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Report of: The Remembrancer	For Information

Summary

Since the financial crisis there have been 5 major legislative initiatives. This report is prompted by the conclusion of the final parliamentary stages of the Government's latest legislative response to the financial crisis. Broadly, the Government has approached its reform of the financial services sector in two ways, firstly through reform of the regulatory architecture (in the Financial Services Act 2012) and subsequently by changing the rules governing market participants (in the Financial Services (Banking Reform) Act 2013).

This report provides an overview of the combined effects of the legislation.

Background

1. Established to scrutinise banking reform and standards, the Parliamentary Commission on Banking Standards spent months examining witnesses and taking evidence (including evidence submitted by the Remembrancer on behalf of the City). At the same time and as part of the wider activity to promote 'standards', the Lord Mayor's City Values Forum has worked with bank chairmen and chief executives as well as more operational staff. Forum sessions have included work with bank chairmen to produce a 'roadmap for governing values' and with senior operational staff on 'performance with integrity'.
2. The Commission's work took on great significance in Westminster with many sub committees examining specialist elements of the financial services sector. When the Government accepted the tenor of the Commission's recommendations but differed markedly on some points, PCBS members were swift to criticise. The Government's timetabling of the Bill in the Commons was condemned and PCBS members in the House of Lords continue to express their disquiet about what they contend are official attempts to water-down the recommendations.

3. Expressing the unhappiness of Commission members at the extent to which the Government resisted some recommendations, Lord Turnbull (a Cross Bencher and former head of the civil service) said during a debate in the Lords: “There is ...a long list of recommendations which the Government have rejected or simply ignored: recommendations on leverage, proprietary trading, special measures, a new regulatory decisions committee for banking, the strategic objective of the FCA, and so on. Amendments made in the Lords, many by PCBS members, totalled three-times the Bill’s original length. Summarising the Government’s view, Commercial Secretary Lord Deighton told peers that “the Government have been prepared to listen, and you will see that we have responded. However, where the Government do not believe the proposals are backed by evidence, or are unreasonable, we have respectfully disagreed and set out our reasons”.

New Regulatory Architecture

4. Extensive criticism of the Financial Services Authority following the financial crisis lead the Chancellor to state his legislative objective as being “for clear unambiguous responsibility for systemic stability to be given to the Governor of the Bank of England”.
5. The reformed regulatory architecture seeks to achieve this aim by establishing the Financial Policy Committee (FPC) and the Prudential Regulation Authority (PRA) within the Bank, and by providing the Governor with a seat on the third new regulator, the Financial Conduct Authority (FCA).
6. The FPC is chaired by the Governor and seeks to regulate the stability and resilience of the financial system as a whole. This macro-prudential role focuses on overall risk and levels of debt in the financial system. Extensive political debate over whether the FPC should be given a mandate to have regard to economic growth was resolved with the introduction of a “growth objective”. The part played by this objective can be seen, at least tangentially, in the Bank’s recent pronouncements on how employment data will affect Bank policy on interest rates.
7. The FPC sits within the Bank of England and its membership must be approved by the Chancellor. FPC members may be appointed by the Chancellor or the Governor to serve for a maximum of two terms of 3 years. Sir Jon Cunliffe is the most recent FPC appointment and he took up his role as Deputy Governor, Financial Stability on 1 November 2013.

Eight others sit on the FPC including Andy Haldane, Executive Director, Financial Stability and Martin Taylor a former Barclays CEO and member of the Independent Commission on Banking chaired by Sir John Vickers.

8. The PRA supervises individual banks that are systemically important to the UK economy. It seeks to ensure that a scheme is in place to ensure any bank failure occurs in an orderly manner. The Chancellor and Mervyn King (when Governor) made it clear that this is not the same as a no-failure regime – which, according to King’s evidence to MPs, would be “the stability of the grave yard”. The PRA is chaired by the Governor and the Bank’s Deputy Governor for prudential regulation is the chief executive of the PRA. According to the Government and supported by the Bank of England, the PRA has a holistic approach to supervision – which they assert is in contrast to the FSA’s ‘tick box’ approach. The PRA’s concept of “supervision” encompasses matters such as monitoring the safety and soundness of PRA-authorized persons, forming a view on the person’s long term strategy for doing business, providing advice and, where appropriate, warnings, monitoring compliance with regulatory requirements and taking disciplinary action where appropriate. Around 1,700 firms are within its scope. While not in the original proposals, the Government accepted PCBS proposals to place a competition objective on the PRA. Drafted as a secondary objective, the requirement will be for the PRA to “facilitate effective competition in markets”.
9. The Financial Conduct Authority has a number of objectives. The FCA’s “consumer protection” objective creates a duty to issue codes and guidance as well as investigating and enforcing regulatory breaches. In addition, the FCA has an objective to ensure the soundness, stability and resilience of the financial system - the “integrity” objective. Making rules to address the risks of money laundering is one example of action the FCA will take under the integrity objective. While not originally in the Bill, a “competition” objective was, after extensive debate, inserted so that the FCA may take action to promote effective competition in the interests of consumers. One example of the way in which the FCA might act is in relation to this objective is in relation to the ease with which customers can change their service provider – a point pursued by Treasury Committee member Andrea Leadsom in relation to bank account switching and partly achieved through pressure on the banks to introduce the ‘seven day switching policy’.
10. The practical inter-relationship of the PRA and the FCA is governed by a memorandum of understanding and the positions held by senior bank

staff on the boards of both regulators. Each regulator operates under a duty to consult the other if it believes its actions may adversely impact the objectives of one or both of the other regulators. The relationship is not, however, intended to be entirely equal – in certain cases where the FCA proposes to exercise a regulatory power, the PRA has the power to direct the FCA not to exercise that power or not to exercise it in a particular manner.

Ring Fencing

11. Initially resistant to the idea of ‘electrifying’ the proposed ring fence between commercial and retail banking operations, the Government moved some way towards meeting the concerns expressed by Sir John Vickers’ Independent Commission on Banking – that ‘high street’ banking should be insulated from the vagaries more commonly seen elsewhere in the sector. It is proposed that ring fenced banks will have separate boards, remuneration arrangements, treasury and balance sheet management, risk management, and human resource management. Strong pressure from the Commission in support of electrifying the ring fence by providing the Treasury with a reserve power to separate all retail operations at all banks, was not conceded by the Government. The Government did, however, introduce a power for regulators to separate the functions of individual institutions. Unhappy with this position, Commission members from the House of Lords tabled a raft of amendments designed, among many other things, to implement a reserve power to carry out an industry-wide break up all banks with a retail and commercial function. The Government rejected the proposals. A senior person at a ring fenced bank will be individually responsible for ensuring compliance with ring fencing requirements.
12. Banks have until 2019 to comply with the ring fence provisions. In a late addition to the Bill, the Government adopted the PCBS’s recommendation that the operation of the ring fence should be independently reviews within 4 years of it coming into force.

Leverage Ratio

13. The Commission spent much time considering the introduction of controls on banks’ credit to debt ratios – their leverage. The Commission made a strong recommendation for the swift introduction of a power for

regulators to set leverage ratios and providing them with the authority to set ratios higher than those agreed internationally.

14. At Mansion House, soon after the PCBS published its recommendations, the Chancellor stated outright that the Government does not agree with the PCBS's recommendations on this issue. The Government's position continues to be that the FPC will have the power to determine leverage ratios only after 2018 and that it will not agree to allowing the regulator to set ratios above internationally agreed minimum requirements. As with disagreements described earlier in this report, the difference of opinion between PCBS members and the Government prompted a volley of backbench amendments seeking -unsuccessfully- to introduce the PCBS's recommendations into the Bill.

Individual Responsibility

15. Making "individual responsibility in banking a reality" was one of the Commission's stated themes. Responding to the Commission's recommendations, the Government introduced proposals to replace, in retail banks, the 'approved persons' regime with a 'senior persons' scheme. The PRA will be responsible for designing a scheme to ensure that key responsibilities are assigned to specific senior individuals.
16. The Banking Reform Act introduces a new criminal sanction against senior bankers who are found guilty of "reckless misconduct" in the management of a bank.
17. The PRA will consult on the rules during 2014 with the intention of implementing the 'senior person' regime in 2015. The PRA will also consult on who should be within the scope of the regime.

Bail In

18. In developments very late in the Bill's parliamentary progress, the Government introduced amendments that would empower the Bank of England to require a 'resolution instrument' in respect of a specific bank or a specific security or type of security. The consequence of such an instrument is to require sophisticated investors holding bank debt to forego payment of that debt in circumstances where the bank faces bankruptcy. These arrangements, usually called a bail in, would leave untouched other creditors of similar stature, such as derivatives

counterparties. Governments in the UK and in the US - where bail in already exists – hope that removing the need for banks to pay back debt will help stabilise and re-float banks at times of grave stress.

19. Bail-in regimes are not traditional bankruptcies, which have strict rules and a court-supervised process that mean creditors are ranked in order of repayment precedence, and because of that have received criticism as giving regulators executive power.

Conclusion

20. After a period of seismic change, the outlook for the UK financial sector from a domestic perspective is now clearer than for some time. The continuing position of financial services as a headline subject and the latest proposals from the European Commission on structural reform of the banking sector, however, mean it must not be assumed future developments are clear.

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