

## **A BRAVE NEW WORLD FOR THE REGULATION OF FINANCIAL SERVICES IN THE UK OR BACK TO THE FUTURE?**

21 June 2010

To Our Clients and Friends:

On 16 June 2010, George Osborne, the UK's Chancellor of the Exchequer, in his first speech to a City audience at the Mansion House, unveiled the UK coalition government's proposals to redress what he described as "the spectacular regulatory failure of the City." The proposals are far reaching. They include: (i) the gradual abolition of the UK Financial Services Authority ("FSA"), the body with statutory responsibility for the regulation of the financial services industry in the UK, by 2012 and (ii) the establishment of four new bodies under the auspices of the Bank of England. Under the proposals, the Chancellor of the Exchequer would have the right to overrule the governor of the Bank of England in a crisis (as yet undefined). Provided that the UK Parliament approve the proposals, this will be the most significant overhaul of UK financial services regulation since 1997 (when the then-Labour government introduced the FSA).

In his speech on 16 June 2010, Mr. Osborne blamed the FSA for failing to spot the approaching financial services hurricane and the weakness of banks such as Northern Rock. He said that:

*"the FSA became a narrow regulator, almost entirely focused on rules-based regulation. No one was controlling levels of debt and when the crunch came nobody knew who was in charge."*

As a result of the recent financial crisis, the UK government's bailout of Britain's banks reached approximately £850 billion. This includes: (i) buying £76 billion of shares in the Royal Bank of Scotland and the Lloyds TSB Group; (ii) indemnifying the Bank of England against losses incurred in providing more than £200 billion of liquidity support; (iii) guaranteeing up to £250 billion of wholesale borrowing by banks to strengthen liquidity; (iv) providing £40 billion of loans and other funding to Bradford & Bingley and the Financial Services Compensation Scheme; and (v) providing insurance cover of over £280 billion for bank assets.

### **THE CURRENT SYSTEM OF REGULATING FINANCIAL SERVICES IN THE UK**

Shortly after coming to power in 1997, the UK's then-Labour government created a "tripartite" system by which the newly established FSA, the Bank of England and HM

Treasury were to share responsibility for the financial system. As a result, unlike in some other jurisdictions where there are a number of different regulators for different sectors of the financial services industry, the FSA is the UK's sole financial services regulator, statutorily responsible for regulating the UK's financial services sector as a whole.

It is worth noting that the FSA took over the responsibility for regulating the whole of the financial services sector in the UK from a number of different bodies, including the Life Assurance Unit Trust Regulatory Organisation, the Financial Intermediaries, Managers and Brokers Regulatory Association Limited and the Investment Management Commission, to mention a few. Those bodies had previously regulated various parts of the financial services sector.

The UK FSA derives its statutory powers from the Financial Services and Markets Act 2000 ("FSMA"), as amended (most recently by the Financial Services Act 2010). It has the powers to regulate individuals and firms engaged in business across the main sectors of the financial markets in the UK, including banking, insurance, asset management, capital markets and mortgage and general insurance mediation. The FSA's current statutory objectives are:

- market confidence;
- financial stability;
- public awareness;
- consumer protection; and
- reduction of financial crime.

In 2000, the FSA took over the role of UK Listing Authority from the London Stock Exchange, and the responsibilities of several other organisations, for example, the Bank of England in respect of banking supervision, the Building Societies Commission, the Friendly Societies Commission and the Investment Management Commission. The FSA is an independent, non-governmental body funded directly by the financial sector. The rolling up of the various different supervisory bodies into a single supervisor was supposed to give the FSA a panoramic view of the financial services sector and enable it to take proportionate enforcement action as and when necessary.

The FSA has relatively limited resources compared to its US counterpart, the Securities and Exchange Commission ("SEC"), whose remit is much narrower than the FSA's. The FSA's budget for 2009/10 is £415 million, which is £76.6 million (22.6%) higher than its budget of £338.4 million for 2008/9. The SEC's budget for 2009/10, on the other hand, was US\$1.1 billion, with an estimated 11% increase for 2011.

The fact that the FSA is both a rule-maker and the enforcer of those rules was a matter of concern for some market participants. It remains to be seen how enforcement will be dealt with under Mr. Osborne's proposed regime.

### **THE FSA'S PRINCIPLES-BASED REGULATION GONE WRONG?**

Initially, the FSA adopted a new principles-based approach to regulation. This focused on setting out desirable regulatory outcomes rather than detailed rules and requirements. It was a popular approach with both the industry and international market participants. This is hardly surprising, as the FSA's existing rulebook consisting of over 8,500 pages plus guidance and practice statements is not easy to navigate.

In 2005, the UK's then Prime Minister, Tony Blair, expressed support for principles-based regulation:

*"In my view, we are in danger of having a wholly disproportionate attitude to the risks we should expect to see as a normal part of life. This is putting pressure on policy making [and] regulatory bodies ... to act to eliminate risk in a way that is out of all proportion to the potential damage. The result is a plethora of rules, guidelines and responses to 'scandals' of one nature or another that ends up having utterly perverse consequences."*

Indeed, until about 2008 when it fell out of favour, the principles-based approach was proposed to be followed by other regulators, for example, the New York State Insurance Department.

The Herculean financial crisis which started in 2007 brought into question the FSA's principles-based approach to financial regulation. The Turner Review, published in March 2009, concluded, amongst other things, that "light touch" regulation had failed and that the FSA should concentrate on macroeconomic regulation as well as scrutinising individual companies. Further, the Turner Review recommended that the FSA should become "more intrusive and more systematic".

In the last year or so, the FSA seems to have taken this to heart and has resorted to a much harsher "hands on" regulatory and enforcement approach. This has manifested itself through a much tougher approach to granting approved person status to individuals, including lengthy interviews with the FSA, prosecutions for insider trading, as well as the imposition of fines on firms and individuals for (sometimes minor) infringements of the FSA's rules. Also, in 2009, the FSA more than doubled the financial penalties it imposed the year before. A recent example of the FSA's tough new approach is the imposition of a £33.32 million fine on J.P. Morgan Securities Ltd. on 3 June 2010 for failing to protect client money by segregating it

appropriately. This is the largest fine the FSA has levied to date. Some commentators view this as a somewhat belated and desperate attempt by the FSA to hang on to its powers.

### **MR. OSBORNE'S PROPOSED NEW STRUCTURE**

Under the new proposal, the Bank of England, which is currently responsible for monetary policy, will gain responsibility for: (i) financial stability; (ii) control of macro-prudential supervision and (iii) oversight of micro-prudential supervision. The Bank of England will: (i) monitor the level of borrowings a bank has assumed relative to the assets that it owns; (ii) decide how much capital a lender should retain as a protection against economic upheaval and (iii) have powers to block bank takeovers.

### **THE PRUDENTIAL REGULATION AUTHORITY**

The first of the four new bodies proposed by Mr. Osborne would be a Prudential Regulation Authority ("PRA") led by the FSA's current Chief Executive, Hector Sants. By persuading Hector Sants, who handed in his resignation earlier this year to stay on to oversee the transition to the new regulatory framework, Mr. Osborne has achieved both a political coup and reassured the markets. The PRA's remit would be to ensure that banks, building societies and (re)insurers operate safely. It would be created under legislation as a subsidiary of the Bank of England and feed intelligence to the second of the four new proposed bodies, the Financial Policy Committee, also a subsidiary of the Bank of England.

### **THE FINANCIAL POLICY COMMITTEE**

The Financial Policy Committee would be chaired by Mervyn King, the governor of the Bank of England, and have responsibility for watching out for threats to economic and financial stability. The Financial Policy Committee would be given unspecified tools to stop a dangerous build-up of credit or asset bubbles. If and when these proposals are enacted, Mr. King would be one of the most powerful central bankers in the world, responsible not only for monetary policy but also the prevention of undue risks building up in the financial sector. Since the FSA was formed, there has been a considerable reduction in the role, resources and influence of the Bank of England. Under the UK's former Labour government, the Bank of England's main role was to set interest rates and combat inflation. A question which now arises is whether the Bank of England still has the skills and resources to assume its proposed duties, as set out by Mr. Osborne.

### **THE CONSUMER PROTECTION AND MARKETS AUTHORITY**

The third of the four proposed new bodies would be a Consumer Protection and Markets Authority. This would regulate the conduct of all authorised financial firms providing services to consumers and preserve the UK's reputation as one of the world's leaders in

financial services. It would inherit the FSA's existing responsibility for the Financial Ombudsman Service, the Financial Services Compensation Scheme and the new Consumer Financial Education Body.

### **THE ECONOMIC CRIME AGENCY**

The last of the four proposed new bodies would be a new Economic Crime Agency. This would be the product of a merger between the prosecuting arm of the FSA and the Serious Fraud Office. It would become a part of the Office of Fair Trading and be responsible for serious economic crime, including white-collar crime. In his statement to the House of Commons on 17 June 2010, the Financial Secretary to the Treasury, Mark Hoban, confirmed Mr. Osborne's proposals and said that the government will undertake full consultation before setting up these new bodies.

Mr. Osborne promised that the proposed reforms would deliver:

*"a new settlement between our banks and the rest of our society – a fairer settlement in which the banks support the people instead of the people bailing out the banks."*

Mr. Osborne also announced that an independent commission headed by Sir John Vickers would be asked to review the banking system with a particular emphasis on competition issues and the possible splitting of the retail and investment operations of banks. Sir John Vickers is expected to report his findings in 2011.

### **REACTIONS TO MR. OSBORNE'S PROPOSALS**

Mervyn King has welcomed the new proposals, saying that his new role in enforcing financial stability would be to "turn down the music when the dancing gets a little too wild". Some banks and brokers said that the FSA had learnt from its mistakes and was now performing their functions adequately. Many fear that the transition will be long and expensive. In order to be effective, processes, systems and controls, reporting lines, culture and accountability would all have to change. The Association of British Insurers' response to the proposals has been that this is a very important time for regulation globally and this restructuring is a distraction. Alistair Darling, the former Labour Chancellor of the Exchequer, said that the proposed reforms merely "emasculated" the FSA rather than fully abolishing it in substance and warned that the proposals could make a "dog's breakfast" of the regulatory system.

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It remains to be seen whether the modus operandi of the FSA will disappear completely, given that a large proportion of the FSA's current staff is likely to be moved to the proposed new entities taking their regulatory instincts and practices with them. It also remains to be seen whether the proposals, if and when they become law, deliver any real change. However,

the proposed changes are likely to affect everyone involved in financial services and deserve close monitoring.

Please feel free to contact either of the undersigned if you have any questions.

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