NEWSSTAND

Climbing the Twin Peaks: First Glimpses of the UK's New Regulatory Structure

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On 26 July 2010 Her Majesty's Treasury (the Treasury) launched its consultation (the Consultation) on the implementation of financial regulation reforms, originally announced by the Chancellor of the Exchequer on 16 June 2010. The Consultation closed on 18 October 2010 and the Treasury's findings are awaited. In the meantime, the Consultation has given us an insight into the future shape of financial services regulation as envisaged by the UK's coalition government.

The Current System: Tripartite Regulation

The current regulatory system is known as a "tripartite system", under which the Treasury sets the overall scope of policy, the Bank of England (the Bank) is responsible for monetary and financial stability and acts as a lender of last resort, and the Financial Services Authority (FSA) implements Treasury policy and is responsible for (among other things) prudential regulation, consumer protection and prevention of market abuse.

In addition to the three bodies referred to above, the FSA also has responsibility for the Financial Ombudsman Service (the Ombudsman) and the Financial Services Compensation Scheme (FSCS) and established the Consumer Financial Education Body (CFEB), although each is run independently.

The Proposal: "Twin Peaks"

Although the name would suggest that the number of regulatory entities is to be reduced from three to two, in fact, "twin peaks" refers to two limbs of regulation – prudential regulation and conduct regulation (or consumer protection). Prudential regulation is, itself, broken down into macro-prudential (focused on systemic risk and financial stability) and micro-prudential (focused on each individual authorised firm).

Prudential regulation will fall into the hands of the Bank, through the creation of a Financial Policy Committee (FPC) which will be responsible for macro-prudential regulation, and a newly-established subsidiary of the Treasury, whose working title is the Prudential Regulatory Authority (PRA), which will be responsible for micro-prudential regulation. Conduct regulation will be the responsibility of another newly-established independent agency, the Consumer Protection and Markets Authority (CPMA).

The FPC will have the power, in support of macro-prudential policy, to require the PRA to take regulatory action with respect to the firms that it regulates. For example, if the FPC considers that a general increase in capital held by banks is required as a result of an upswing in the credit cycle, then it will instruct the PRA to amend its rules accordingly. The FPC will also have similar macro-prudential controls over the CPMA if necessary.

The PRA will have operational responsibility for the prudential regulation and supervision of individual firms. The Consultation specifically notes that the PRA's responsibilities will include minimising the disruption caused by any firms that fail. The PRA will have responsibility to:

- make rules governing the performance of regulated activities classified as "prudential"
- supervise firms and enforce compliance with those rules
- authorise firms to engage in regulated activities classified as "prudential"
- approve individuals carrying out certain functions within those firms.

Hector Sants, currently the Chief Executive of the FSA, who was due to step down in the summer of 2010, has agreed to stay on with the FSA to oversee the transformation. Mr. Sants will then become the first Chief Executive of the PRA and, *ex officio*, a deputy governor of the Bank. The CPMA will:

- assume the core regulatory function of making rules governing the conduct of firms, in both retail and wholesale spheres, and supervise compliance with those rules
- grant permissions for all regulated activities classified as "non-prudential"
- approve individuals carrying out conduct-related controlled functions within firms regulated by the PRA and all controlled functions within firms that it regulates alone
- assume responsibility for market conduct and market infrastructure including investment exchanges.

Divided but Coordinated?

Given the Consultation's observation that "*no single institution [currently] has the responsibility, authority or powers to monitor the system as a whole… and respond*" it is unsurprising that coordination between the newly divided PRA and CPMA is addressed in some detail. A number of formal arrangements will be legislated for, including:

- an obligation on each authority to have regard to the objectives of the other
- a seat on the CPMA board for the CEO of the PRA, and vice versa
- memoranda of understanding between the PRA and CPMA will be required by statute
- the establishment of "colleges" to support joint working on the supervision of firms falling under the remit of both the PRA and the CPMA
- requirements for each of the PRA and CPMA to consult the other, and the FPC, when making new rules.

New Regulators, Old Regulator?

Under the proposals, the PRA and the CPMA will effectively divide the current FSA role between them. The FSA has submitted a memorandum to the Treasury discussing implementation of that division. The memorandum discusses the high level processes put in place to achieve the transition to the new structure, and the risks associated with it. It also identifies the long term issues and opportunities associated with the new regime. Among the risks identified are people retention issues, "personnel stretch" as management of the transition occupies staff who would otherwise be focused on regulatory activities and a requirement for redesign of supervisory procedures including authorisation and ARROW which currently deal with prudential and consumer protection issues in a fully integrated manner.

It seems likely that much of the present FSA Handbook of Rules and Guidance will also be divided and re-used. It remains to be seen whether more fundamental changes will be made to the rules and whether the two regulators will be able to maintain sufficient consistency between their respective rules to ensure that firms are not required, in circumstances where an activity has both prudential and consumer protection implications, to deal with at least two regulators and at least two different sets of rules regulating the same activities.

Other Agencies

The Ombudsman, FSCS and CFEB will remain independent of the regulators. It is proposed that the CPMA will assume responsibility for all three, although they will maintain their independence, but the Consultation acknowledges that the FSCS will also have to work closely with the PRA and calls for comments on whether the FSCS fits better within the remit of the PRA or the CPMA.

The Treasury also intends to consult on transferring responsibility for consumer credit regulation from the Office of Fair Trading (OFT) to the CPMA.

Implications for the Insurance Industry

The proposals have left those in the insurance industry with little guidance as to how they will be regulated from 2012. The Consultation, reflecting the majority of the post credit-crunch calls for reform, is almost exclusively focused on banking and capital markets, with insurers appearing little more than an afterthought (with just seven mentions in a 76 page document) and insurance intermediaries failing to register at all. Consequently, although it appears from the document that insurers will be regulated by both the PRA and the CPMA and it appears to follow that insurance intermediaries will be regulated by the CPMA alone, the position remains far from clear. In particular, there will inevitably be an element of prudential regulation carried out by the CPMA if it is the sole regulator of intermediaries. The CPMA's role will clearly extend beyond protection of retail customers to encompass wholesale markets activities and it is essential that its rules, systems and processes reflect the differing natures of those functions.

Sean McGovern, Director, North America and General Counsel of Lloyd's notes that: "*The PRA is the right place to regulate insurer solvency but it should have a separate insurance division headed by a senior and respected person with insurance expertise who would sit on the board…*". He also expresses concern that the CPMA's primary role is as a consumer champion: *"It is dangerous for a regulator to be an advocate for one side of the financial contract rather than to simply formulate clear rules of engagement…*".

Insurers at Lloyd's, in particular, have voiced concern at the prospect of having to deal with three separate regulators, while the brokers who bring the business to them, and who handle many millions of pounds and dollars of premiums and claims money on a daily basis, fall to be regulated only by the CPMA.

Insurance intermediaries will be aware of the current review of the Insurance Mediation Directive, with a public hearing to be held in Brussels on 10 December 2010, and a revised text to be presented to the Council and European Parliament in early 2011. With Solvency II still expected to be implemented on 31 December 2012, that year is set to be a regulatory watershed for insurers in particular, but also for intermediaries. What they, and the individuals with responsibility for implementing the new regulations, need least of all in the run up to such fundamental regulatory changes is a root and branch reshaping of the UK regulatory authority that is to apply it.