Joint Committee on the Draft Financial Services Bill
Memorandum from the Financial Services Authority (FSA)

1. We welcome the opportunity to submit this memorandum to the Joint Committee on the Draft Financial Services Bill. The Committee's scrutiny presents an important opportunity to debate the major reforms proposed in this Bill and to identify the key judgements and decisions which Parliament and Government will need to make during the passage of this legislation.

2. We support the high-level policy objectives of the draft legislation and are working closely with the Treasury and the Bank of England (BoE) to prepare for the new regulatory regime.

3. In this memorandum we comment on the draft Bill, highlighting those areas the Committee may wish to consider as part of their scrutiny, and noting a number of other points on which we would find it particularly helpful to have the Committee's views. We also set out our assessment of the principal implementation risks and our proposed mitigations. Our memorandum covers:

   - the Prudential Regulation Authority (PRA);
   - the Financial Conduct Authority (FCA);
   - effective coordination, in the UK and internationally;
   - accountability of the new regulators; and
   - other important issues on which the Committee has invited views.

4. We believe that if the new regulators are to succeed in delivering the required improvements in prudential and conduct regulation, it will be very important that their objectives are clearly articulated and agreed at the outset and that they are given the necessary statutory powers. We would urge the Committee to focus on these aspects of the legislation and to resist industry pressure to cut back those powers or to constrain their use in a way which would be likely to make them ineffective in practice.

5. The new regulators will need to take stronger action to limit the growth of emerging problems in financial stability, consumer protection and market developments. To do this they will need to make difficult balancing judgements and important trade-offs. It will be important, therefore, for Government, Parliament and society to give the new authorities guidance on the appropriate balance to be struck between cost and effectiveness of regulation; consumer freedom and protection; early intervention and innovation; and structural intervention and market autonomy[1]. Furthermore, Parliament will also need to recognise that the new regulators will continue to depend significantly on, and be constrained by, detailed requirements to be set out in international agreements that are still currently in negotiation.

6. This memorandum does not address issues relating to the wider financial stability remit of the BoE and the Financial Policy Committee (FPC).

[1] In a recent speech, the FSA Chief Executive, Hector Sants, commented on these balancing judgements and trade-offs, in the context of the FCA. The Committee may find this useful further background to its deliberations. (Financial Conduct Authority Conference, June 2011) http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2011/0628_hs.shtml

7. The FSA has also provided the Committee with three papers, recently published, which outline the proposed regulatory approaches of the PRA to banking and insurance supervision (jointly with the BoE) and of the FCA[2].

The Prudential Regulation Authority

8. The FSA shares the Government's objective to improve the arrangements for supporting financial stability in the UK, through the establishment of the FPC and the PRA. Since 2008, the FSA has made significant improvements in its approach to the regulatory supervision of firms, in particular by implementing a more intensive and intrusive regime. This legislation and the establishment of the PRA (and the FPC) represent an important opportunity to build on those improvements and to close the major gaps in the current arrangements. However, it should be considered that no regulatory system or supervisory model can guarantee to prevent another financial crisis.

9. We have already recognised the deficiencies of the previous prudential regulatory framework (set out in international agreements, in particular Basel II), especially the capital and liquidity regimes, and the inadequacy of the FSA's historic supervisory approach. That approach – based on a widely-held belief in efficient, self-correcting markets - reflected the broad consensus at the time and the FSA's understanding of Government's, Parliament's and society's expectations of what a regulator should and should not do.

10. We welcome the PRA's single focused objective to promote the stability of the financial system through the supervision of individual firms. Other measures in the Bill designed to improve the oversight of financial stability include:

    - establishing the FPC, which should ensure that firm-specific supervision by the PRA is fully integrated with macro-prudential oversight of the system as a whole;
    - placing greater emphasis on recovery plans and "resolvability" which, building on the work of the FSA and the BoE over recent years, should provide scope to return firms to a more stable position after a period of stress.

11. The PRA will seek to achieve its financial stability objectives through building on the recent approach of the FSA. The principal elements of its new supervisory strategy will be:
    - a significantly improved international capital and liquidity regime which will be implemented in the UK through the Capital Requirement Directive IV;
    - greater focus on recovery and resolution planning to increase the probability of orderly failure without recourse to public funds;
    - a forward-looking judgment-based approach to supervision. This will include a new supervisory assessment framework, replacing the current Advanced Risk Responsive Operating Framework (ARROW) and a formal proactive intervention

[2] *The Bank of England, Prudential Regulation Authority*: *Our approach to banking supervision* (Bank of England and FSA, May 2011); *The Bank of England, Prudential Regulation Authority: Our approach to insurance supervision* (Bank of England and FSA, June 2011); *The Financial Conduct Authority: Approach to regulation* (FSA, June 2011).

framework which will ensure that the regulator acts swiftly and transparently when remedial action is required; and
- a focus on improving market discipline through increased transparency.

12. The PRA's new supervisory assessment framework will focus on the main issues which could affect an institution's safety and soundness, concentrating on outcomes rather than process. The PRA will engage in thorough and forward-looking analysis of firms' business models, governance, capital and liquidity, and, in the case of insurance companies, the adequacy of reserving policies. It will also look at risks posed to the financial system as a whole by individual institutions (a perspective which it is not realistic to expect the management of individual firms to take). It will focus its resource on the institutions that pose the mains risks to that system.

13. We support measures in the draft legislation which give the PRA prudential oversight of insurance firms. We welcome the two complementary objectives for insurance supervision - to secure an appropriate degree of protection for policyholders and, as needed, to minimise the adverse impact that the failure of an insurer or the way it carries out its business could have on the stability of the system. However, we recognise that the division of prudential issues from conduct is not as straightforward for insurance companies as it is for banks and we therefore support the current wording of the PRA's objective, which ensures clarity of responsibility in relation to policyholders' returns.

14. We agree with the Government's intention that the PRA should be responsible for overseeing the integrity of the balance sheets of individual insurance companies. This will include reviewing an insurer's governance processes and assessing whether these involve management making informed, forward-looking assessments of the firm's financial strength, including risks both to the assets and liabilities on its balance sheet. Inadequacy of reserves was an underlying issue in a number of past cases, including Equitable Life. We will of course also have to consider carefully the interaction between the FCA and PRA in relation to other consumer protection issues in the insurance sector.

15. We recognise the importance of diversity in the financial sector, including the contribution made by mutuals. We therefore welcome measures that will allow the PRA to take a proportionate and risk-based approach to the supervision of these firms. We also support the additional requirement on the regulators to include in cost benefit analyses an assessment of the impact of proposed rules on mutually-owned institutions.

16. We also support measures in the draft legislation which will allow the Government to add to or adapt the PRA's objectives if this is required in the future.

<u>Ensuring orderly failure and reducing the likelihood of using public funds to support troubled banks</u>

17. We strongly support measures designed to reduce the likelihood of having to use public funds to support troubled banks and to ensure that if failure does occur it does so in an orderly manner.

    - In pursuit of this objective, the PRA will ensure that all deposit takers draw up credible recovery plans which will be comprehensive and include measures to restore capital and liquidity and improve governance.

- It is not the PRA's responsibility to prevent firm failures altogether. It will therefore ensure that all deposit takers put in place effective resolution plans. The framework is now established and was endorsed by the International Monetary Fund (IMF) in its recent assessment of the UK financial system[3]. Once it has been developed, it will be possible to handle future failures in more orderly way, which will reduce the probability of the need to utilise public funds. Furthermore, the PRA and the FPC and the Special Resolution Unit will all reside in the BoE group, which should ensure clear lines of responsibility and the ability to react quickly, effectively and in a coordinated way to any further crisis.
- The BoE and the PRA will play an important role in developing international crisis management arrangements. Given the number of complex cross- border banking groups operating in the UK effective international crisis management arrangements are a priority.
- Notwithstanding the progress made to date to put in place effective domestic resolution plans, we would draw the Committee's attention to the fact that major banking groups are complex structures and it will be some time before effective resolution plans can be achieved, and furthermore, effective plans for many large complex groups will not be possible without international agreement.

18. Against this background the PRA will need to have a very low tolerance of risk where a firm's failure could have an impact on financial stability. This could arise where, because of the firm's size and complexity, it is inherently the case that there can be no complete certainty that the failure would be orderly. It also needs to be recognised that the failure of an individual firm might lead to the risk that the peer group or class of firm might fail due to a common cause, generating significant harm to the system.

<u>Clearing and settlement</u>

19. **We acknowledge 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.**

The Financial Conduct Authority

20. We also welcome the measures set out in the draft Bill which, through the establishment of the FCA, seek to enhance the protection of consumers, especially retail consumers, in the financial services sector. This legislation is being debated against a background of low levels of confidence in the financial services sector as a whole. Conduct issues have been a major factor since 1990, particularly the significant instances of widespread mis-selling of financial products to retail consumers – personal pensions, mortgage endowment policies, split capital investment trusts and, most recently, payment protection insurance.

[3] IMF Article IV consultation with the UK (July 2011) http://www.imf.org/external/country/gbr/index.htm

21. The FSA's historic approach to conduct focused on point of sale regulation – disclosure of information to consumers and a requirement on advisers to give suitable advice – and on dealing with observable consumer detriment after the event. The FSA has recognised the inadequacy of this essentially reactive approach in preventing a series of episodes of systematic mis-selling and last year announced a revised approach to dealing with conduct risk. This involves earlier intervention in the product chain, to anticipate and head off consumer detriment at a much earlier stage, before risk crystallises. Since then the FSA has made some progress in the new direction. This legislation and the establishment of the FCA represent an important opportunity to make further improvements, using the FCA's enhanced powers. We believe that achieving this will be crucial to fulfilling public expectations and making the FCA a credible regulator.

<u>Objectives</u>

22. We welcome the Government's policy of setting out objectives in the Bill to give a clear steer to the regulator on what it is expected to achieve. However, we have some observations about the objectives as currently drafted.

The strategic objective

23. The FCA's strategic objective is a very broad one - 'protecting and enhancing confidence the in the UK financial system'[4]. In our view it is important to recognise that the FCA is only one of a number of bodies whose actions can have an impact on confidence in the UK financial system. In particular, the level of confidence in the financial system that arises from financial stability is a matter for the BoE, the FPC and the PRA. Furthermore, confidence in the financial system is also affected by the general state of the economy. The current formulation, therefore, risks giving rise to a lack of clarity as to precisely what the FCA is required to deliver. **We would favour a change to the FCA's draft strategic objective which explicitly recognises that the FCA <u>contributes to</u> protecting and enhancing confidence**.

Efficiency and choice objective

24. **In the draft Bill the FCA has an operational objective of 'promoting efficiency and choice in the market for [financial services]' and an overall duty to promote competition[5]. We are concerned that this does not establish the extent and nature of the FCA's responsibilities with sufficient clarity.**

This is for two reasons:

- first, the draft efficiency and choice operational objective and the competition duty raise questions about the interaction between the respective responsibilities of the FCA and the Office of Fair Trading. Our experience in other areas has shown that conferring overlapping responsibilities on two authorities risks real confusion (both in the authorities themselves and in the minds of the regulated industry and the wider public) as to who is responsible for what. For the FCA, the question will be particularly acute where, for example, both the FCA and the competition

[4] As defined broadly in new section 2B (6) of the Draft Financial Services Bill.
[5] New section 1E(4) of the Draft Financial Services Bill

authorities are able to take action where they perceive markets are not working effectively;

- second, on occasions there can be real conflict between promoting choice and securing an appropriate degree of protection for consumers. For example, the FCA expects to use its powers of early intervention to ban or restrict the distribution or promotion of particular products, which will of course limit consumer choice. The draft legislation would therefore put the FCA in the position of having to decide which of two potentially competing objectives it wishes to advance.

25. We recognise that there are a variety of views on what competition remit the FCA should have. For example, it has been recommended (by the Treasury Select Committee and in the interim report from the Independent Commission on Banking) that the FCA should have either a competition objective or a primary duty to promote competition. This is possible; however, Parliament should be aware that this would make the FCA a very different organisation from that which is currently envisaged in the draft Bill. It would be likely to move the regulator away from pursuing consumer protection for its own sake, and towards seeking to achieve such protection through the efficient operation of the markets. However, our experience is that even where certain markets appear to be competitive, the regulator needs to use tools other than competition to ensure that consumers receive an appropriate degree of protection.

    An alternative approach might be for the FCA not to have an operational objective related to efficiency and choice, but to rely on a standalone duty to promote competition where compatible with its statutory objectives, similar to the duty currently in Section 1B (4) of the draft Bill. This would give the regulator a clear steer about what society expects it to do in carrying out its functions; however, it would limit the regulator’s ability to intervene actively on competition issues as many of our powers are tied to our statutory objectives. This could therefore have consequences for the FCA’s ability to address the root causes of problems where weakness in competition is the principal driver.

26. **Either of the alternatives set out above would give the FCA a clear steer as to what was expected of it, but both have ramifications for the FCA’s approach to regulation. Our concern with the current formulation is that it might place the FCA in an unclear intermediate position. We recognise that this is a complex and important question and we would, therefore, very much welcome the Committee debating this matter fully to provide further clarity on these issues.**

<u>Authorisations</u>

27. The FSA welcomes the provisions in the draft Bill which provide for the FCA to consent to the authorisation by the PRA of a firm which will be dual-regulated. We also welcome the Government’s decision that the authorisation process for dual-regulated firms should be run by one regulator so as to reduce the need for firms to submit two separate applications.

28. However, the future senior management of the FCA have a significant concern about the parallel provisions relating to approved persons. The draft Bill provides that the PRA alone is responsible for approving individuals performing significant influence functions in dual-regulated firms. In doing so, we would expect the PRA to consult the FCA under

the general duty to consult[6]. By way of example, the PRA would be solely responsible for approving the Chief Executive Officer of a major bank or insurance company. In doing so, it will consider their fitness and propriety; however, it will do so through the lens of prudential regulation, for which it is responsible, taking account of the FCA's views, as appropriate. However, our experience has shown that the attitude of firms' senior management towards conduct issues can be a real driver of the way firms treat their customers – which points to the need for FCA consent to the appointment of such individuals.

29. Recent events in the Netherlands have called into question the efficacy of the arrangement proposed in the draft Bill. 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.

30. **We recognise there are differing views on this issue. However, taking account of the Dutch experience and the IMF's view in its recent report[7], the future senior management of the FCA feels strongly that the 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.**

Powers to deal effectively with misconduct and mis-selling

31. We consider that the Government's proposed legislation provides a basis for the FCA to deal effectively with misconduct and mis-selling, for example through the FCA:

- being more ready to intervene, making full use of its enhanced powers, to tackle potential and emerging risks to consumer protection and market integrity before they materialise, and in order to prevent large-scale detriment. This will include a new and intrusive approach to the way firms bring financial services products to the retail market;
- shifting the balance towards tackling the root causes of problems (for example, their commercial drivers), not just the symptoms (for example, poor firm conduct at point of sale);
- having a more interventionist stance and lower tolerance for consumer detriment is likely to require further enhancement of the FSA's recent strong activity in enforcement; and

[6] Draft Financial Services Bill - Section 3D (1) (a).
[7] The IMF in its recent Financial Services Action Plan review noted the importance of the approved person's regime to the UK's regulatory and supervisory structure. The IMF recognised the benefits of adopting a system of dual approval for certain key positions supported with coordinated information requests and assessment processes. http://www.imf.org/external/pubs/ft/scr/2011/cr11230.pdf.

- ensuring that firms provide prompt and effective redress where things do go wrong (given the FCA will not be able, with finite resource, to prevent every incidence of poor consumer outcomes from crystallising).

32. Our experience tells us that the successful implementation of this approach will require the strengthening of our early intervention powers, and we recognise the product intervention power in the Bill as a step in the right direction.

33. However, it is important for Parliament and society to recognise how even these enhanced powers will operate in practice. Our experience is that members of the public and Parliamentarians have been of the view that - as a matter of public policy – the breach of the FSA's rules should in all cases entail the consumer receiving 100% redress. However, the FCA's ability to ensure that consumers receive redress is constrained by the general law, in particular by questions of causation. If the breach of rules either did not cause the loss, or was merely a contributory factor, the FCA will not be able to require firms to pay full redress.

34. **If society expects as a matter of public policy that the regulator should be in a position to require greater levels of redress to be paid then the FCA needs to be given a clear mandate and powers to do so in the new legislation. This is a difficult issue that gives rise to real questions as to how far the regulator's powers should extend and we would very much welcome the Committee debating this matter, in particular to achieve further clarity as to the FCA's mandate in this area.**

<u>Increased transparency of enforcement actions</u>

35. We welcome the Government's intention to give the new regulators power to publicise that a Warning Notice has been issued. However, the Bill as drafted requires the regulators to consult the subject of the notice before doing so. In our judgement this will seriously undermine the effectiveness of this power as we believe most, if not all, firms and individuals are likely to object to details of the Warning Notice being published. This in turn is likely to lead to satellite litigation with firms and individuals seeking injunctions through the courts to restrain the authorities from making matters public. We do not believe this would be in the public interest, and would lead in large part to the power being undermined to a point that it is likely to be of little use, and almost certain not to achieve the policy intention of greater openness on the part of the regulators. **Our strong preference, therefore, would be for the requirement to consult the subject of the notice to be removed from the Bill. The effect would be to bring this provision into line with standard civil and criminal legal powers and would counter the suggestion that the regulatory process is disproportionately biased in favour of non-disclosure in the interests of financial services and industry practitioners.**

<u>Powers for the effective regulation of markets</u>

36. It is important that the FCA should have a strong and broadly-based markets regulation function. We therefore welcome the Government's confirmation that the FCA will continue to perform the functions of UK Listing Authority currently undertaken by the FSA. This will give the FCA the necessary coverage of the capital markets transaction chain, spanning both primary and secondary markets. The legislative framework and objectives proposed for the FCA will enable it to implement a regulatory regime

appropriate for wholesale markets, with the focus on ensuring the integrity of markets and proper standards of conduct by market participants.

37. Under the Government's proposals the BoE 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.

Prudential supervision

38. We support the measures in the draft legislation in relation to the prudential regulatory responsibilities of the FSA towards FCA-only regulated firms. All 24,500 firms in this category will be subject to a minimum level of baseline supervision in line with international standards. For the vast majority, prudential supervision will be on a 'gone concern' basis where the focus will be on ensuring that firms can fail in an orderly manner, with appropriate levels of consumer protection through the Financial Services Compensation Scheme (FSCS) and the protection or segregation of client assets. **For the small number of firms whose failure, even if orderly could threaten the integrity of a particular market[8], we believe the FCA should follow a more active supervisory programme on a 'going concern' basis. This should give the FCA sufficient time to intervene when problems occur and where necessary allow the firm to fail in an orderly fashion.**

Effective coordination, in the UK and internationally

39. Good co-ordination is designed to ensure that the institution or person taking a decision has the right information available; arrangements for co-ordination need to complement clarity of responsibility for decision-making. Experience tells us that where it is not clear which institution has the responsibility and power to take a decision, or where demarcation lines between authorities are not clear, the outcome is delay, inefficiency and poor regulatory outcomes. **We would therefore urge Parliament at every stage in the legislation to ensure that responsibility for taking decisions on particular issues is clearly set out – accompanied, of course, in appropriate cases by a duty to consult others, take into account their views etc.**

40. It is widely recognised, including in the draft legislation, that the success of the new regime will depend substantially on the new authorities' ability to co-ordinate their activities, among themselves within the UK, with other authorities in the UK (for

[8] Examples include large asset managers whose trading activity is disrupted and investment firms who deal as principal and are therefore the counterparty to consumers (both wholesale and retail), such as inter-dealer brokers.

example, the Financial Ombudsman Service and the Financial Services Compensation Scheme) and in their engagement in the EU and internationally. We therefore support the measures in the draft legislation to address these challenges:

41. The PRA and the FCA will seek to minimise the impact of dual regulation on the 2000+ PRA firms, but there is likely to be a degree of overlap and duplication. Co-operation will be enhanced through establishing domestic colleges to handle supervisory issues for dual-regulated firms.

42. The FSA is currently considering with the BoE 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 BoE 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.

43. The policy and regulations which govern the PRA and FCA will be significantly determined by decisions taken in the EU. In addition to EU legislation, the new European Supervisory Authorities (ESAs) have the power to set binding technical standards. It will be important therefore for the UK authorities to seek to ensure that the EU policy framework leaves scope for regulators to make informed judgements about the risks to their objectives, the risks to their markets and consumers, and the actions they wish to take.

44. The FSA (together with the Government, the BoE, and other stakeholders) has played an active role in shaping the development of the common framework for regulation and supervision at a European level. We are confident this work will be continued by the PRA and FCA. The FCA will represent the UK, in close coordination with the PRA and BoE in the European Securities and Markets Authority (ESMA), where the FCA's priorities are likely to have much in common with the EU's consumer protection goals, including issues under the Markets in Financial Instruments Directive. The FCA will also be active in ESMA in seeking to achieve sensible outcomes in the regulation of wholesale markets. The PRA will represent UK interests in the European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA), in close coordination with the FCA and, in the case of EIOPA, with The Pensions Regulator.

Accountability

45. The FSA welcomes robust arrangements to hold the new regulatory authorities to account for their performance and their achievement of their objectives. They should be accountable to Parliament, Government and the public, not to the firms they regulate. The backbone of an effective accountable system is clearly defined and agreed objectives for each regulator, against which success or failure can be measured; otherwise, future regulators will be criticised for failing to do things which they did not believe to be their responsibility. We expect the Treasury Select Committee to play a key role in the new accountability arrangements, and we welcome their recent announcement of an inquiry into the accountability of the FCA.

46. It is right that regulators with the powers available to the PRA and the FCA should be subject to checks and balances. Regulated firms, who will fund the new regulators, have a legitimate interest in their economy and efficiency, so, while the FSA already makes use of the National Audit Office for its own audit, we welcome Government's proposal to put this on a statutory footing for the FCA and the PRA.

47. We also welcome the Government's other proposals for holding the new regulators to account and for improving transparency. These include a new requirement on both regulators to make a report to the Treasury in the event of a regulatory failure. The operation of this requirement in practice will require careful consideration and clarity around the triggers that would set off any requirement to report. For example, the obligation to publish a report, and the desirability of transparency, should not impede or prejudice the FCA's ability to pursue its primary obligations as a regulator. This concern is most acutely apparent where the FCA is conducting enforcement investigations. We feel strongly that the Bill should provide that the duty to report should not be triggered while enforcement activity is ongoing.

48. **Finally, although we agree that the regulators should be accountable to Parliament, we would welcome further debate in Parliament as to where it wishes to draw the line between ensuring adequate accountability and allowing the regulators to make judgements, both in rule making and in relation to individual firm decisions.** Historically, allowing the regulator a space in which to make its regulatory judgements has been seen as a good model in terms of independence of decision-making, including by the IMF in their Financial Services Action Plan, and more widely**.**

49. Furthermore, it needs to be recognised that in a judgment-based approach to regulation, which requires regulators to base their assessments of risk on their view of the future, there will be inevitably be occasions where the supervisor's judgment turns out in the light of events not to be the best option chosen. It is important, however, that the accountability process does not prevent such judgments being made, for if it were to, the future concept of supervision which parliament envisages would be undermined. The accountability and appeals process should focus on ensuring that the regulator has acted within its authority and done so in a reasonable manner.

Other important issues on which you have invited views

<u>Legislative process</u>

50. The decision on the most appropriate legislative means through which changes to the UK financial regulatory system should be implemented is in our view a matter for Government and Parliament.

<u>Operational issues</u>

Staffing, skills and expertise

51. Ministers have explained in what ways they expect the new regime to improve on the past. We recognise that the success of the new authorities will depend crucially on the quality, motivation and performance of their staff. The new regulators will build on the progress

that the FSA has made in recent years to improve its supervisory processes, to upskill its existing staff and to recruit and retain additional staff with the right range of market, regulatory and other skills and experience. The PRA will benefit from being part of the BoE group.

52. When the work to develop the new regulators' target operating models - which is progressing well - is complete, we will carry out a skills audit to identify areas in which our staff need further development, and we will develop a targeted training programme tailored to the objectives of each regulator. This will form part of a wider package designed to help recruit and retain staff.

53. In order to deliver the agenda of the new authorities it is clear that there will need to continue to be significant investment in staff. Recruitment in particular areas will remain challenging due to demand for a limited supply of certain types of skills, since the regulators are not in a position to match the level of pay offered by the open market.

Lessons from overseas regulators

54. Our extensive discussions with overseas regulators underline the importance of effective co-ordination, whatever the institutional arrangements. We recognise that each regulatory structure has advantages and disadvantages, depending on the circumstances of the country concerned. No one model is perfect. Previously well-regarded systems such as those in the United States and Spain are now suffering well publicised gaps in coordination or financial stability problems. However, in Australia, the regulatory structure, based on a twin-peaks model that was reformed in the early 2000s, has come through the crisis well.

The cost of regulation

55. Another important factor is that reform and improvements of this kind will necessarily involve costs. The FSA takes very seriously its duty to be economic and efficient in the use of its resources.

56. We have previously said that we do not expect to have to increase employee numbers to staff the PRA[9]. Over the last year, the FSA has increased its headcount by nearly 500 staff, recruiting the additional people and skills that we have needed to expand our prudential supervision capability – based on the lessons we learned from the crisis. We anticipate the costs to operate the PRA when it is established will be broadly equivalent to the costs of prudential regulation carried out by the FSA. Moreover, there are likely to be opportunities for efficiency savings and, as a result, we aspire to being able to reduce costs in the longer term.

57. By contrast, the FSA has not hitherto changed its approach to, or resources devoted to, conduct regulation to the same extent. It is clear that the FCA is being asked to operate in a different way from the FSA, for example by intervening earlier to prevent consumer detriment. We have already made a start in moving in the new direction, including through our credible deterrence strategy in relation to enforcement, and most recently in

[9] *FSA Business Plan* 2011/12

our Discussion Paper on product intervention, and we expect this trend to a more interventionist approach to continue.

58. It must be recognised that these reforms may have implications for the cost of regulation. There are always efficiency savings that can be made in any organisation, and the FSA is committed to making those where it can. However, efficiency savings may be insufficient to offset the costs that the new approach to regulation envisaged by the draft Bill will entail. As noted earlier, a system which requires 2000+ firms, out of a total of 27,000, to be regulated by two authorities is inherently likely to cost more than a system of unitary regulation. We believe this is a price worth paying, but it should in our view be clearly recognised at the outset.

Implications of a zero-failure regime

59. In addition, society will need to accept that the new regulators will tolerate some degree of prudential and conduct failure. It is important that Parliament consider whether this is an acceptable reality. On occasions in the past it has seemed that Parliament, in its response to individual cases, reveals a preference for zero failure – that is, no firms failing and no consumers losing money. This is neither realistic nor desirable in principle. The lower Parliament's appetite for prudential or conduct failure, the more interventionist and expensive the regulatory regime will be. **We would welcome further parliamentary debate on this issue, as this is one of the key choices to be made in the course of finalising this legislation.**

60. We look forward to supplementing this Memorandum in oral evidence to the Committee in due course. If the Committee would find it helpful to have further written evidence on particular points at this stage, we would be happy to supply it.

5 September 2011