The new regime

THE RECENT FINANCIAL SERVICES BILL OFFERS SOME INSIGHT INTO HOW THE FINANCIAL SERVICES SECTOR WILL BE POLICED IN FUTURE. **GRAHAM BUCK** EXAMINES ITS PROPOSALS.

Although the news attracted rather less media attention than the furore over RBS chief Stephen Hester's annual bonus payment, the Financial Services Bill moved a step closer in late January when the Treasury published its proposals for the new financial regulatory regime.

The publication was announced by George Osborne, the chancellor, as he attended the latest meeting of the World Economic Forum in Davos, Switzerland. Within weeks of the coalition government taking office in May 2010 Osborne had declared that the government planned a shake-up of City legislation. The Bill fleshes out some of the detail and outlines how ministers plan to strengthen the financial sector and prevent any repeat of the exposure to bad loans that triggered the 2007–08 crisis.

Under the proposed new regulatory structure, the Bank of England will be at the centre, with its powers reinforced. The Bank will take on responsibility for protecting and enhancing financial stability and also take over the role of supervising the banks from the Financial Services Authority (FSA).

This new regime replaces what has been dubbed the tripartite system – with authority divided between the Treasury, the FSA and the Bank – which was introduced by Gordon Brown early into his tenure as chancellor when Labour returned to power in 1997.

TICKBOX CULTURE "The failings of that system are now well understood," said Osborne. "The tripartite structure was incoherent, without clear lines of accountability. Everyone was so focused on ticking off a regulatory checklist that nobody felt it was their responsibility to use their judgment."

The chancellor is likely to have in mind the situation faced by his predecessor, Alistair Darling, who felt he was unable to order the Bank to inject more liquidity into the system when the financial crisis intensified in 2008.

The Bill also outlines where responsibilities lie in the event of a future financial crisis, giving the chancellor powers to direct the Bank where public money is at risk and there is a serious threat to financial stability, such as ordering extra liquidity to be provided to support either the economy or a specific financial institution that is in trouble.

The bill paves the way for the abolition of the FSA and its replacement by a "strengthened regulatory architecture" consisting of three new regulatory bodies for overseeing financial services and consumer protection:

- the Financial Policy Committee (FPC), a "macro-prudential authority" within the Bank will take over the main responsibility for financial regulation and monitoring any systemic risk posed by the financial sector to the general economy. The FPC will also oversee the other two new regulatory bodies;
- the Prudential Regulation Authority (PRA), also a subsidiary of the Bank, which will be responsible for supervising the correct conduct of business by all financial services and markets so that it "advances the interests of all users and participants"; and

- the Financial Conduct Authority (FCA), which will be responsible for consumer protection and compliance by finance sector workers. It will, for example, have powers to crack down on practices such as high-interest payday lending and conduct more rigorous checks on firms seeking to enter the market.

The interim FPC has already been meeting quarterly since last June to prepare for when it takes over from the FSA. Its membership proved controversial from the outset as former Confederation of British Industry chief Sir Richard Lambert withdrew even before its first sitting. The Treasury select committee also expressed concerns over the appointment as an FPC member of Alastair Clark, who worked at the Bank and the Treasury for more than 40 years. Michael Fallon, the Conservative Party's deputy chairman described Clark as the "ultimate insider", but Clark has retained his position.

"THE EXPERIMENT OF MAKING NO ATTEMPT TO MODERATE THE CREDIT CYCLE, LETTING THE BUBBLES GROW AND BURST AND THEN CLEANING UP AFTERWARDS HAS BEEN AN UNMITIGATED DISASTER."

In addition to King, the FPC's 11 members include the Bank's Paul Tucker and Charles Bean, the PRA's designated CEO Hector Sants and FSA chairman Adair Turner. Its four external members include Michael Cohrs, former head of global banking and co-head of investment banking at Deutsche Bank, former US Federal Reserve vice chairman Donald Kohn, and Robert Jenkins, former chairman of the Investment Management Association.

Minutes released by the Bank show the interim FPC's members were already divided last Autumn over whether to let the banks reduce their liquidity buffers to help maintain lending to business in the stressed funding market conditions.

The external members have already been making a name for themselves in their new roles. Jenkins attracted headlines last November when he attacked the banks for what he called their "intellectual dishonesty" in suggesting that tighter regulation would have a negative impact on the provision of credit to business.

Kohn has also revealed that the FPC has begun work to build on the Bank's existing risk identification structure and, through the FSA, was gathering information on several practices that raised questions about financial stability.

DISQUIET OVER COMPLEX STRUCTURES Members were particularly concerned by the complex funding structures surrounding synthetic exchange-traded funds (ETFs) and collateral swaps, which they felt could contribute to mispriced risk and instability, although the FSA had found that UK banks are not active in this particular area. Kohn added that the FSA had also been asked to work with the British Bankers' Association to improve the transparency of UK banks. Their US peers publish complete reports on a quarterly basis rather than twice-yearly.

The FCA, described as a "focused new conduct of business regulator", takes over the regulation of consumer credit from the Office of Fair Trading (OFT). The latter has traditionally applied a light-touch regime that kept down costs but also attracted criticism from consumer groups that it has not done enough to protect more vulnerable borrowers. Martin Wheatley, the FCA's chief executive designate, has already said that products that do not serve consumers' best interests should be limited or banned, and hinted that structured products could be the FCA's first target.

The FCA's enhanced powers also mean that financial services firms will be required to go public with the news when the regulator has intervened to prevent a promotion that it has decided either breaches the rules or is likely to prove misleading. While the FSA currently writes to firms when it has concerns over their advertising or promotions, it does not require them to disclose this publicly.

According to the Treasury: "This provision is intended to enable the FCA to take swift action to minimise consumer detriment. The FCA can direct the firms to refrain from making a promotion, to withdraw a promotion, to publish details of it, or to do anything else the FCA directs it to do in relation to the promotion."

The Bill's publication follows a pre-legislative review period over the second half of 2011, following which it was decided to amend crisis management arrangements between the Treasury and the Bank and to give the FCA responsibility for consumer credit regulation.

CLEARLY IN CHARGE Speaking in Parliament on 6 February, Osborne said the Bank would offer a "single point of accountability for financial stability, ensuring there is a decisive answer to the question about who is in charge", while the FPC would be entrusted with the stability for the whole financial system. "Its job will be to identify bubbles as they develop, spot dangerous interconnections, warn about poorly understood financial instruments and take action to stop excessive levels of debt building up before it's too late."

The chancellor added that the FPC might have the ability to raise capital ratios at banks during a boom period, although this proposal could prove controversial and would first need to be approved by MPs.

"I freely accept that we are largely in uncharted territory in policymaking here or indeed anywhere in the world," Osborne admitted. "I am aware that lots of other jurisdictions are considering these types of things but I think we are ahead of many jurisdictions. But surely the experiment of making no attempt to moderate the credit cycle, letting the bubbles grow and burst and then cleaning up afterwards has been an unmitigated disaster, and I think we would be failing if we didn't look for an alternative approach."

The government announced that it has provisionally scheduled the Bill for royal assent before the end of this year so that the new system can become operational in early 2013.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org