for a sufficiently independent system at the PRA. We believe that the PRA should, mirroring arrangements under the current system, have an independent complaints commissioner whose appointment must be confirmed by the Treasury. In order to ensure that complaints concerning co-ordination between the PRA and FCA are properly handled and resolved, we recommend a single complaints commissioner and system covering both the FCA and the PRA. (para 343)

Appealing regulatory decisions

426. We acknowledge the concerns that in certain cases the Upper Tribunal will be confined to referring contested decisions back to the regulators, rather than substituting its own opinion. However, we believe that the PRA or FCA, as the regulators, will remain better placed to reach an informed judgement. Allowing the Tribunal to substitute its own opinion for that of the regulator would undermine the principle of judgement-based regulation. (para 348)

Reports on regulatory failure

427. It should standard practice to publish a report after major regulatory failure. (para 349)

428. There are some advantages to have an objective set of triggers for regulatory failure inquiries, to ensure clarity and increase accountability. However, these would be very difficult to define. It is important to note that even if the FCA or PRA does not think the threshold for an inquiry has been met, the Treasury will, under the proposals, be able to direct the regulators to undertake an inquiry. Given this, we do not think that the Bill needs to contain more specific objective triggers. (para 358)

429. The Treasury should be required to consider impacts on other regulatory activity, including enforcement activity, when making directions to the regulator on the conduct of investigations into regulatory failure. We also recommend that the regulator should be required to consider the impacts on other regulatory activity, including enforcement activity, when deciding how to conduct a regulatory failure investigation. (para 362)

APPENDIX 1: JOINT COMMITTEE ON THE DRAFT FINANCIAL SERVICES BILL

The Members of the Joint Committee that conducted this inquiry were:

Baroness Drake
Lord Maples
Lord McFall of Alcluith
Lord Newby
Lord Skidelsky
Baroness Wheatcroft
Nicholas Brown MP
David Laws MP
Peter Lilley MP (Chairman)
David Mowat MP
George Mudie MP
David Ruffley MP

Professor Alistair Milne, Professor of Financial Economics at Loughborough University and Professor Kern Alexander, senior research fellow, Centre for Financial Analysis and Policy, University of Cambridge, were the Specialist Adviser's for this inquiry.

Declaration of Interests

The following interests were declared:

Lord McFall of Alcluith
Revenue from advising KPMG on a consultancy basis

Baroness Wheatcroft
Shareholding in Barclays
Consultant at DLA Piper LLP

Rt Hon David Laws MP
Membership of the Investment Committee of Stanhope Capital

Rt Hon Peter Lilley MP
Holdings in a JP Morgan investment trust

David Mowat MP
Shareholdings in Lloyds, Credit Agricole, Barclays, Banco Santander, HSBC, Legal & General, Prudential, RBS and Standard Chartered

No other relevant interests have been declared.

Dr Alistair Milne
No relevant interests

Dr Kern Alexander
Member of the Expert Panel on Financial Services for the European Parliament

Full lists of Members' interests are recorded in the Commons Register of Members' Interests:
http://www.publications.parliament.uk/pa/cm/cmregmem/contents.htm
and the Lords Register of Interests:
http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests/

APPENDIX 2: LIST OF WITNESSES

Evidence is published online at www.parliament.uk/financialservicesbill and available for inspection at the Parliamentary Archives (020 7219 5314)

Evidence received by the Committee is listed below in chronological order of both oral evidence session and in alphabetical order. Those witnesses marked with * gave both oral evidence and written evidence. Those marked with ** gave oral evidence and did not submit any written evidence. All other witnesses submitted written evidence only.

Oral evidence in chronological order

**	QQ 1–29	Mr Charles Dumas, Chairman, Lombard Street Research Ltd
*		Ms Gillian Tett, US Managing Editor, Financial Times
**	QQ 30–63	Lord Burns, non-Executive Chairman of Santander UK plc and of Alliance & Leicester plc
**	QQ 64–98	Mr Andrea Enria, Chairman, European Banking Authority
**	QQ 99–118	Dr Malcolm Edey, Reserve Bank of Australia
*	QQ 119–155	Consumer Focus
*		Which?
*		Citizens Advice Bureau
*		moneysavingexpert.com
**		Mr Paul Lewis, freelance financial journalist
*	QQ 156–206	Financial Services Compensation Scheme
*		Financial Ombudsman Service
*		Money Advice Service
**	QQ 207–245	Rt Hon Alistair Darling MP
**	QQ 246–287	Professor Charles Goodhart CBE
*		Professor Eilis Ferran
**		Professor John Kay
**	QQ 288–530	Sir John Vickers, Chair, Independent Commission on Banking
*	QQ 351–394	Association of Financial Markets in Europe (AFME)
**		British Private Equity and Venture Capital Association (BVCA)
**	QQ 395–437	Association of Private Client Investment Managers and Stockbrokers
*		Investment Management Association (IMA)
**		National Association of Pension Funds

*	QQ 438–481	Complaints Commissioner
*		Financial Services Consumer Panel
*		Financial Services Practitioner Panel
**		FSA Smaller Businesses Practitioner Panel
*	QQ 482–557	Association of British Credit Unions (ABCUL)
**	QQ 438–557	Association of Financial Mutuals
*	QQ 438–557	Association of Independent Financial Advisers
*	QQ 438–557	Building Societies Association
**	QQ 438–521	Institute of Financial Planning
**	QQ 522–557	International Regulatory Strategy Group (City of London)
*	QQ 558–642	Association of British Insurers
**	QQ 643–691	Sir John Gieve
*	QQ 692–761	Barclays
*		HSBC
**		Royal Bank of Scotland
*	QQ 762–847	Bank of England
**	QQ 848–914	Deutsche Bank
*		Goldman Sachs
**		JP Morgan
*	QQ 915–1004	Financial Services Authority
*	QQ 1005–1076	Rt Hon George Osborne MP, Chancellor of the Exchequer, HM Treasury
*		Rt Hon Mark Hoban MP, Financial Secretary, HM Treasury

Alphabetical list of witnesses

AEGON

AGE UK

* Association of British Credit Unions Limited (ABCUL)

* Association of British Insurers (ABI)

* Association for Financial Markets in Europe (AFME)

** Association of Financial Mutuals

* Association of Independent Financial Advisers (AIFA)

** Association of Private Client Investment Managers

AVIVA

AXA Group

* Bank of England

* Barclays
Berwin Leighton Paisner LLP
TRG Bingham
Professor Julia Black, London School of Economics and Political Science
Brewin Dolphin
British Bankers Association (BBA)
British Insurance Brokers' Association (BIBA)
** British Private Equity and Venture Capital Association (BVCA)
The Building Societies Association (BSA)
Campaign for Community Banking Services
Cazenove Capital Management
The Chartered Financial Analyst Society of the United Kingdom (CFA UK)
Chartered Insurance Institute (CII)
* Citizens Advice Bureau
City of London Corporation
TheCityUK
Confederation of British Industry (CBI)
Consumer Credit Association (CCA)
* Consumer Focus
Council of Mortgage Lenders (CML)
** Rt Hon Alistair Darling MP
Mr TWR Davies
Deloitte LLP
** Deutsche Bank
** Mr Andrea Enria, European Banking Authority
Euroclear UK & Ireland Limited (EUI)
* Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University
Fidelity International
Finance and Leasing Association (FLA)
Financial Ombudsman Service
* Financial Services Authority (FSA)
** Financial Services Authority Smaller Businesses Practitioner Panel
* Financial Services Compensation Scheme
* Financial Services Consumer Panel
* Financial Services Practitioner Panel
Futures and Options Association

** Sir John Gieve
* Goldman Sachs
** Professor Charles Goodhart CBE
Professor Maximilian J B Hall, Loughborough University
Herbert Smith LLP
* HM Treasury
* HSBC
ICE
Institute of Chartered Accountants in England and Wales
** Institute of Financial Planning
Institute of Insurance Brokers (IIB)
Intellect
** International Regulatory Group
* Investment Management Association (IMA)
** JP Morgan
** Professor John Kay, Economist
Lansons Communications LLP
Legal and General Group
** Mr Paul Lewis
Listing Authority Advisory Committee
Lloyds Banking Group
London Stock Exchange Group
Professor Niamh Moloney, London School of Economics
* Money Advice Service
The Money Advice Trust
* MoneySavingExpert.com
** National Association of Pension Funds
Nationwide Building Society
NYSE Euronext
* Office of the Complaints Commissioner
Office of Fair Trading
Old Mutual plc
Positive Money
Quoted Companies Alliance (QCA)
Rathbone Brothers
** Reserve Bank of Australia
Reynolds Porter Chamberlain LLP

* Royal Bank of Scotland
Shelter
Smaller Businesses Practitioner Panel
* Ms Gillian Tett, US Managing Editor, Financial Times
Unite the Union
** Sir John Vickers, Chair, Independent Commission on Banking
Mr Michael J Wade, Chairman, Besso Insurance Group
* Which?
Williams Farrell Woodward

APPENDIX 3: CALL FOR EVIDENCE

A new joint committee has been appointed by both Houses of Parliament to conduct pre-legislative scrutiny of the draft Financial Services Bill. The Joint Committee comprises 6 MPs and 6 Peers. It will take oral and written evidence and make recommendations in a report to both Houses. The Joint Committee invites interested organisations and individuals to submit written evidence as part of the inquiry.

Below are specific questions about the details of the draft Bill. The Joint Committee would appreciate written submissions on any of these questions on which you have evidence to contribute. It is not necessary to address every question.

In addition to the detailed questions the Joint Committee is interested in whether the draft legislation will or could better:

- prevent another financial crisis,
- handle a financial crisis,
- deal with bank failure and protect the public purse.

The Joint Committee is also interested in whether the proposals in the draft Bill will increase or decrease the risk or regulatory arbitrage of financial businesses.

The following detailed questions are also of interest:

(1) Is the separation of prudential and conduct regulation into a "twin peaks" system the right approach?

(2) What lessons can be learnt from the approach of other countries to regulation of the financial sector?

(3) Is it appropriate to make such major changes to the regulatory system by way of amending legislation, rather than starting afresh?

(4) Are the accountability and governance arrangements for the Bank of England, FPC, PRA and FCA satisfactory?[301]

(5) Are the FPC's objectives the right ones? Is the concept of financial stability adequately understood for the FPC to be able to perform against its objectives?

(6) Should the FPC be limited in the actions it can take which might affect the growth of the financial sector?

(7) How will the interaction between macro-prudential and monetary policies be handled by the FPC and the MPC?

(8) Has the right balance been struck between the powers of the FPC and the powers of the Treasury?

(9) Can Parliament take an informed decision about the proposals for the FPC without details of the macro-prudential tools at its disposal?

(10) Does the draft Bill adequately deal with the risks posed by the shadow banking system?

[301] Please do not send submissions that were originally prepared for the Treasury Select Committees inquiry into the accountability of the Bank of England. The Joint Committee already has access to those submissions.

(11) Are the PRA's objectives clear and appropriate?

(12) Are there any risks in the Government's proposed 'judgement-based' regulation?

(13) Is the Government's proposed approach to 'orderly' firm failure satisfactory?

(14) Given that the PRA and the FCA will inherit FSA staff does the draft Bill do enough to ensure a new regulatory culture and a more proactive approach to regulation? Will these two new bodies have staff with the appropriate skill and expertise?

(15) Are the FCA's primary objectives appropriate? Is significant emphasis given to the promotion of competition?

(16) Are the responsibilities of the FCA towards the regulation of markets appropriate?

(17) Does the draft Bill strike the right balance between the responsibilities of consumers and firms? Are the FCA's new powers in the area of consumer protection appropriate?

(18) Are the prudential regulatory responsibilities of the FCA towards FCA-only regulated firms given sufficient emphasis and detail?

(19) Will the new regulatory arrangements reduce the risk and cost of dealing with miss-selling of financial products?

(20) Are the proposals for co-ordination between the PRA and FCA clear and adequate? What would be the advantages and disadvantages of having a Single Point of Contact and/or a joint rule book for dual-regulated firms?

(21) How do the proposals in the draft Bill fit within the new European regulatory regime? What freedoms and constraints will the UK have to operate within that regime?

(22) Does the draft Bill contain any proposals or omissions, not covered by the questions above, which cause concern?

You need not address all these questions. Short submissions are preferred. A submission longer than six pages should include a one-page summary. Submissions should be in Word format where possible.

Submissions, which should be original and not copies of papers written for the Government consultations or any other inquiry, must be received by **Friday 2 September 2011**.

APPENDIX 4: FORMAL MINUTES

Extract from the House of Lords Minutes of Proceedings of 21 June 2011

Draft Financial Services Bill—Lord Strathclyde moved that it is expedient that a Joint Committee of Lords and Commons be appointed to consider and report on the draft Financial Services Bill presented to both Houses on 16 June (Cm 8083) and that the committee should report on the draft Bill by 1 December 2011. The motion agreed to and a message was sent to the Commons.

Extract from the Vote and Proceedings of the House of Commons of 19 July 2011

Draft Financial Services Bill—Resolved, That this House concurs with the Lords Message of 21 June, that it is expedient that a Joint Committee of Lords and Commons be appointed to consider the draft Financial Services Bill presented to both Houses on 16 June (Cm 8083).

Ordered, That a Select Committee of six Members be appointed to join with the Committee appointed by the Lords to consider the draft Financial Services Bill presented to both Houses on 16 June (Cm 8083).

That the Committee should report on the draft Bill by 1 December 2011.

That the Committee shall have power—

(i) to send for persons, papers and records;

(ii) to sit notwithstanding any adjournment of the House;

(iii) to report from time to time;

(iv) to appoint specialist advisers; and

(v) to adjourn from place to place within the United Kingdom.

That Mr Nicholas Brown, Mr David Laws, Mr Peter Lilley, David Mowat, Mr George Mudie and Mr David Ruffley be members of the Committee-(*Sir George Young*).

Amendment proposed, in line 14, leave out 'David Laws'-(*Thomas Docherty*.)

Motion made and Question put forthwith, That, at this day's sitting, the Motion in the name of Sir George Young relating to Draft Financial Services Bill (Joint Committee) shall be proceeded with, though opposed, until any hour-(*Mr Philip Dunne*.)

The House divided.

Division No. 329.

Ayes: 297 (Tellers: Mr Philip Dunne, Mark Hunter).

Noes: 6 (Tellers: John Mann, Thomas Docherty).

Question accordingly agreed to.

Motion made and Question put forthwith, That, at this day's sitting, Standing Order No. 41A (Deferred divisions) shall not apply to the Motion in the name of Sir George Young relating to Draft Financial Services Bill (Joint Committee)–(*Mr Robert Goodwill*.)

The House divided.

Division No. 330.

Ayes: 290 (Tellers: James Duddridge, Mark Hunter).

Noes: 6 (Tellers: John Mann, Thomas Docherty).

Question accordingly agreed to.

The House resumed the debate.

Mr Alistair Carmichael claimed to move the closure (Standing Order No. 36).

Question put, That the Question be now put.

The House divided.

Division No. 331.

Ayes: 273 (Tellers: Mr Philip Dunne, Mark Hunter).

Noes: 9 (Tellers: John Mann, Kelvin Hopkins).

Question accordingly agreed to.

Question accordingly put, That the Amendment be made.

Question negatived.

Main Question put and agreed to.

Resolved, That a Select Committee of six Members be appointed to join with the Committee appointed by the Lords to consider the draft Financial Services Bill presented to both Houses on 16 June (Cm 8083).

That the Committee should report on the draft Bill by 1 December 2011.

That the Committee shall have power-

(i) to send for persons, papers and records;

(ii) to sit notwithstanding any adjournment of the House;

(iii) to report from time to time;

(iv) to appoint specialist advisers; and

(v) to adjourn from place to place within the United Kingdom.

That Mr Nicholas Brown, Mr David Laws, Mr Peter Lilley, David Mowat, Mr George Mudie and Mr David Ruffley be members of the Committee.

Extract from the House of Lords Minutes of Proceedings of 20 July 2011

Draft Financial Services Bill—The Chairman of Committees moved that the Commons message of 19 July be considered and that a Committee of six Lords be appointed to join with the Committee appointed by the Commons to consider and report on the draft Financial Services Bill presented to both Houses on 16 June (Cm 8083) and that the Committee should report on the draft Bill by 1 December 2011;

That, as proposed by the Committee of Selection, the following members be appointed to the Committee:

B Drake, L McFall of Alcluith, L Maples, L Newby, L Skidelsky, B Wheatcroft;

That the Committee have power to agree with the Committee appointed by the Commons in the appointment of a Chairman;

That the Committee have power to send for persons, papers and records;

That the Committee have power to appoint specialist advisers;

That the Committee have leave to report from time to time;

That the Committee have power to adjourn from place to place within the United Kingdom;

That the reports of the Committee from time to time shall be printed, regardless of any adjournment of the House; and

That the evidence taken by the Committee shall, if the Committee so wishes, be published.

The motion was agreed to and a message was sent to the Commons.

Extract from the House of Lords Minutes of Proceedings of 13 September 2011

Draft Financial Services Bill—Lord Strathclyde moved that, notwithstanding the Resolution of this House of 21 June, it be an instruction to the Joint Committee on the Draft Financial Services Bill that it should report on the draft Bill by 16 December 2011. The motion was agreed to.

Extract from the Votes and Proceedings of the House of Commons of 13 September 2011

Draft Financial Services Bill (Joint Committee on)—The Lords have come to the following resolution to which they desire the agreement of the Commons: That, notwithstanding the Resolution of this House of 21 June, it be an instruction to the Joint Committee on the Draft Financial Services Bill that it should report on the draft Bill by 16 December 2011.

Wednesday 20 July 2011

Present**:**

Lord McFall of Alcluith	Mr Nicholas Brown MP
Lord Maples	Mr Peter Lilley MP
Lord Newby	David Mowat MP
Baroness Wheatcroft	Mr David Ruffley MP

Members' interests: The full lists of Members' interests as recorded in the Commons

Register of Members' Interest and the Lords Register of Interests are noted. Declared interests are appended to the report.

Lord McFall of Alcluith declared revenue from advising KPMG on a consultancy basis.

Baroness Wheatcroft declared a shareholding in Barclays.

Mr Peter Lilley MP declared holdings in a JP Morgan investment trust.

David Mowat MP declared shareholdings in Lloyds, Credit Agricole, Barclays, Banco Santander, HSBC, Legal & General, Prudential, RBS and Standard Chartered.

It is moved that Mr Peter Lilley MP do take the Chair—(Lord Newby.)

The same is agreed to.

The Orders of Reference are read.

The Joint Committee deliberate.

The Call for Evidence is agreed to.

Ordered, That the public be admitted during the examination of witnesses unless otherwise ordered.

Ordered, That written evidence and the uncorrected transcripts of evidence given, unless the Committee otherwise ordered, be published on the internet.

Ordered, That the Lords Delegated Powers and Regulatory Reform Committee be invited to submit a memorandum to the Committee.

Ordered, That the Joint Committee be adjourned to Tuesday 6 September at half-past Three o'clock.

Tuesday 6 September 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord Newby	David Mowat MP
Lord Skidelsky	Mr George Mudie MP
Baroness Wheatcroft	Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

Ordered, That Professors Alistair Milne and Kern Alexander be appointed as Specialist Advisers.

Resolved, That the Joint Committee request an extension to its deadline.

Ordered, That the Joint Committee be adjourned to Thursday 8 September at 9.30am.

Thursday 8 September 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	Mr George Mudie MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Mr Charles Dumas, Chairman, Lombard Street Research Ltd, Ms Gillian Tett, US Managing Editor, Financial Times; and Lord Burns, non-Executive Chairman of Santander UK plc and of Alliance & Leicester plc.

Ordered, That the Joint Committee be adjourned to Tuesday 13 September at 3.30pm.

Tuesday 13 September 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	Mr George Mudie MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Mr Andrea Enria, Chairman, European Banking Authority.

Ordered, That the Joint Committee be adjourned to Thursday 15 September 2011 at 8.15am.

Thursday 15 September 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	Mr George Mudie MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Dr Malcolm Edey, Assistant Governor (Financial system) of the Reserve Bank of Australia *(via video link);* Ms Christine Farnish, Chair, Consumer Focus, Mr Peter Vicary-Smith, Chief Executive, Which?, Ms Gillian Guy, Chief Executive, Citizens Advice Bureau, Mr Martin Lewis, moneysavingexpert.com and Mr Paul Lewis, freelance financial journalist; Mr Mark Neale, Chief Executive, Financial Services Compensation Scheme; Ms Natalie Ceeney, Chief Executive and Chief

Ombudsman, Financial Ombudsman Service; and Mr Tony Hobman, Chief Executive, Money Advice Service.

Ordered, That the Joint Committee be adjourned to Tuesday 11 October 2011 at 3.30pm.

Tuesday 11 October 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	Mr George Mudie MP
Baroness Wheatcroft	Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Rt Hon Alistair Darling MP, former Chancellor of the Exchequer (2007–10)*;* Professor Charles Goodhart CBE, Professor Emeritus of Banking and Finance, London School of Economics, Professor Eilis Ferran, Professor of Companies and Securities Law, Cambridge University, and Professor John Kay, Economist.

Ordered, That the Joint Committee be adjourned to Thursday 13 October 2011 at 9.30am.

Thursday 13 October 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Mowat MP
Lord McFall of Alcluith	Mr David Ruffley MP
Lord Skidelsky	
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witness is examined:

Sir John Vickers, Chair, Independent Commission on Banking.

Ordered, That the Joint Committee be adjourned to Tuesday 18 October 2011 at 3.30pm.

Tuesday 18 October 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP

Lord McFall of Alcluith
Lord Newby
Lord Skidelsky
Baroness Wheatcroft
David Mowat MP
Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Mr Peter Beales, Managing Director, Policy Division, Association of Financial Markets in Europe (AFME), and Mr Mark Florman, Chief Executive, British Private Equity and Venture Capital Association (BVCA); Mr Richard Saunders, Chief Executive, Investment Management Association (IMA), Mr Ian Cornwall, Chief Executive, Association of Private Client Investment Managers and Stockbrokers, and Mr David Paterson, Head of Corporate Governance, National Association of Pension Funds.

Ordered, That the Joint Committee be adjourned to Thursday 20 October 2011 at 9.30am.

Thursday 20 October 2011

Present:

Lord Maples
Lord Newby
Lord Skidelsky
Baroness Wheatcroft
Mr Nicholas Brown MP
David Laws MP
Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Mr Russell Collins, Chairman, Financial Services Practitioner Panel; Mr Guy Matthews, Chairman, FSA Smaller Businesses Practitioner Panel, Mr Adam Phillips, Chairman, Financial Services Consumer Panel, and Sir Anthony Holland, Complaints Commissioner; Mr Mark Lyonette, Chief Executive, Association of British Credit Unions Limited, Mr Martin Shaw, Chief Executive, Association of Financial Mutuals, Mr Jeremy Palmer, Head of Financial Policy, Building Societies Association, Mr Steve Gay, Director General, Association of Independent Financial Advisers, and Mr Nick Cann, Chief Executive, Institute of Financial Planning; Andre Villeneuve, Chairman, International Regulatory Strategy Group (City of London).

Ordered, That the Joint Committee be adjourned to Tuesday 25 October 2011 at 3.30pm.

Tuesday 25 October 2011

Present:

Baroness Drake
Mr Nicholas Brown MP

Lord McFall of Alcluith	David Laws MP
Lord Newby	David Mowat MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Maggie Craig, Director of Conduct Regulation, and Hugh Savill, Director of Prudential Regulation and Taxation, Association of British Insurers.

Ordered, That the Joint Committee be adjourned to Thursday 27 October 2011 at 9.30am.

Thursday 27 October 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord McFall of Alcluith	David Laws MP
Lord Newby	David Mowat MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witness is examined:

Sir John Gieve, Deputy Governor of the Bank of England, 2006–09.

The Joint Committee deliberate.

Ordered, That the Joint Committee be adjourned to Tuesday 1 November 2011 at 3.30pm.

Tuesday 1 November 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	George Mudie MP
Lord Skidelsky	Mr David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Bob Diamond, Chief Executive, Barclays; Stuart Gulliver, Chief Executive, HSBC and Stephen Hester, Chief Executive, Royal Bank of Scotland.

Ordered, That the Joint Committee be adjourned to Thursday 3 November 2011 at 9.30am.

Thursday 3 November 2011

Present:

Baroness Drake
Lord McFall of Alcluith
Lord Newby
Baroness Wheatcroft
Mr Nicholas Brown MP
David Laws MP
David Mowat MP
George Mudie MP
Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Bank of England: Sir Mervyn King, Governor; Paul Tucker, Deputy Governor for Financial Stability; and Andrew Bailey, Deputy Chief Executive designate of the PRA

Ordered, That the Joint Committee be adjourned to Tuesday 8 November 2011 at 3.30pm.

Tuesday 8 November 2011

Present:

Baroness Drake
Lord Maples
Lord McFall of Alcluith
Lord Newby
Lord Skidelsky
Baroness Wheatcroft
Mr Nicholas Brown MP
David Mowat MP
George Mudie MP
Mr David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Andrew Procter, Global Head of Government and Regulatory Affairs, Deutsche Bank, Sally Dewar, Managing Director, International Regulatory Risk, JP Morgan, and Robert Charnley, Head of Regulatory Controllers, EMEA and Asia, Goldman Sachs.

The Joint Committee deliberate.

Ordered, That the Joint Committee be adjourned to Thursday 10 November 2011 at 9.30am.

Thursday 10 November 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	George Mudie MP
Lord Newby	
Lord Skidelsky	
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

The following witnesses are examined:

Hector Sants (CEO of the FSA and CEO designate of the PRA) and Lord Turner (Chairman of the FSA); Martin Wheatley, Managing Director, Conduct Business Unit and CEO designate of the FCA and Margaret Cole, Managing Director, Enforcement, Financial Crime & Markets.

Ordered, That the Joint Committee be adjourned to Tuesday 15 November 2011 at 3.30pm.

Tuesday 15 November 2011

Present:

Baroness Drake	Mr Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	George Mudie MP
Lord Skidelsky	David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate.

Resolved, That the Joint Committee visit the Bank of England in connection with its inquiry.

The following witnesses are examined:

Rt Hon George Osborne, Chancellor of the Exchequer and Mr Mark Hoban, Financial Secretary, HM Treasury.

The Joint Committee further deliberate.

Ordered, That the Joint Committee be adjourned to Monday 21 November at 2.30pm.

Monday 21 November 2011

Present:

Lord McFall of Alcluith	Mr Nicholas Brown MP

Lord Newby	David Mowat MP
Lord Skidelsky	David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (in the Chair)

At 2.30pm, the Joint Committee attended a meeting at the Bank of England, in accordance with the Committee's decision of 15 November. The Committee met with Sir Mervyn King, Governor, Paul Tucker, Deputy Governor for Financial Stability; and Andrew Bailey, Deputy Chief Executive designate of the PRA.

Ordered, That the Joint Committee be adjourned to Tuesday 22 November 2011 at 3.30pm.

Tuesday 22 November 2011

Present:

Baroness Drake	David Mowat MP
Lord Maples	David Ruffley MP
Lord McFall of Alcluith	
Lord Newby	
Lord Skidelsky	
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

The Joint Committee deliberate

Ordered, That the Joint Committee be adjourned to Tuesday 6 December 2011 at 3.30pm.

Tuesday 6 December 2011

Present:

Baroness Drake	Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	George Mudie MP
Lord Skidelsky	David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

A draft Report is presented by the Chairman.

The Joint Committee deliberate

Ordered, That the Joint Committee be adjourned to Thursday 8 December 2011 at 9.30am.

Thursday 8 December 2011

Present:

Baroness Drake	Nicholas Brown MP
Lord McFall of Alcluith	David Laws MP
Lord Newby	David Mowat MP
Lord Skidelsky	George Mudie MP
Baroness Wheatcroft	David Ruffley MP

Mr Peter Lilley MP (*in the Chair*)

A draft Report is presented by the Chairman.

The Joint Committee deliberate

Ordered, That the Joint Committee be adjourned to Tuesday 13 December 2011 at 3.30pm.

Tuesday 13 December 2011

Present:

Baroness Drake	Nicholas Brown MP
Lord Maples	David Laws MP
Lord McFall of Alcluith	David Mowat MP
Lord Newby	George Mudie MP
Lord Skidelsky	David Ruffley MP
Baroness Wheatcroft	

Mr Peter Lilley MP (*in the Chair*)

A revised draft Report is presented by the Chairman.

The Summary is agreed to.

The Appendices to the Report are agreed to.

Ordered, That the Summary of Conclusions and Recommendations be printed at the end of the Report.

The Committee agrees that the draft Report, be the Report of the Joint Committee.

Ordered, That certain papers be appended to the Minutes of Evidence.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No 134 of the House of Commons.

Ordered, That the Joint Committee be now adjourned.

APPENDIX 5: NOTE OF VISIT TO THE BANK OF ENGLAND ON 21 NOVEMBER 2011

Bank of England, London, 21 November 2001 at 2.30pm.

Attendance

From the Committee

Lord McFall of Alcluith	Mr Nicholas Brown MP
Lord Newby	Mr Peter Lilley MP
Lord Skidelsky	David Mowat MP
Baroness Wheatcroft	David Ruffley MP

From the Bank of England

Sir Mervyn King, Governor

Paul Tucker, Deputy Governor for Financial Stability

Andrew Bailey, Deputy Chief Executive designate of the PRA

Note of discussion

The Bank of England's lender of last resort function

The Committee and the Bank representatives discussed the Bank's function as lender of last resort. In the course of the discussion the Bank made the following points:

- It was important for central banks to provide liquidity insurance to help institutions overcome short-term liquidity constraints. The provision of short-term liquidity was different to the long-term funding of banks. The problems banks were encountering in raising funds reflected the market's concern about the capital held by banks, relative to the risks they faced.
- Liquidity assistance was provided against collateral in the form of assets held by institutions. Central banks would assess the value and risk of the collateral and lend accordingly. The percentage reduction in the liquidity provided relative to the value of the collateral was known as a 'haircut'. Properly graduated haircuts provided an incentive for institutions to hold good collateral, as well as protecting the central bank.
- The Bank of England had arrangements with financial institutions whereby collateral was assessed and haircuts calculated in advance through 'prepositioning' the collateral with the Bank. In a crisis this would allow for quicker action and more considered haircuts.
- In this way, a central bank could provide a lender of last resort function while helping to incentivise proper management of liquidity in institutions and the holding of good collateral.
- The lender of last resort function was originally intended to support the market as a whole, rather than simply allowing existing banks to remain in business. This was still the key guiding principal. The Bank of England had traditionally been willing to assist individual banks on the basis that

their failure could have consequences for the rest of the market. It was preferable that banks should be able to fail without endangering the stability of the financial system, via employment of effective resolution regimes.

- If a bank was failing, it would eventually get to the point where it did not hold the collateral that would allow the Bank of England to provide liquidity assistance. At this point the Government might choose to step in and provide taxpayers' money. The use of taxpayers' money would always be a decision for the Government, not for the Bank. The Bank may, however, carry out a 'support operation' outside its normal remit, on the decision of the Chancellor. The draft Bill would formalise this procedure. Such operations would be carried out with an indemnity from the Government if the Bank determined that the risk involved exceeded the capacity of the balance sheet.
- 'Normal' liquidity insurance arrangements were carried out with a high degree of transparency. In certain cases the provision of liquidity to a certain institution as part of a 'support operation' would need to be done covertly. In these cases the Chancellor and the Governor would give a private briefing to the Chairs of the Treasury Select Committee and the Public Accounts Committee. The broad substance of the liquidity arrangements would always be revealed at a later date.
- The FPC's role in the liquidity insurance regime would be, for instance, to advise on whether the financial environment required the Bank of England to adjust its arrangements for lender of last resort to the market. The FPC would not have a role in support for individual banks—that would be handled by the Bank executive and Court, PRA Board (on regulatory decisions), and the Government.
- Sound liquidity insurance arrangements and a good resolution regime within the Bank of England should greatly reduce the need for the Chancellor to intervene.
- Any deposit-taking institution would be potentially eligible for liquidity support, whether incorporated in the United Kingdom or abroad, provided it had a banking operation in the UK (whether a branch or subsidiary). A solvency and viability test would be applied to the firms as a whole, in the case of a branch operation. In cases concerning international institutions of this kind the Bank of England would work closely with the 'home' authority and other concerned central banks.

Judgement-led regulation

The Committee was told that FSMA had been designed to be a rules and compliance based regime and that it would be a challenge to amend it to become a piece of legislation promoting judgement-led supervision. The Bank suggested that, in order to empower the regulator to make judgement-based decisions, paragraph 17(1) of new Schedule 1ZB (inserted by Schedule 3 of the draft Bill), should be amended from a duty on the PRA to maintain arrangements designed to enable it to determine whether persons it regulates are complying with relevant requirements, to a duty on the PRA to maintain arrangements that allow it to supervise firms.

The Bank also proposed that threshold conditions for regulation should be amended in line with Paul Tucker and Hector Sants' letter to Mr Lilley of 18 November. This would allow supervision to be focused primarily on judgement-based regulation, rather than on compliance with a rule book. The Bank also suggested that the language of the threshold conditions should be made clearer.

The FPC ought to play a useful role in "backing-up" PRA supervisors, especially in situations where supervisors were using their judgement to impose additional requirements on institutions. The FPC would also have a role in ensuring supervisors pursued potentially systemic issues that might not be apparent to supervisors of a single institution. But the FPC is not a substitute for, and should not become involved in, the discussion of supervisors on institutions. The FPC could also provide support to supervisors tackling highly complex or obscure practices.

The EU single market regime has created a problem for so called "host authorities" where firms branch across borders. This was a particular issue in the UK, where some very large EU banks operate on a brand basis and the regime provides the FSA with very few formal prudential powers. Moreover, the FSA was not always invited to be on the international supervisory colleges for certain "big players" with branches inside the UK. The Bank would expect to pursue that in due course.

Macro-prudential powers

It would be necessary to have an expedited procedure for adjusting the macro-prudential tools established under secondary legislation, with a high threshold and appropriate checks and balances.

Information-gathering powers

For firms within the regulatory perimeter, the Bank agreed that the FPC should gather information indirectly, via the PRA and FCA. However, the Bank felt that the FPC should have the power to gather information directly from firms *outside* the regulatory perimeter. This would make clear that the information gathering was not linked to any supervisory role: if the PRA had the power to gather information from outside its regulatory perimeter, this could create confusion and give the impression that the PRA was somehow supervising those individual firms.

APPENDIX 6: GLOSSARY OF TERMS

Basel III	2010 amendment to the 1988 set of international capital standards developed by the Basel Committee on Banking Supervision. Basel III is a set of reform measures designed to strengthen the regulation, supervision and risk management of the banking sector by improving resilience, transparency, governance and risk management.
capital (adequacy) requirements / capital rations	Levels of capital that institutions must hold to comply with regulations. These requirements are designed to help deal with unexpected losses.
Capital Requirements Directive (CRD)	A European Union directive which implements the Basel agreements on banking supervision.
College of regulators	International forum of the various national regulators of an individual cross-border financial institution
Competition Commission (CC)	Independent Public Body which conducts in-depth inquiries (following a reference made by another authority, most often the OFT) into mergers, markets and the regulation of the major regulated industries, with the aim of ensuring healthy competition.
Counter-cyclical capital buffer	Instrument through which regulators may require banks to hold additional capital during periods of prosperity, in order to slow the growth of credit and also to provide a reserve that can absorb losses in times of difficulty.
Court (of Directors)	The entity that governs the Bank of England, consisting of the Governor, two Deputy Governors and nine non-executive directors drawn mostly from business.
Dodd-Frank Act	Common name for the Wall Street Reform and Consumer Protection Act 2010, a United States Act which aimed to promote financial stability and address the 'too big to fail' problem in the US financial sector.
dual-regulated firms	Firms that, under the draft Bill, would be subject to micro-prudential regulation by the PRA (because they are deemed to be of systemic importance) and conduct of business regulation by the FCA.
European Banking Authority (EBA)	European supervisory authority acting as a 'hub and spoke network' of EU and national bodies safeguarding public values such as the stability of the financial system, the transparency of markets and financial products and the protection of depositors and investors.
European Insurance and Occupational Pensions Authority (EIOPA)	European supervisory authority with specific responsibility for protecting insurance policy holders, pension scheme members and beneficiaries.
European Securities and Markets Authority (ESMA)	European supervisory authority responsible for the transparency and functioning of securities markets.

European Supervisory Authorities (ESAs)	Three European authorities responsible for the regulation of financial services in Europe. Specifically, working to create a single EU rule book and issuing guidance and recommendations to national regulators and firms. The three ESAs are the European Securities and Markets Authority (ESMA), the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA).
European Systemic Risk Board (ESRB)	European body with a mandate to oversee risk in the financial system as a whole, with the power to issue warnings and recommendations.
Financial Conduct Authority (FCA)	New body proposed by the draft Bill, to be responsible for the regulation of conduct of business.
Financial Policy Committee (FPC)	New body proposed by the draft Bill, to be based within the Bank of England, with responsibility for macro-prudential regulation.
Financial Services Authority (FSA)	Independent non-governmental body, established by the Financial Services and Markets Act 2000, currently responsible for regulating the United Kingdom financial industry.
Financial Services Compensation Scheme (FSCS)	Scheme providing compensation to customers of UK-regulated deposit-takers in the event that the institution is no longer able to meet its own claims. Under the scheme, retail deposits receive compensation up to £85,000.
Financial Stability Board (FSB)	Organisation set up to coordinate at the international level the work of national financial authorities and international standard setting bodies.
Independent Commission on Banking (ICB)	Commission, chaired by Sir John Vickers, established by the Government in June 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. The Commission published its final Report on 12 September 2011.
leverage	A firm's ratio of assets to equity (or another measure of capital)
macro-prudential regulation	Regulation that aims to ensure the stability of the banking and financial system as a whole.
Market investigation reference (MIR)	Procedure whereby the OFT refers a market directly to the Competition Commission, on the basis of suspicions that market features are preventing, restricting or distorting competition.
micro-prudential regulation	Regulation that aims to ensure the health and stability of individual financial institutions.
Monetary Policy Committee (MPC)	Committee within the Bank of England composed of nine members (five from within the Bank and four external members) with responsibility for setting interest rates.

Office of Fair Trading (OFT)	A non-ministerial government department and the UK's consumer and competition authority, responsible for enforcing consumer protection legislation, and also competition law under the Competition Act 1998.
Payment protection insurance (PPI)	Payment protection insurance covers loans or debt repayments in the event of problems such as inability to work due to illness or redundancy.
proportionality principle	The regulatory principle, set out in Clause 3B of the draft Bill, that "a burden or restriction that is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction".
Prudential Regulation Authority (PRA)	New body proposed by the draft Bill, under the auspices of the Bank of England, with responsibility for ensuring the "safety and soundness" of systemically-significant financial institutions.
Resolution	The process whereby the authorities seek to manage the failure of an institution in a safe and orderly way
retail banking	the provision of services to individuals and small / medium sized businesses, largely deposit-taking, payment services and lending.
ring-fencing	The isolation of certain banking services in an independently capitalised entity. The Independent Commission on Banking recommended a retail ring-fence to isolate certain retail banking services.
shadow banking	Term covering a broad range of institutions that are not banks in themselves but which conduct banking activities. Hedge funds and securities dealers could fall into this category.
Solvency II	A review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements.
Special resolution regime (SRR)	The Special Resolution Regime (SRR) sets out a permanent framework providing tools for dealing with distressed banks and building societies. It was introduced by the Banking Act 2009.
sunset clause	Clause in legislation setting an expiry date for a particular provision, designed to prevent the continuation in statute of unnecessary or (in hindsight) undesirable provisions.
super-complaint	Complaint made to the Office of Fair Trading by a designated consumer body, where a feature, or combination of features, of a market appears to be significantly harming the interests of consumers. The OFT has a duty to respond to a super-complaint within 90 days.
systemic risk	The risk of significant disruption to the financial system as a whole.

Tribunal	Specialist judicial body with responsibility for deciding disputes in particular areas of law.
tripartite system	Current UK regulatory system under which three authorities—the Bank of England, the Financial Services Authority and the Treasury—are collectively responsible for financial stability, with financial regulation resting with the FSA.
twin peaks	Financial regulation model under which prudential regulation and conduct of business regulation are carried out by different bodies.
Vickers Commission	The Independent Commission on Banking (see above)

APPENDIX 7: ABBREVIATIONS

ABI	Association of British Insurers
BBA	British Banking Association
BoE	Bank of England
CBI	Confederation of British Industry
CC	Competition Commission
CMA	Competition and Markets Authority
CRD	Capital Requirements Directive
EBA	European Banking Authority
EIOPA	European Insurance and Occupational Pensions Authority
ESA	European Supervisory Authority
ESMA	European Supervision and Markets Authority
ESRB	European Systemic Risk Board
FCA	Financial Conduct Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
ICB	Independent Commission on Banking
MIR	Market Investigation Reference
MOU	Memorandum of Understanding
MPC	Monetary Policy Committee
OCC	Office of the Complaints Commissioner
OFT	Office of Fair Trading
PPI	Payment Protection Insurance
PRA	Prudential Regulation Authority
RBS	Royal Bank of Scotland
RIE	Recognised Investment Exchange
SRR	Special Resolution Regime

APPENDIX 8: MEMORANDUM FROM THE DELEGATED POWERS AND REGULATORY REFORM COMMITTEE

NB: References in this memorandum to page numbers are to the page numbers of the draft Bill itself (and not the white paper).

I. This memorandum responds to your invitation of 20 July to the Delegated Powers and Regulatory Reform Committee to contribute to your Committee's scrutiny of the draft Financial Services Bill. The Committee considered the draft bill at its meeting this morning. We have been assisted by a memorandum by HM Treasury (HMT) which identifies and explains the delegations in the bill.

2. We value the opportunity to contribute to the pre-legislative scrutiny of this draft bill. In making these observations, our opinion should not be taken to prejudge our position should a bill be introduced: we will report to the House at that stage on whether its provisions inappropriately delegate legislative power or whether they subject the exercise of legislative power to an inappropriate degree of parliamentary scrutiny. We have considered each issue purely as a question of delegation, and not of policy.

Powers conferred on the Treasury

3. The draft Bill confers a number of powers on the Treasury to make orders or regulations.

Henry VIII powers—powers to amend primary legislation may be found at:

Clause 5	• new section I F (page 18, line 11)
	• new section 3B(3) (page 26, line 39)
Clause 6	• new section 22A(3) (page 34, line 4)
Clause 24	• new section 192A(4) (page 99, line 13)
	• new section 192B(8) (page 100, line 24)
Clause 37	• new section 3540(4) (page 113, line 5)
Schedule 8, para 4	• new section 204A(6) (page 192, line 42)
Schedule 8, para 13(5)	• new subsection (11) (page 195, line 13)
Schedule 8, para 15(7)	• new subsection (14) (page 196, line 10)
Schedule 8, para 17(8)	• new subsection (12) (page 197, line 10)

Other delegated powers—other powers to make orders or regulations may be found at:

Clause 3	• new section 9K (page 7, line 25)
Clause 5	• new section 21(6) (page 24, line 30)
	• new section 3G(1) (page 29, line 25)
Clause 6	• new section 22A (page 33, line 30)
Clause 8	• new section 55D (page 37, line 15)
	• new section 55Q(I) and (4)(a) (page 46, lines 25 and 34)
	• new section 55R(2) (page 47, line 43)
Clause 21	• new section 137C(1)(b) (page 72, line 29)

	• new section 1370(7) (page 80, line 11)
	• new section 138E(6) (page 84, line 25)
	• new section 138L(6)(c) (page 88, line 42)
Clause 24	• new section 192B(4) (page 100, line 6)
Clause 45(4)	• (page 117, line 33)
Clause 53(6)	• (page 122, line 29)
Clause 69(2)	• (page 135, line 21)
Schedule 4, paras 2(3), 3(3), 15(3) and 16	• (page 163, line 36; page 164, line 38; page 167, line 40; page 168, line 3)
Schedule 5, para 15(3)	• (page 177, lines 11 and 22)
Schedule 8, paras 4, 13(3), 15(7) and 17(6) and (8)	• (page 192, lines 21 and 34; page 194, line 28; page 196, line 2; page 196, line 28; page 197, line 2)
Schedule 9, para 3(4)	• (page 203, line 41)

There are also various expansions or other modifications of existing powers, including at clauses 26 (page 104, line 9), 59 (page 125) and 66 (page 134, line 29).

Powers conferred on regulators

4. The Financial Services and Markets Act 2000 (the 2000 Act) confers numerous powers on the Financial Services Authority (FSA) to make rules, give directions and issue codes, statements and guidance. There are various requirements as to consultation, procedure and publicity which must be met in relation to rules, but the rules are not subject to any Parliamentary control.

5. Clause 5 of the draft Bill re-names the FSA as the Financial Conduct Authority (FCA). There will also be a second regulator, the Prudential Regulation Authority (PRA). Though neither the FCA nor the PRA will actually be established by legislation, there are rules about their constitution and governance set out in new Schedule IZA and IZB respectively to the 2000 Act, inserted by Schedule 3 to the draft Bill (page 141). These provisions are similar to those which currently apply to the FSA.

6. The draft Bill gives the FCA and the PRA extensive powers to make rules, give directions and issue codes, statements and guidance. These powers do not differ significantly in principle from those which Parliament has already conferred on the FSA, nor, generally speaking, does the overall procedural framework within which those powers must be operated differ significantly from the existing framework. This framework is summarised at paragraphs I 0 to 17 of HMT's memorandum, and Annex I to the memorandum shows the provisions in the 2000 Act from which the powers to make rules conferred by the draft Bill derive and summarises the differences.

Issues for the Joint Committee

7. Though the structure of regulation for financial services under the draft Bill is more complex than current arrangements (because there will be two regulators rather than one) the overall approach of the draft Bill does not seem to raise any novel issues about delegated powers. But there are some points of detail the Delegated Powers Committee draws to the attention of the Joint Committee.

Clause 3—macro-prudential measures

8. Under new section 9G of the Bank of England Act 1998, inserted by clause 3 of the draft Bill, the Financial Policy Committee (a sub-committee of the court of directors of the Bank of England) may give a direction to the FCA or the PRA requiring them to exercise their functions so as to secure implementation of a macro-prudential measure described in the direction. The direction must be complied with (new section 9H). But it is left to the Treasury to prescribe by order what is a "macro-prudential measure" in respect of which a direction may be given (new section 9K).

9. The reason for this power is explained at paragraph 28 of HMT's memorandum. We do not consider it inappropriate; and the importance of the power is recognised by the application of the draft affirmative procedure or, in urgent cases, the 28-day "made affirmative" procedure, explained at paragraph 39 of HMT's memorandum.

10. There are, however, two aspects of this power to draw to the Joint Committee's attention which are notable, not inappropriate. First, the macro-prudential measure may be framed by reference to a publication issued by FCA, the PRA, another body in the UK or an international institution, as the publication has effect from time to time. This inevitably permits an element of sub-delegation (see paragraph 34 of HMT's memorandum) since the scope of the order may be determined by changes to the other publication, over which there is no Parliamentary control. Secondly, the order may exclude or modify any procedural requirement that would otherwise apply under the 2000 Act in relation to cases where the FCA or the PRA is complying with a direction (see paragraph 36 of HMT's memorandum). The affirmative procedure should be a sufficient safeguard against inappropriate use of these powers.

Clause 5—consumer protection and integrity objectives

11. There is an important new power, subject to affirmative procedure, at new section 1F of the 2000 Act (page 18, line 12). The FCA has extensive rule-making powers, but this is balanced by a framework set out in some detail in the Act. (This is acknowledged at paragraph 12 of HMT's memorandum.) The new power enables the Treasury to modify that framework by re-defining "consumers" and "services" for the purposes of two of the FCA's objectives. (There is also a related power to alter the meaning of "consumers" for the purposes of new section 3B (regulatory principles) on page 26.) However, there is an element of "fine-tuning" about this and in view of the affirmative procedure the Delegated Powers Committee is not concerned by the extent of the powers.

Clause 5—FCA/PRA boundaries

12. New section 3G(1) (page 29, line 25) enables the Treasury to specify matters which, for PRA-authorised persons, are primarily the responsibility of one regulator rather than the other. The explanation for this power is at paragraphs 74 and 75 of HMT's memorandum and we do not question the appropriateness of the delegation.

13. However, we do draw the Joint Committee's attention to the choice of Parliamentary procedure, which in all cases is the made affirmative procedure (28-day order), i.e. the order is made and may have effect immediately (before approval) but lapses unless approved within 28 days. This is justified at paragraph 77 of HMT's memorandum partly by reference to the possibility of the need to act

urgently. But it is not suggested that there will be urgency in every case and in those circumstances one might have expected the 28-day procedure to apply only where the Treasury considered that urgency required it, with the normal draft affirmative procedure applying in other cases. Powers with procedural provisions of that kind occur elsewhere in the Bill—on pages 8 (new section 9L of the Bank of England Act 1998—paragraph 9 above) and 99 (new section 192A(5) to (9) of the 2000 Act). But another consideration for the choice of procedure is consistency with the procedure for orders under section 22 (as to which see paragraphs 14 and 15 below).

Clause 6—PRA-regulated activities

14. New section 22A of the 2000 Act (page 33, line 30) enables the Treasury by order to specify which regulated activities are to be regulated by the PRA and provide for exceptions and other ancillary matters. These orders are generally subject to negative procedure, which seems appropriate. But in three cases the orders are 28-day affirmative orders:

- the first order under section 22A;
- orders which, in exercise of the power in section 22A(2)(e) and (3) make consequential etc. provision which amends an Act;
- orders which bring an activity within PRA regulation or move it out of PRA regulation.

15. As respects those three cases, the same point appears to arise here as with orders under new section 3G(1) (paragraphs 12 and 13 above, and see paragraph 96 of HMT's memorandum). But paragraph 95 of the memorandum suggests that the procedure for orders under section 22A should reflect that for orders under section 22 (under paragraph 26 of Schedule 2 to the 2000 Act), which deal with what is a regulated activity. This is reasonable and is what the draft Bill achieves. But it is usual nowadays for the 28-day affirmative procedure to apply only where there is urgency. The procedure for orders under section 22 of the 2000 Act derives from that in section 2 of the Financial Services Act 1986 which pre-dates the establishment of the Delegated Powers Committee. There is certainly a case for HMT to consider whether any adjustment might be made to the procedure for orders under section 22 so that the draft affirmative procedure should apply in those non-urgent cases to which the negative procedure does not apply.

Clause 21—product intervention

16. New section 137C(1)(b) enables the Treasury to enlarge the FCA's powers to make product intervention rules by allowing the FCA to make them for the purpose of advancing the integrity objective. The orders are 28-day affirmative orders, and the reason given at paragraph 170 of HMT's memorandum is the possible need to act quickly. The same point arises here as on new section 3G, but here there is no obvious link to section 22 or 22A. Accordingly, the Delegated Powers Committee takes the view that the 28-day procedure should be confined to urgent cases, with the draft affirmative procedure applying in other cases.

Clause 37—request to OFT

17. New section 354D(2) of the 2000 Act requires the Office of Fair Trading (OFT) to respond within 90 days to a request made by the FCA under subsection (I). Section 354D(4) enables the 90-day period to be altered (up or down) by an

order subject only to negative procedure. Since the scope of the power is limited, and is precedented in section 11 (4) of the Enterprise Act 2002 (super-complaints to the OFT), the Delegated Powers Committee consider the negative procedure sufficient, even though this is a Henry VIII power. We do not, however, share the view at paragraph 266 of HMT's memorandum that the length of the time for responding has implications only for the OFT.

Schedule 9, para 9—Compensation Scheme Annual Report

18. Section 218 of the 2000 Act (headed "Annual Report") requires the manager of the Financial Services Compensation Scheme to make and publish a report at least once a year. Paragraph 9(3) of Schedule 9 adds three new subsections to section 118, the first of which (subsection (4)) enables the Treasury (subject to no Parliamentary procedure) to require the scheme manager to comply with any provisions of the Companies Act 2006 about accounts and their audit which would not otherwise apply or direct that provisions of that Act are to apply to the scheme manager with such modifications as are specified in the direction. New section 218ZA of the 2000 Act (audit of accounts), inserted by paragraph I0 of Schedule 9 to the draft Bill, exempts the scheme manager from the requirements of Part 16 of the 2006 Act (audit) "except as provided by section 218(4)".

19. If the application of provisions about audit to the manager's annual report is significant, there is at least an issue as to whether any modifications of the 2006 Act should be contained in a statutory instrument subject to negative procedure, since the net effect of the Bill might otherwise be to remove requirements currently contained in primary and subordinate legislation outside any Parliamentary control.

Clause 21—product intervention rules by the FCA

20. We draw the Joint Committee's attention to only one aspect of the powers conferred on the FCA (and not subject to Parliamentary control)—new sections 137C and 138N of the 2000 Act (pages 72 and 89).

21. New section 137A empowers the FCA to make general rules applying to authorised persons with respect to carrying out activities, for the purpose of advancing one or more of its operational objectives. New section 137A(1), which has no equivalent at present in the 2000 Act, provides that the FCA's power to make general rules includes power to make rules prohibiting authorised persons from doing any of the list of prohibited things in subsection (2). The power may be exercised only for the purpose of advancing one or both of two operational objectives (consumer protection and efficiency and choice), but there is power for the Treasury to extend it to the third (integrity—paragraph 16 above). Paragraph 158 of HMT's memorandum explains the things which may be prohibited. The power given to the regulator is considerable.

22. The power in new section 137C is also notable in two particular respects. First, new section 138F(3) disapplies from product intervention rules the general principle contained in new section 138F(2) (page 84) that no contravention of a rule made by a regulator makes any transaction void or unenforceable; and new section 137C(7)(a) enables rules under section 137C to provide for agreements or obligations defined in section 137C(8) to be unenforceable. Secondly, the rules under section 137C may provide for the payment of compensation for loss sustained in relation to such agreements or obligations, (in addition to the principle in new section 138E(2) that contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person). Though

neither of these aspects of the power seems inherently inappropriate, the Joint Committee may wish to consider whether as a matter of policy the extent of the perceived difficulties which conferring the powers seeks to address justifies the extent of the powers to be given. We have assumed that the power would not be exercised so as to apply to agreements made before the rules come into force, but the Joint Committee may wish to seek clarification on this from the Treasury.

23. When considering the FSA's rule-making powers in the draft of the Bill which was enacted as the 2000 Act, the Delegated Powers Committee attached "considerable importance to the requirement to consult widely on a draft and to provide a cost-benefit analysis" (paragraph 18 of Appendix 2 to the 7th Report of the Delegated Powers Committee for 1999–2000). This is a particular aspect of the concept that the wider the powers given to a regulator subject to no Parliamentary control, the stronger must be the other mechanisms in place for reducing the possibility of an inappropriate use of the powers. In this connection it is notable that new section 138N enables the consultation procedures in sections 138J(1)(b) and (2) to (5) and 138L to be disapplied merely if the FCA considers it necessary or expedient not to comply with them for the purpose of advancing the relevant operational objective. Where this is done, the rules cannot extend beyond 12 months from the date of their coming into force. This is explained at paragraphs 181 to 189 of HMT's memorandum.

24. Section 155(7) of the 2000 Act (to be re-enacted under the draft Bill as section 138M(1)) currently disapplies the consultation procedures where the FSA considers that the delay involved in complying with them would be prejudicial to the interests of consumers. Accordingly, section 138N is about cases where the FCA cannot say with the requisite degree of certainty that those interests would be prejudiced (see paragraphs 182 and 183 of HMT's memorandum). The Joint Committee may wish to consider, in particular, whether there is a need for a test as flexible as the "expedient not to comply with them" test. The actual problem may be more specific, i.e., the FCA believes that delay might be prejudicial to the interests of consumers. On the other hand, flexibility might be considered necessary because product intervention rules might be made for advancing the efficiency and choice objective as well as the consumer protection objective.

14 September 2011