



House of Commons
Treasury Committee

**Financial Regulation: a
preliminary consideration
of the Government's
proposals**

Seventh Report of Session 2010–11

Volume I

Volume I: Report, together with formal minutes

Volume II: Oral and written evidence

Additional written evidence is contained in Volume III, available on the Committee website at www.parliament.uk/treascom

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The Treasury Committee

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Summary

This Report responds to the Government's initial proposals for radical change to economic policy-making and the way in which financial services are regulated in the United Kingdom. We expect to return to the subject in future Reports.

The Governor of the Bank of England told us in relation to international regulation:

my concern would be that people are trying to get to an end point too quickly. Many of these decisions would be better made in a slightly more relaxed timeframe, but trying to get it right.¹

This is also the case with national regulation. As experience with the draft legislation for the Financial Services and Markets Act 2000 showed, it is more desirable that the Government gets these reforms right than sticks to an arbitrary timetable.

The Government's reforms are taking place at a time when the Basel Committee on Banking is proposing major changes to bank capital and liquidity requirements, and related regulatory changes. International agreement is also being sought on a range of other financial stability measures. The European Union has recently established a new system of European Supervisory Authorities, and the European Systemic Risk Board. It is important that the United Kingdom, with a particularly large share of the financial services activity of the EU, secures proper representation on the EU regulatory bodies. The Government has set up an Independent Commission on Banking, to look at competition in banking, with a remit which could include radical structural reforms, due to report in the autumn.

The financial services industry is an important contributor to the United Kingdom's economy. It needs to be regulated effectively but proportionately. It should not have to deal with regulation in a state of flux, which could result if the initial reforms turn out to require further change. Urgency could be counter-productive for stability and certainty.

The Government proposes to give a Financial Policy Committee (FPC), based in the Bank of England, power to monitor the system to ensure financial stability, and to take action when that stability is threatened. This is a further shift of powers for economic policy-making away from Government. There are sound reasons for insulating economic policy decisions from short-term political pressures. However, 'financial stability' is a very broad concept, and may be hard to define in practice. The Government needs to give a great deal more information on what it considers constitutes financial stability and to demonstrate that due thought has been given to it.

The macro-prudential tools which the FPC is to use are as yet undefined and untested, and may have unexpected consequences. The Government needs to decide which macro-prudential tools it proposes to make available to the FPC. We welcome the fact the

Government is going to set out these macro-prudential tools in secondary legislation; that legislation needs to be published as soon as possible, so that Parliament can assess the nature of the powers to be devolved to the FPC. Without such information, Parliamentary and wider scrutiny cannot be effective.

There must be strong accountability mechanisms. The accountability of the Monetary Policy Committee is secured by its extremely clear remit, and the mechanism for exchanging letters with the Chancellor if inflation breaches the target of 2% by plus or minus one percentage point. In addition, the Bank of England has engaged with the Treasury Committee in an exemplary way to achieve accountability to Parliament. The need for secrecy, among other things, will mean that the accountability of the FPC will be different from that of the Monetary Policy Committee (MPC). This Committee will consider what is required in the light of more detail on the Government's reform proposals. Without knowing these it is not possible to put forward accountability proposals of our own.

Given the high profile yet uncertain nature of its tasks, it will be essential that the FPC has a strong core of credible external members and contains at least one person with recent experience of risk management at the highest level. The Government should reconsider the balance between Bank personnel and external members, and, at the least, provide a fuller explanation of the reason for including two bank executives as part of the FPC.

The Government proposes to establish a prudential regulator, the Prudential Regulation Authority, as a subsidiary of the Bank of England. Financial stability does not mean that firms will not fail; it means that failures can take place without threatening the system as a whole. In the absence of further explanation, suggestions that the authority would have a "low tolerance" for the failure of systemically important institutions imply the opposite.

The Consumer Protection and Markets Authority (CPMA) will regulate the conduct of financial institutions. Proper regulation of conduct should in itself produce good outcomes for consumers. However, branding the CPMA as a 'consumer champion' would be inappropriate, confusing, and potentially dangerous. The job of the regulator is to ensure regulation is effective and proportionate. That requires a balance between preventing abusive behaviour and ensuring that regulation does not impose excessive costs and restrictions. Financial markets are primarily about the management and pricing of risk, not its removal.

The CPMA should have competition as an objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy handed regulation. Greater competition should also help prevent firms becoming too big to fail.

The financial crisis has resulted in a sharp increase in the direct costs of regulation. The indirect costs have doubtless increased further, although they remain difficult to quantify. Both are borne by the consumer. We are concerned that the proposals say little about the cost of regulation, or about the non-bank sector. Regulatory changes should not be

considered without proper evaluation of both their direct and indirect costs. The new regulators should bear this in mind.

1 Introduction

Financial regulation - from Tripartite to 'Twin-peaks'

1. In July 2010, the Treasury published a consultation document, *A new approach to financial regulation: judgement, focus and stability*, proposing changes to financial regulation in the United Kingdom.² The Government proposes to do away with the tripartite system, in which the Treasury, the Bank of England, and the Financial Services Authority work together. Instead, the Government is consulting on:

giving the Bank of England powers over macro prudential regulation through a newly established Financial Policy Committee (FPC),

and creating:

A new prudential regulator under the control of the Bank of England [...] which will be responsible for supervising the safety and soundness of individual financial firms.

A new Consumer Protection and Markets Authority (CPMA) to act as a single integrated regulator focussed on conduct in financial markets.³

The new regulatory framework will follow a 'twin-peaks' model, in which prudential regulation of financial institutions is separated from the oversight of consumer protection and markets conduct.

2. The reforms are intended, among other things, to deal with the problems of the tripartite system. In the aftermath of the collapse of Northern Rock, the then Treasury Committee concluded:

we are concerned that, to outside observers, the Tripartite authorities did not seem to have a clear leadership structure. We recommend that the creation of such an authoritative structure must be part of the reforms for handling future financial crises.⁴

The system was amended somewhat after the Committee's report, but the basic structure remained.

3. The Government's proposals go further than simply dividing prudential regulation and conduct of business regulation between two regulators. They would create a macro-prudential regulator with wide, as yet undefined, power to intervene not only in the affairs of individual institutions, but to take action system wide. The consultation paper states:

Domestically, a major deficiency in the UK's tripartite system has been precisely that no authority had clear, overall responsibility for identifying, monitoring and

2 Cm 7874

3 HM Treasury Press Notice, 32/10. 26 July 2010

4 Fifth Report of Session 2007-8, *The run on the rock*, HC 56-I, para 284

responding to risks building up and fault lines in the system as a whole. While recent attempts have been made to fill this gap by providing statutory objectives for financial stability to the Bank, and latterly, to the FSA, these changes assigned responsibility without appropriate powers, and entrenched rather than addressed the fundamental problem.

The Government will therefore legislate to put the Bank of England in charge of macro-prudential regulation, by creating a strong Financial Policy Committee (FPC) within the Bank, with ultimate authority to identify imbalances, risks and vulnerabilities in the financial system and take decisive action to mitigate these in order to protect the wider economy.⁵

4. There will be three major bodies. The Financial Policy Committee (FPC), to be created within the Bank of England, and chaired by the Governor, will have “primary statutory responsibility for maintaining financial stability”. A Prudential Regulation Authority (PRA) “will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks.”⁶ As well as being a subsidiary of the Bank, the PRA will have strong working links with it: its board will be chaired by the Governor, and the PRA Chief Executive will be a Deputy Governor of the Bank. The Consumer Protection and Markets Authority (CPMA) will have “a primary statutory responsibility to promote confidence in financial markets”.⁷ The CPMA will be a freestanding organisation, but with strong links to the other regulators: its Chief Executive will sit on the FPC and the regulators will have statutory duties to consult one another.

The financial services industry

5. The UK financial sector was estimated to have contributed about 10% of GDP in 2009, and employed around 993,000 people as of June 2010.⁸ It is a diverse industry which includes banking, insurance, securities dealing, and fund management. Regulatory changes can have significant impacts, both on individual firms and on the efficiency of the UK financial industry as a whole. The challenge will be to produce a regulatory structure which reduces the systemic risks financial services pose while ensuring economically advantageous activity is not driven out by inappropriate regulation. Good regulation can provide competitive advantage, as many of our witnesses told us. For example, a home regulator can provide standards which are accepted throughout the world. Mr Abbott, CEO of the London Metal Exchange noted that:

90%-plus of all of the metal futures trading in the world [...] takes place here in London. [...] Therefore, the regulation of the LME takes place here in London by the FSA. We are subject to regulation in other jurisdictions around the globe. We are

5 Cm 7874, paras 2.8-2.9

6 Cm 7874, para 1.14

7 Cm 7874, para 1.21

8 *Financial Markets in the UK November 2010*, TheCity UK; estimates of the contribution of financial services to the UK economy are however not straight forward.

approved, for instance, in North America by CFTC; also in jurisdictions such as Singapore, Hong Kong, Australia. They accept that the best regulator to regulate any business is the home regulator [...]⁹

6. The banking industry is the largest segment in financial services, with over 400,000 employees. However, other sectors within the financial services industry also contribute significantly to the economy:

- the UK insurance industry is the largest in Europe and third largest in the world, with insurance premiums collected reaching almost £200bn in 2009;
- the London equity market had a global share of 17% in 2009, second only to New York;
- the UK fund management industry is one of the largest in the world, with assets under management reaching £4.1tn in 2009.¹⁰

Figure 1: Contribution of output and employment to the UK economy from each financial services sector

	Output (% of GDP)	Employment
Banking	5%	435,000
Insurance	2%	300,000
Fund management	1%	50,000
Others including securities, derivatives, commodities and bullion	3%	208,000
Total	10%	993,000

Source: data from TheCityUK

The sector is estimated to have been the largest payer of corporation taxes in 2010 and accounted for 11.2% of total tax receipts for the year.¹¹

7. The Government has said that it intends to bring in a Bill on its proposals by “mid-2011”, with an intermediate consultation on more detailed proposals early in 2011.¹² Given this timetable, the importance of the sector, both as a direct and indirect influence on the United Kingdom economy, and the potential impact of the changes, we made it a priority to provide a preliminary examination of the Government’s initial proposals. The Committee intends to return to a number of these key issues in the light of the findings of the Independent Commission on Banking. We have not attempted to respond to each of the consultation questions: rather we have identified areas where the Government may need to reconsider, or at least give a fuller account of its reasoning. The Government’s proposals are evolving, and we expect to return to this matter again during this Parliament.

9 Oral evidence taken before the Committee on 2 December 2010, European Financial Regulation, HC 658-i Q 15

10 All data comes from Financial Markets in the UK – November 2010, TheCityUK

11 PricewaterhouseCoopers, *The Total Tax Contribution of UK Financial Services*, Report prepared for the City of London Corporation, December 2010)

12 Cm 7874, 7.12, 1.26

Conduct of the inquiry

8. We thought it was important to gather the widest range of views possible on the Government's proposals, and to hear from many different sectors. Accordingly, our inquiry spanned 18 oral evidence panels, taking place from July to November 2010. A full list of witnesses is given at pages 81-3. We are grateful to our many witnesses for sharing their views on this important subject with the Committee. We are also grateful to those who submitted written evidence and to our specialist advisers, Bill Allen, Alex Bowen, John Tiner and Professor Geoffrey Wood.¹³

Overview

9. There have been large costs from the crisis, both to the taxpayer and the wider economy. On top of this, the taxpayer remains exposed to potential loss through the shareholdings it retains in banks such as Lloyds Banking Group or Royal Bank of Scotland (RBS) and through the Asset Protection Scheme. In a speech in November 2009, Andrew Haldane, Executive Director for Financial Stability at the Bank of England, suggested that the support packages provided by Governments and central banks amounted to 74% and 73% of GDP in the UK and US respectively.¹⁴

10. The costs of the crisis to the wider world economy were significant as well. In a speech in March 2010, Mr Haldane noted that "World output in 2009 is expected to have been around 6.5% lower than its counterfactual path in the absence of crisis".¹⁵ This cost, borne by taxpayers at home and abroad, as well as those directly affected by the financial crisis, carries a significant lesson. Failure of financial services companies can have effects which reach far beyond the companies involved. Mr Haldane outlines the problem, and potential government action:

The banking industry is [...] a pollutant. Systemic risk is a noxious by-product. Banking benefits those producing and consuming financial services—the private benefits for bank employees, depositors, borrowers and investors. But it also risks

13 Relevant Interests of the specialist advisers are as follows (a complete list of interests is published in the formal minutes available on the Committee's website):

Professor Geoffrey Wood: Director, Hansa Trust; Member, Investment Advisory Panel, Strathclyde Pension fund; Member and Adviser, PI Capital (private equity group); Adviser, Elliot Advisors.

William Allen: Financial and economic consultant; Two current consultancy contracts. One is with a company called Ad Satis Ltd (their internet site is <http://www.adsatis.com/>). Ad Satis itself provides consultancy services to banks, and the contract is to provide them with pieces of research on bank regulation. The other is with NBNK Investments PLC, which intends to acquire banking assets in the UK and establish a new retail banking company to compete with the established incumbents; Consultancy work for the International Monetary Fund in the past and am on their list of occasional consultants.

Alex Bowen: No relevant interests declared

John Tiner: Partner and CEO of Resolution Operations LLP, an FSA authorised firm, Non-Executive Director – Lucida Plc, an FSA authorised firm, Non-Executive Director – Credit Suisse Group, Swiss Bank with major businesses in the UK.

14 Bank of England, Banking on the State, Piergiorgio Alessandri & Andrew G Haldane, Bank of England, November 2009

15 Bank of England, The \$100 Billion Question, Speech by Andrew G Haldane, Executive Director, Financial Stability, Bank of England, March 2010

endangering innocent bystanders within the wider economy—the social costs to the general public from banking crises.¹⁶

11. Against this background, the Government’s desire for urgent action to strengthen the regulatory system is understandable. However, the speed with which its consultation was prepared and published has meant that, although the Government has described the regulatory structures which it wishes to put in place, and their broad objective—the new regulators will pursue ‘financial stability’—there are many places where more explanation is essential. In its report on *Financial Stability and Transparency*, published in 2008, the Treasury Committee noted “There is a continuing lack of clarity about what is meant by financial stability as well as what events constitute a ‘serious threat to financial stability’”.¹⁷ The new Government now needs to define what it considers financial stability to be. As we will explore throughout this Report, at this stage there is more clarity about the regulatory architecture than the detailed outcomes the Government wishes to achieve.

It’s not all about banking

12. The consultation has been criticised for an overemphasis on the banking sector, which may be the result of the speed with which these reforms have been worked out. The banking crisis demonstrated the need to reform bank regulation. Bank activities have been the source of financial instability in the past, and are clearly continuing sources of risk, given their activities in maturity transformation, their use of leverage, and the interconnectedness of their activities. However we heard that regulatory reforms which focus too much on banks may adversely affect other areas of financial activity.¹⁸ To give one example, the Government’s proposal to set up two new regulators, the PRA and CPMA, may lead to confusion about which firms will be regulated, or part-regulated, by which regulator. Under the proposals, all banks (including building societies and credit unions), broker-dealers (including investment banks) and insurers will be regulated by the PRA, while the CPMA will pick up the rest of the financial sector, including the conduct of business regulation of any PRA-regulated firms.

13. The split in responsibility between the PRA and CPMA may not be clear in some cases. Whilst most banks will be prudentially regulated by the PRA and by the CPMA on conduct of business, regulation of the non-banks is less clear. For example, most large insurance firms would have asset management arms. Under the new structure, it is not clear whether the PRA or CPMA will be the lead regulator for such organisations. Aviva told us:

no single body will be charged with taking a holistic view of the whole Aviva group. Under the proposed new structure, supervisors would have to gain such an overview despite the fact that substantial businesses within the Aviva group would be subject to prudential supervision by different regulatory bodies: the insurance business by

16 Bank of England, *The \$100 Billion Question*, Speech by Andrew G Haldane, Executive Director, Financial Stability, Bank of England, March 2010

17 Sixth Report of Session 2007-08, HC 371, para 7

18 Q 467

the Prudential Regulatory Authority (PRA), and Aviva Investors (our asset management business) by the Consumer Protection & Markets Authority (CPMA).¹⁹

14. Furthermore, the proposed structure could cause problems for asset management firms associated with deposit-taking activities. Blackrock told us:

Some asset managers may have entities within their group in the United Kingdom which have permissions as a deposit-taker for insurance business only [...]. It is unclear from the consultation whether these permissions will bring some or all of asset management group entities in the United Kingdom within the scope of prudential regulation by the PRA and conduct regulation by the CPMA or whether it is intended that these activities would be excluded from the scope of the PRA.²⁰

15. There are other areas within the financial sector which merit more focus than the consultation paper gave them. Lloyd's, the specialist insurance market with more than £22bn of premium income in 2009, was hardly mentioned in the document. Lord Myners described the consideration given to regulation of Lloyd's as an "afterthought":

It really does appear right at the end of this document. Lloyd's is a significant market. It has been very well regulated, very well run and has produced large tax revenues and large employment in the UK. It is almost an afterthought in this document. We need to make sure that this structure does not in any way disadvantage the UK as a centre for insurance and reinsurance.²¹

We are concerned that the current proposals for reform say relatively little about some key segments of the UK financial sector. Inappropriate regulation of non-banking sectors could cause serious and unintended damage to companies within those sectors, and to the UK more widely. As the Treasury's consultation evolves, it is important that the Government clarifies the regulatory impact of its proposals on the non-bank sectors.

19 Eww 14

20 Eww 12

21 Q 94

2 The Government's timetable

16. The Government's intention is that the legislation to implement its proposals should be introduced in "mid-2011", and that "In order to minimise uncertainty for regulated firms the Government will seek to ensure the passage of the necessary primary legislation within two years" from July 2010.²²

17. While it is important to keep uncertainty to a minimum during a period of institutional upheaval, it is even more important that the reforms are carefully thought through. Financial services are intrinsically mobile. Witnesses told us that good regulation was a key part of ensuring a healthy and competitive financial services industry, but that bad regulation was counter-productive in equal measure. The passage of the Sarbanes-Oxley Act in the US has been considered as a factor behind London's continuing success as a financial centre, as business has migrated to the UK.²³

18. There are already some signs that the Government may be proceeding with undue haste. As we explore in more detail later, proposals in the initial consultation have already been radically altered—for example, the markets division of the CPMA is now to keep responsibility for the UK Listings Authority, rather than see it transferred to the FRC as previously suggested. While the initial consultation appeared in July, the consultation on transferring regulation of consumer credit from the OFT to the CPMA was not published until 21 December 2010.

19. Wider policy issues relating to the financial sector also need to be settled. There are significant uncertainties in the way in which competition policy will be handled in future. On 14 October 2010 the Cabinet Office review of public bodies announced that the OFT and the Competition Commission were to merge and that "Government will consult in the new year on a merger with the competition functions of the Office of Fair Trading."²⁴ One of the key questions in our inquiry has been whether any of the new regulatory bodies should be concerned with competition; it is hard to consider this without a wider view of competition arrangements.

20. We acknowledge the danger of a loss of focus if reform is not pushed through, but that risk can be mitigated more easily than the danger that well-intentioned but ill-considered reform may fail to ensure stability, while also undermining the strength of the United Kingdom financial services industry.

21. In contrast to the speed with which it has introduced its regulatory reforms, the Government has established an independent commission to examine competition in the

22 Cm 7874, paras 7.12- 7.14

23 Luigi Zingales, *Is the U.S. Capital Market Losing Its Competitive Edge?*, Working Paper No.1, The Initiative on Global Markets, University of Chicago School of Business, November 2006

24 <http://www.cabinetoffice.gov.uk/sites/default/files/resources/2010-10-14-Public-bodies-list-FINAL.pdf> accessed 26 January 2011

banking sector, and given it until September 2011 to report. The Independent Commission's remit is extremely broad. Its terms of reference state:

it will formulate policy recommendations with a view to:

- Reducing systemic risk in the banking sector, exploring the risk posed by banks of different size, scale and function;
- Mitigating moral hazard in the banking system;
- Reducing both the likelihood and impact of firm failure; and
- Promoting competition in both retail and investment banking with a view to ensuring that the needs of banks' customers and clients are efficiently served, and in particular considering the extent to which large banks gain competitive advantage from being perceived as too big to fail.²⁵

These are all significant issues, which will have an impact on financial regulation, and its institutional framework.

22. Once the Commission reports, the Government will have to decide its policy. Some of the Commission's recommendations may turn out to have a bearing on the regulatory framework or the ends that framework should achieve. There are significant issues where it will be important to know the Government's position. For example, in the previous Parliament, the Treasury Committee considered the problem of institutions which were 'too important to fail', and the trade-offs which had to be considered in regulation. Among the Report's recommendations were several relating to the use of bank subsidiaries, rather than branches, to increase financial stability:

The first benefit from subsidiarisation would lie in ensuring that local regulators, if informed and competent, have greater control over subsidiaries, and are able to impose the policy trade-offs that their country requires. If it becomes necessary for a subsidiary to be closed down, it will be helpful to have access to its capital, and as international firms will be less complex, resolution may be easier.²⁶

This remains a live issue: Sir John Vickers, the Chairman of the Commission, has explored the possible benefits of greater use of subsidiarisation in a recent speech.

23. We welcome the establishment of the Independent Commission on Banking. The Government should pay full regard to Vickers before coming to conclusions. Once Vickers has reported it will be equally important to maintain the political will to act on the Commission recommendations, if, after scrutiny, action is needed. This has implications for the timetable for the reforms set out in the current consultation paper.

24. At the outset of our inquiry, the Governor of the Bank of England told us:

25 <http://bankingcommission.independent.gov.uk/bankingcommission/terms-of-reference/> accessed 26 January 2011

26 Ninth Report of Session 2009-10, *Too important to fail—too important to ignore*, HC 261-I, para 101

my concern would be that people are trying to get to an end point too quickly. Many of these decisions would be better made in a slightly more relaxed timeframe, but trying to get it right. I understand there is political pressure to get on with it and we do not want to lose the momentum for change, but I would be happy if we could maintain the pressure of momentum for change, [...] but actually take our time to implement it over a slightly longer period.²⁷

25. **The Government needs to take the time required to get its reform of financial regulation right. We note there was a year between the first publication of draft clauses on the Financial Services and Markets Bill, and the appearance of a further draft. Although the Joint Committee which scrutinised the Bill was given only eight weeks for the task, it subsequently took from 17 June 1999, when the Bill was presented in the Commons, to 14 June 2000 to become law. The Bill was very heavily amended in Committee in response to widespread criticism after its initial publication. It is one of the longest and most complex pieces of legislation on the statute books. The Government's current proposals include a suggestion that FSMA could be revisited in its entirety. We urge the Government to ensure that this is done, and present a new Bill only after full consideration has been given to responses to initial consultation. Drafting the legislation will then be likely to secure a more coherent final product and may eventually be quicker, given the complexities involved in comprehensive amendment of FSMA.**

26. **The legislation to establish the new regulatory structure should be subject to pre-legislative scrutiny, over a reasonable timescale; the eight weeks allowed for the Joint Committee on the Financial Services and Markets Bill was inadequate. Even with proper pre-legislative scrutiny, once introduced, the timetable for the Bill should be generous enough to allow proper parliamentary consideration, using carry-over if necessary.**

27. **However, scrutiny of the legislation will not be possible without fuller discussion of what financial stability might look like and how the democratic responsibilities of government can be combined with the delegation of significant economic policy making powers to an independent body. There also needs to be greater clarity about the wider regulatory framework; the major decisions on the structure of financial regulation should not be taken until there has been time to consider the recommendations of the Independent Commission on Banking. Whether or not it is possible to produce the final legislation within the two year time frame the Government envisages, the aim of introducing the legislation in "mid-2011" appears optimistic and, if pursued too rigidly, runs the risk of compromising its quality.**

28. **The need for a more rapid set of reforms is in part determined by the stability of the transition arrangements. The FSA in their written evidence noted that:**

[...] in order to minimise the risk of staff losses, we plan to move in early 2011 to a shadow split (reflecting the mandates of the 'Prudential Regulation Authority' and 'Consumer Protection and Markets Authority') within the FSA for our current risk and supervisory functions in early 2011. This will also allow us to modify the operational aspects of the new approach before its formal launch in 2012. The FSA will be responsible for operating the shadow split but in designing the interim structure is consulting with Bank of England to ensure maximum continuity. The final design of the PRA will be a joint decision with the Bank of England.²⁸

29. The FSA will divide internally, in preparation for the new arrangements. The Bank of England will continue to publish the Financial Stability Report, which is likely to be more influential in the interim period. While the draft legislation is being thought through, clear non-statutory interim arrangements will need to be in place. The Treasury should consider the preparation of an Memorandum of Understanding with the Bank of England and the FSA setting out those arrangements.

3 A super regulator—the Bank of England

Financial Policy Committee

30. *A new approach to financial regulation* says:

Perhaps the most obvious failing of the UK system, however, is the fact that no single institution has the responsibility, authority or powers to monitor the system as a whole, identify potentially destabilising trends, and respond to them with concerted action.²⁹

The core of the Government’s proposal is to deal with this problem by creating a new macro-prudential regulator, the Financial Policy Committee (FPC) within the Bank of England “with ultimate authority to identify imbalances, risks and vulnerabilities in the financial system and take decisive action to mitigate these in order to protect the wider economy.”³⁰

31. Paul Tucker, Deputy Governor of the Bank of England responsible for Financial Stability, told us that the Bank of England had previously been able to identify problems, but that policy makers lacked instruments to use in response:

[...] whether in this country or globally, there were essentially two problems. There was a lack of a system-wide perspective that fed through to tools, to instruments; and I do not think there was a lack of analysis, but there was a lack of action. [...] The Government’s consultative paper sets out two elements to that: one, policies and rules that would make the system more resilient and less vulnerable, whatever the circumstances; and, two, leaning against over-exuberant credit booms. Those tools were lacking in the past.³¹

32. The FPC will have a primary objective of maintaining financial stability by assessing the systemic risks in the financial sector and taking action to mitigate them. To fulfil its objective, it will have power to decide whether macro-prudential tools (see section below) should be used, by giving directions and making recommendations to the PRA and CPMA to take actions on its behalf.

29 Cm 7674, para 1.6

30 Cm 7874, para 2.9

31 Q 11

How to define financial stability

33. The Government consultation notes:

The Bank's existing financial stability objective is framed as: 'an objective of the Bank shall be to contribute to protecting and enhancing the stability of the financial systems of the United Kingdom'.

This statutory objective, provided for in the Banking Act 2009, is deliberately general. The practical difficulties in setting a more precise definition of financial stability are well-established—financial stability is a concept that is highly context-specific and subject to change over time.³²

34. Adrian Coles, Director General of the Building Societies Association, contrasted this open ended definition with the more tightly-defined definition used for monetary stability:

The great advantage of the Monetary Policy Committee is that it has a measurable objective: 2% inflation. How do we measure financial stability? How do we measure the success of the PRA? Is it one collapsed institution a year is okay but five, the Governor of the Bank has to write a letter to the Chancellor of the Exchequer?³³

35. Defining financial stability may be difficult, but if responsibility for securing it is to be devolved to the FPC and the Bank of England, there needs to be some consensus about what it might be, the extent to which such stability is achievable, what powers are needed, whether trade-offs with other policy objectives are created and, if so, how those trade-offs are going to be managed.

36. In the previous Parliament the Treasury Committee noted:

[...] while better regulation and higher capital ratios could mean that crises are less severe, they cannot stop them. History is littered with examples of financial boom and bust, from the tulip boom in 17th century Netherlands, to the South Sea Bubble, to the dot-com boom. The challenge is to make sure that the financial system itself is not, as it has been recently, a prime cause of such instability, and to ensure that, in so far as possible, financial institutions bear the consequences of their own actions.³⁴

The Governor also believed that firms should be allowed to fail, as "it is very important that management fears failure, that they can be thrown out of their jobs, not by us but by the shareholders, and that if necessary, an institution can be allowed to fail in a way that does not disrupt the financial system as a whole [...]."³⁵

37. This would imply a definition of financial stability as being a system in which individual companies could (and inevitably would) fail, but that the system itself would not

32 Cm 7874, paras 2.21-2.22

33 Q 164

34 HC (2009-10) 261-I, Summary

35 Q 803

be threatened by such failures because contagion would be limited, and losses would be borne by the company's shareholders and creditors. However, given the complexity and interrelation in today's financial markets, such stability may be hard to achieve. Indeed, the Governor told us that, even had the FPC been put in place before 2007, the banking crisis would not have been avoided. He explained:

I do not think we would have been able to prevent a crisis because I think it was global in nature and I think the underlying causes, namely the imbalances in the world economy and the massive capital flows into the banking systems of the US, UK and Western Europe, that would still have been the case and we could not have stopped that nationally[...]³⁶

38. Financial stability is not necessarily a free good. In this respect it is unlike price stability, which can be achieved without any loss of output, growth or employment, except possibly in the short term. Pursuing financial stability can in some instances mean compromising other policy objectives. Moreover, financial stability, unlike price stability, cannot be achieved by manipulating a small number of policy instruments (such as the level of short-term interest rates), but is affected by a wide range of laws and institutions. One example is bankruptcy laws. The heavier the penalties the law imposes on people who become bankrupt, the fewer risks entrepreneurs will take. That will certainly contribute to financial stability, but it is likely to retard economic growth.³⁷ **Until now, such policies have been seen as the responsibility of the elected Government. If the Financial Policy Committee is to be given lead responsibility for securing financial stability there needs to be clarity about what such stability means. The overall stability of the financial system should certainly not mean that no firm will ever fail. However, there is room for debate about how frequent and severe firm failures may be before it is considered that the system is unstable. Moreover, in the short term, there could be trade-offs between some types of stability and growth if, for example, regulation restricts free entry and exit of firms or discourages innovation in other ways; there are trade-offs between the stability of the individual firm and growth. Unlike the MPC, which has a clear inflation target and the well-defined tool of interest rates and now quantitative easing to achieve its target, the remit for the FPC is difficult to define rigorously. Nonetheless, the Government needs to give a view, and a detailed one, of what the financial stability 'target' should be, how it should be assessed, and how any trade-offs that financial stability policy requires are to be managed.**

FPC membership

39. The Government has proposed that there will be 11 members in the FPC, comprising six executives from the Bank of England, including the head of the PRA, the head of the CPMA and four external members. There will also be a non-voting representative from the Treasury. As matters currently stand, FPC membership would include:

36 Q 21

37 Wei Fan and Michelle J. White, 'Personal Bankruptcy and the Level of Entrepreneurial Activity', *Journal of Law and Economics*, October 2003

- Governor (Mervyn King)
- Deputy Governor for monetary policy (Charlie Bean)
- Deputy Governor for financial stability (Paul Tucker)
- Deputy Governor for prudential regulation (Hector Sants)
- Bank executive on Markets, under Charlie Bean (name to be confirmed)
- Bank executive on financial stability, under Paul Tucker (name to be confirmed)
- Head of CPMA (name to be confirmed)
- 4 external members (names to be confirmed)
- Non-voting representative from HM Treasury.³⁸

External membership

40. The four external members will have an extremely important role. For the FPC to be credible, those members will need to be highly-respected in the financial industry, as well as commanding respect within the Bank itself. Given that only four out of eleven members are recruited externally, we questioned whether the FPC would be too Bank-focused, and whether external voices could be suppressed.

41. The Governor was more concerned about having the right people appointed as external members than about the balance between external FPC members and Bank employees:

Their [external members'] job is not to hold us to account, it's to contribute to a balanced judgment. I think they will. I think we've seen that on the MPC where it's four out of nine. I think with four out of 11, they won't all be internal bank executives. One of the seven, other than the four external members, will be the chief executive of the CPMA, the consumer protection body, and then you will have Hector Sants coming in as the chief executive of the PRA. So we have quite a range of different positions that people hold. I think they will have no difficulty in contributing fully.³⁹

Paul Tucker went further by saying that the number of external members did not matter hugely, and that the main purpose of having external members was "to liberate the internals from a monolithic line management structure"⁴⁰ and 'having the externals there means that you just don't go along and say, 'Well, it's absolutely clear what we ought to do and we all agree'.⁴¹

42. We expect that both the FPC and the MPC Committees will have access to analysis prepared by the Bank of England.⁴² However, while this will improve co-ordination between them, it will be very difficult for outsiders to challenge. Most of the members of FPC from the Bank of England will also be members of the MPC, as we discuss further

38 Cm 7874, paras 2.39-2.45

39 Q 768

40 Q 768

41 Q 768

42 The PRA and the CPMA will also brief the FPC.

below. This will make the independence of the external members still more important. There were disputes about the resources available to MPC members early in that organisation's development; it will be important to avoid such disputes on the FPC.

43. The independent members of the FPC will play a crucial role, at least as important as that of the equivalent members of the MPC. Given the close links between the internal members, the external members will play an essential role in ensuring that the Committee does not succumb to organisational 'groupthink'. They will need adequate support from the Bank. They should be given the right to commission any information and analysis they feel they need.

44. Whilst the MPC has four external members out of a total of nine, the FPC would have four external members out of eleven. A better balance between internal and external members of the FPC seems desirable. It could be achieved by increasing the number of external members on the FPC, to say six. That would increase the Committee's size to thirteen, so that it would become rather unwieldy. The alternative would be to reduce the Bank's representation. The Treasury has given no explanation of the rationale for having Bank executives on markets and financial stability as full members of the FPC, rather than non-voting participants, when their respective bosses are already present, or for including such executives rather than staff of the PRA.

45. The choice of the external members is crucial in that, for the FPC to be successful and credible, not only will the externals need to command respect across the financial industry, they will also need to possess deep knowledge and understanding of how macro-prudential policies may work in practice and their effects on the real economy. The Governor was open-minded about the type of experience required from the external FPC members, telling us that "there could be a wide range of people. What matters is not the sort of label we attach to them but the individual qualities they bring".⁴³

46. Sean McGovern, Director and General Counsel of Lloyds, told us that as the FPC would have influence over both macro-prudential and micro-prudential matters "they do need to be properly informed about insurance business so we don't get a complete focus on banking. So we would certainly be encouraging the FPC to have insurance skills as part of that committee structure."⁴⁴ In contrast, the Governor told us that, although the appointment of the external members was a matter for the Treasury, he considered:

[...] what matters is not that people are representatives of particular types of business, industry, and certainly not representing an interest. It can't be that. Indeed, conflict of interest is a major criterion in choosing the right people. They must be free of any conflict of interest. What we need are people who understand the financial sector but can think through what the issues are.⁴⁵

43 Q 771

44 Q 467

45 Q 769

47. At least some of the external members of the FPC should have a recent senior background in the financial services industry. It has been put to us that conflicts of interest may arise, for example when members still hold assets whose prices could be influenced by FPC decisions; such conflicts need to be carefully managed.

48. Peter Vipond, Director of Financial Regulation and Taxation at the Association of British Insurers (ABI), believed that it would be appropriate for those with major roles in the City to serve on the FPC, as long as there were adequate compliance procedures or Chinese walls between their day job and their FPC responsibilities. He explained:

I think there must be a case for some people on that group [external FPC members] who are, for example, chief executives and chairmen of major city institutions, insurance companies, life and general, of course, and investment banks and others. They would be in a position where they would be, in compliance terms, beyond the wall—they wouldn't necessarily be able to go back to their firm and talk about any of the conversations they've had—but that would bring you a kind of market sensitivity at the highest levels.⁴⁶

49. However prestigious a regulator may be, it will always lose many of its best staff to the industry it regulates. This is why the experience and credibility of the external members will be particularly important in ensuring the success of the FPC, and its credibility in the industry. The Committee must contain someone with recent experience of risk management at the highest level from the regulated sector. It would be wrong to require that the FPC contain members with experience in particular industries; the task of the FPC is to look at the financial system as a whole. However there must be no room for accusations that it is overly focused on banking nor that it lacks the expertise to look at important sectors, such as insurance.

50. Conflicts of interest will be hard to avoid, even if external members have retired from the industry. They will need to be managed carefully. Some have made a case for those with current experience serving on the FPC, and we do not exclude that possibility. However, if the Government is considering this, it should set out clearly how those conflicts of interest will be dealt with.

An interim FPC

51. The Government stated in the consultation document that an interim FPC would be established by the autumn of 2010.⁴⁷ Its membership will include Bank executives as well as Lord Turner and Hector Sants. The role of the interim Committee will be to prepare for the establishment of the permanent FPC, and to set out exactly what macro-prudential tools should be given to the permanent body. Lord Turner noted:

This [setting out macro-prudential tools] is going to be the crucial issue for the interim FPC when it is established. In preparation for that, there are people in the

46 Q 250

47 Cm 7874, para 7-11

relevant bit of the Bank already producing papers that will be before the interim FPC when it first meets.⁴⁸

52. There is nothing in the public domain which suggests that the interim FPC has been set up and met, despite the Government's original plan to set it up "by the autumn". We asked the Financial Secretary to the Treasury to explain the delay. He admitted that it has been taken slightly longer than the Government hoped, "because we are going through quite a radical process, as part of this whole regulatory reform package and it does take some time to put these bodies in place."⁴⁹

53. We pressed the Financial Secretary to give us a clearer timetable of when the membership will be identified, and when the meeting will take place. He told us that appointment would be completed by the end of 2010, although no timetable for any future meeting had been set:

We don't have a timetable for it to meet. Once its membership has been established, then it will be in a position to meet and then to undertake some of the tasks that we are keen for it to look at, including, for example, assessing the macro-prudential tools that will be available to the full FPC.⁵⁰

Our aim is to complete the appointment by the end of this year, as is sufficient to meet and undertake its work and fulfil the remit that we want it to undertake, including, as I said, a review of the macro-prudential tools.⁵¹

54. The interim FPC is intended to have an important role in carrying out preparatory work and analysis for the permanent FPC. Its work may well result in fine tuning or even substantial amendment of the Government's proposals. It should be engaged in developing proposals for macro-prudential tools, and ways in which they might be adjusted. Given that this body has yet to be established, the current restructuring timetable, where the new regulatory system will be in place by the end of 2012, may be too challenging. We note that the Government has been unable to avoid delay on this, despite its desire for speed and the considerable control it had over this part of the process.

Macro-prudential tools

55. The FPC will publish a Financial Stability Report every six months. It will include the FPC's assessment of the outlook for the financial sector, the level of systemic risks and the rationale behind any actions taken by the PRA or CPMA on the FPC's recommendations. The Bank of England already publishes a six-monthly Financial Stability Report. We asked Paul Tucker whether the new report under the FPC would be any different. He told us that,

48 Q 701

49 Q 810

50 Q 811

51 Q 813

in addition to the bi-annual report, the FPC would publish minutes following each quarterly meeting. These minutes would include an explanation of any FPC decisions:

It will take the current Financial Stability Report as the base, but I think it will end up being somewhat different because it will be explaining the decisions, and the analysis lying behind the decisions that the FPC are taking.

The really big change here, and I do think the FPC is the big institutional change, is moving the Bank of England away from commentary to taking decisions, making concrete recommendations, and the FSR will have to move away from a document where it's trying to set out an analysis in the hope that somebody with some levers somewhere will pick them up and use them.⁵²

56. The FPC will decide whether to use “macro-prudential tools” to deal with any risks it detects. Such tools are subject to debate. The Treasury’s consultation lists the following potential tools:

(i) Countercyclical capital requirements: These would add a ‘buffer’ to capital requirements based on the current cyclical position of the economy. For example, when private sector credit is growing rapidly, banks might be forced to hold additional levels of capital. This should increase the resilience of the banking sector by giving it more capital to absorb losses in any subsequent downturn, and may also damp the cycle by reducing lending in the upswing.

(ii) Variable risk weights: This would involve raising capital requirements against specific types of lending. If the authorities felt financial institutions’ exposure to a certain asset class was too great, they could try to discourage it in this way.

(iii) Leverage limits: This would impose an overall limit on the amount of leverage financial institutions can hold. It would act as a ‘backstop’ to capital requirements, which are typically risk-weighted.

(iv) Forward-looking loss provisioning: Banks would be forced to set aside provisions against prospective future losses on their lending. There are various ways this could be used as a macro-prudential tool, with Spain’s ‘dynamic provisioning’ system offering a useful practical example. This system links loss provisions to the credit cycle, so banks are forced to hold higher provisions when credit is growing strongly[...]

(v) Collateral requirements: These would limit specific types of lending by imposing higher collateral restrictions during times of unsustainable growth in that lending. Possible examples include loan-to-value limits on secured lending, margin requirements on stocks/purchases or the imposition of haircuts on repurchase transactions for investment banks.

(vi) Quantitative credit controls and reserve requirements: These would limit lending by imposing limits on lenders and/or increasing financial institutions' short-term liquidity requirements. Such a system was used in the UK until the early 1980s, but is likely to lead to distortions if applied over an extended period.⁵³

57. The counter-cyclical capital requirement is by far the most discussed of the tools suggested by the Treasury. Lord Turner believed it would be an effective way to control credit booms:

Clearly the debate about what those tools should be is important. I think we know some of the tools. One of the tools is a countercyclical capital requirement, the ability—in addition to the consistent continuous capital requirements in Basel III—to impose additional capital requirements on the banks when credit conditions are expanding rapidly. That is clearly set out in the Basel III regime where it talks about an extra layer of capital of up to 2.5% of risk-weighted assets, though—almost certainly—with freedom for national authorities to go beyond that. That, in itself, will be a powerful tool. It is not a tool that one would imagine switching on every six months or so. I think it is a tool that would highly likely not to be applied at all for five or six years and then would be brought in when there is a major credit boom emerging—as a very important tool.⁵⁴

58. Some macro-prudential tools, such as the counter-cyclical capital requirements proposed by the Bank for International Settlements, are being developed in the international arena. The challenge will be to ensure that, in a time of highly competitive mobile capital, individual countries are able to use such tools effectively.

Macro-prudential tools: socio-economic consequences

59. As the Treasury's consultation noted, macro-prudential tools can be broadly grouped into two categories. The first is to address the fundamental vulnerabilities in the system, while the second is to increase the resilience of the financial system to cyclical developments. Whichever macro-prudential tools are used, there will be consequences on the level of supply and price of credit available to the real economy.

60. Monetary policies can control inflation by changing the level of short-term interest rates. Similarly, financial policies can influence economic activities and stability in the financial system by controlling the amount of credit that can be lent to the real economy. For example, by increasing the capital adequacy requirements, banks will need either to raise extra capital or to reduce their risk-weighted assets, from which the consequences will be a higher lending rate and reduced availability of lending, including mortgages, from UK banks. Introducing a loan-to-value cap and leverage limits will have similar effects—as long as funds do not flow from non-bank sources, or from overseas.⁵⁵

53 Cm 7874, Box 2.C

54 Q 701

55 See, for example, Qq129-130

61. This means that macro-prudential regulation will inevitably affect individual consumers. Actions taken to protect the financial system as a whole, which should benefit consumers in aggregate, may have adverse effects for some individuals. Martin Lewis, financial journalist and owner of moneysavingexpert.com, told us:

[...] what tends to happen, when you look on a macro level, is rules are made that seem very sensible, but miss the impact on real people and real lives. Certainly, putting caps for people who are desperately trying to get to new borrowing out there, would cause a tremendous strain on the public.⁵⁶

Dominic Lindley, from Which?, considered that, although the FPC could be made to work, the impacts on consumers might need more attention:

I think the FPC in theory is a good idea. We just want to make sure that the impacts on consumers from it are properly addressed, and that there is not just a kind of technical, economic discussion about how this affects economic growth, but that real consideration is given to how it affects consumers.⁵⁷

We discuss this further in paragraph 65 below

Role of the Treasury

62. The banking industry expressed concerns that the Treasury may have too little influence on FPC decisions. In particular, the BBA questioned whether fiscal policy would be put to one side when the FPC made its decisions, and feared that economic growth might be compromised:

[...] the question of whether there will be the means by which consistency and inter-connectivity between monetary, fiscal and financial policy can be achieved. [...] Under the new framework, fiscal policy is put to one side and the link between the MPC and FPC is embodied principally in the Governor of the Bank of England, with the Treasury afforded no formal role beyond 'observer' status. It is difficult to see where aspirations for economic growth fit within the arrangements proposed.⁵⁸

63. The non-voting Treasury representative sitting on the FPC will be an important link between the FPC's decisions and the Government. Angela Knight, Chair of the British Bankers' Association, suggested that the FPC should have the approval of the Chancellor on using macro-prudential tools which have deep socio-economic impacts:

If a macro-prudential tool is going to be used that had a significant socio-economic effect, it had to be agreed with the Treasury, with the Chancellor first. We think that is an additional safeguard.⁵⁹

56 Q 283

57 Q 681

58 Ev 195

59 Q 168

In contrast, we note that a recent Geneva Report on the World Economy recommended that “objective criteria and pre-specified rules should be put forward to guarantee that financial regulation is strictly enforced” since:

When regulation is needed, no one wants it, because asset prices are rising, there is a boom, everyone is optimistic and regulation just gets in the way [...] Almost every regulator/supervisor will seek maximum discretion. Because of the above considerations, regulation should be based on preset rules; otherwise few regulator/supervisors will actually dare to face the odium of tightening in boom conditions.⁶⁰

64. We asked the Governor whether the Treasury should have a vote or even a veto power on FPC decisions. He objected to such an idea, and told us that only when public money is needed in a bank rescue should the Chancellor be involved:

I think there is a very clear division of responsibilities and this is why I think to give the Treasury a vote puts the Chancellor in a more difficult position because he might then feel accountable for the decisions of the FPC, and he’s not. [...] The fundamental area where the Chancellor has the overriding power of decision is on any action that involves the use of taxpayers’ money. Any use of public money is a matter of decision for the Chancellor. [...] When it comes to the decisions on the regulation of individual institutions or the decisions about the instruments that you will give to the FPC about, for example, countercyclical capital requirements, those are the responsibility of the FPC and shouldn’t be second guessed by the Chancellor. They have to be decided by those bodies.⁶¹

In particular, he argued that the Chancellor should leave the FPC to make decisions on macro-prudential policies; otherwise there was no point in setting it up in the first place:

If you don’t like the idea of those bodies taking those decisions, then please don’t set up the FPC or the PRA board. But if you choose to set them up, then let them do their job. But where public money is concerned there will be arrangements in place to ensure that the Chancellor always takes those decisions.⁶²

65. While in the long-term effective macro-prudential tools should increase economic welfare overall, particular individuals and companies find their access to credit affected, even though they are confident they could service the debt they seek. Many macro-prudential tools are only now being developed, and their effectiveness will need to be monitored. As the consultation paper notes, quantitative credit controls, which were used until the early 1980s, led to distortions. Moreover, financial innovation can be redirected to get around new regulations.

60 *The Fundamental Principles of Financial Regulation*, Markus Brunnermeier, Andrew Crocket, Charles Goodhart, Avinash D Persaud and Hyun Shin, ICMB, 2009, p 37

61 Q 798

62 Q 798

66. The Government has proposed that the tools available to the FPC should be set out in secondary legislation so that they can be ‘fine tuned’ if necessary. Given the impact that the use of macro-prudential tools may have, we recommend that secondary legislation used to introduce or alter them require the approval of Parliament. This raises wider scrutiny issues, to which we shall return. Parliament needs to assess the nature of the powers which it is to devolve to the FPC, and the extent to which these can be satisfactorily encapsulated in legislation. This means that the bulk of the secondary legislation should be available before the House begins detailed examination of any Bill.

67. Once appropriate tools are defined, we understand the rationale for giving the FPC discretion—in ‘peacetime’—on when to use such tools, without reference to the Treasury. “To take away the punch bowl just as the party gets going” is easier said than done: it will be far harder if the FPC first has to identify a problem and then get the Chancellor to agree to the use of the tools which might mitigate it. However, only the Government and the House of Commons have the power to authorise the expenditure of public money. As we discuss further below, the accountability issues raised by the Government’s proposals are complex, and hard to resolve and are discussed further in Chapter 9.

Interaction between monetary policy and financial stability—MPC and FPC

68. As the Treasury’s consultation acknowledged, managing the interaction between monetary policy and financial stability will be a significant challenge for the Bank. Decisions made by one committee will be likely to have consequences for the other, for example financial stability policies are likely to affect the monetary transmission mechanism and monetary policy decisions can lead to financial instability. As the Governor will chair both the MPC and FPC, we asked him whether there would be any potential conflicts between the two committees. He was confident that the two committees should complement each other:

[...] the FPC takes actions about its judgments that are needed to improve the resilience of the financial system, that may well make it possible for the Monetary Policy Committee to take a different decision on the Bank Rate, but I think it would be removing the awkwardness of a trade-off which, in the new regime, the Monetary Policy Committee will not have to contend with, so the idea that the two committees will be unhappy with each other’s decisions is not one that I think I am particularly concerned about [...].⁶³

However, other witnesses had concerns about the possibility that FPC and MPC policies could conflict, or send mixed signals.⁶⁴

69. The interaction between macro-prudential regulation and monetary policy is as yet uncertain. The Government’s consultation noted that “further analysis on the possible interactions between macro-prudential regulation and monetary policy will be needed as part of the wider discussions about the macro-prudential tool(s) assigned to the FPC.”⁶⁵ As Thomas Huertas, Banking Sector Director at the FSA has written:

The choices made by central banks with respect to monetary policy and its execution have very significant implications for regulation, supervision and resolution. Choices about the level of interest rates have a significant impact on the real economy, on credit and market conditions and on the degree of stress to which banks may be exposed and for which they must prepare. Choices about the way in which monetary policy is executed have significant implications for the degree to which liquidity might be available to banks. In particular, the choice of the range of eligible assets and the determination of the credit cut-off for eligible assets creates the dividing line between normal funding and emergency liquidity or lender of last resort facilities.⁶⁶

70. To smooth the interaction between financial and monetary policies, the Government is proposing executive cross-membership, where the Governor and Deputy Governors for

63 Q 6, see also Qq50-54

64 See Q 133

65 Cm 7874, Box 2.D

66 Thomas F. Huertas, *Crisis: Cause, Containment and Cure*, Palgrave Macmillan, 2010, page 104

financial stability and monetary policy will sit on both the FPC and the MPC. Two Bank executives, responsible for financial stability and markets, will also be members of the FPC. We note that the Bank of England Act 1998 specifies that one of the Bank appointees to the MPC should “be a person who has executive responsibility within the Bank for monetary policy operations”;⁶⁷ so there may be another overlap. The Chief Executive of the PRA will be made a Deputy Governor for prudential regulation, but will not sit on the MPC.⁶⁸

71. There are concerns that the arrangements set out in the consultation paper do not deal with the relationship between monetary and financial policies adequately. Both RBS and the Association for Financial Markets in Europe (AFME) believed that a “consistent and coordinated approach across all policy areas should be pursued” and were critical of the means to achieve this, namely cross membership and sequencing of meetings.⁶⁹

72. **In its consultation document, the Government states that “the objectives of price stability and financial stability should generally be consistent and complementary”. However, in acting to achieve their respective objectives, the MPC and the FPC will employ tools that may interact in unexpected ways. These interactions may mean the actions of one committee could affect the achievement of the other committee’s objective.**

73. **The Government’s proposals divide responsibility, but address coordination by having cross membership between the committees. At least three Bank officials will be members of both committees, giving them immense influence on monetary and macro-prudential policy making. Given this cadre of Bank cross-members, ensuring that adequate resources and support are available to the external members of each committee will be extremely important.**

74. **One of the ways to monitor the influence of the Bank cadre will be through the transparency of the minutes of the two committees. We will expect full disclosure of voting within the FPC on the use of the macro-prudential tools. External members of either committee will always have the ability to write to this Committee with any concerns they may have. Other aspects of accountability are discussed in Chapter 9.**

75. **The consultation paper proposes “Meetings of the MPC and the FPC will be carefully sequenced in order to ensure that both committees are able to fully take into account the most recent decisions of the other.”⁷⁰ This presumably means that one committee will not meet until the minutes of the other have been published. We support this, as likely to strengthen the position of the independent members.**

76. **Cross membership and sequencing of meetings may be sufficient in times of stability. However, in crisis periods the committees may need to work together more**

67 Bank Of England Act 1998, s 13

68 Cm 7874, para 2.47; The Bank of England Act 1998 will need to be amended, since currently Deputy Governors are ex officio members of the MPC.

69 Ev w45 ; Ev 212

70 Cm 7874, para 2.47

closely. Provision for joint MPC/FPC meetings so that policies on financial stability can be coordinated more effectively may be required.

Wider policy framework

77. The consultation paper says:

2.31 The FPC’s ‘monitoring’ role will include the following key functions:

- monitoring the financial stability of the UK’s financial system, identifying emerging risks and vulnerabilities, and cyclical imbalances;
- monitoring and assessing the activities of the PRA and the CPMA, in order to identify any financial stability implications that may derive from these authorities’ actions;
- monitoring the regulatory perimeter, both to ensure that the split in responsibilities between the PRA and the CPMA remains appropriate and to ensure that activities being undertaken on or outside the boundary of prudential regulation with potentially systemic consequences are understood;
- showing a close interest in the other aspects of the Bank’s work that are relevant to financial stability, such as infrastructure regulation, resolution arrangements for failing firms and the provision of liquidity insurance to the financial sector; and
- assessing the effectiveness of the FPC’s macro-prudential tools and considering any potential additions or adjustments to the toolkit.

78. As witnesses warned, risk may migrate between sectors as a response to regulation. This may arise from the transfer of “banking” functions to other sectors, or from other sources of systemic weakness which may emerge in future.

79. Hector Sants, the chief executive of the FSA and the CEO-designate of the new PRA, told us that risks could be pushed onto consumers in the next crisis:

[...] what worries me in the generality is that effectively where we saw the build-up in risk over the last 20 or so years, and particularly in the key period pre-2007, was within the banks and also within the shadow banking system, but basically within the managers of risk. [...] But one of the consequences of that could well be to push risk out of that aspect of the system, not just into the shadow system but out of the system altogether. So, you can then push risk effectively into the consumer—into the user of product and out of the manufacturer of product.⁷¹

Andrew Haldane from the Bank of England also believed that future crises may well arise outside the banking system:

I think looking forward from now, there is some danger, as we tighten regulation of the banking system, that risk migrates elsewhere. [...] There are vehicles or conduits off the balance sheet that can harbour leverage or maturity mismatch and can cause many of the same problems we saw banks causing during the crisis. So I think that is a real risk. It was a risk in the run-up to the crisis that was realised, and the risk hasn't been lessened by the crisis.⁷²

Risks to financial stability may evolve, and may change in response to regulation. We welcome the proposal to give the FPC responsibility for monitoring the regulatory boundary.

80. The stability of the financial system may, however, be affected by matters outside the remit of the FPC or the Bank's remit. There may be cases where changes in the law would make it easier to secure stability. For example, the financial crisis exposed the lack of an appropriate legal framework for bank resolution, which has now been remedied. Other such changes may be needed. **The FPC should also have the power and the responsibility to recommend changes to the wider legal and regulatory framework, including arrangements that go across national boundaries, such as those for the resolution of cross-border banks. Any such recommendations should be copied to us.**

4 Micro-prudential Regulation

The PRA as a subsidiary of the Bank of England

81. The daily regulation and supervision of financial firms, or micro-prudential regulation, will be carried out by a new Prudential Regulation Authority (PRA). It will be a new subsidiary of the Bank of England, and will be responsible for sectors such as deposit-takers, investment banks and insurance firms. It is anticipated that approximately two thirds of the existing FSA staff will join the PRA.

82. The PRA will be chaired by the Governor. Hector Sants, the current Chief Executive at the FSA, will remain to oversee the transition and will become Chief Executive of the PRA and a Deputy Governor of the Bank. Andrew Bailey, the Bank's Chief Cashier, will be Deputy Chief Executive in the new regulator, and will help with the transition. The Deputy Governor for Financial Stability (Paul Tucker as it stands) will also sit on the PRA Board.

Combining financial stability and micro-prudential regulation

83. The rationale for combining macro- and micro-prudential supervision is clear. Policy-makers must have an intimate understanding of how the relevant financial institutions behave and what risks they run if they are to safeguard the stability of the financial system as a whole. And changes in the macro-economic environment affect the risks faced by individual institutions and may warrant across-the-board changes in the intensity and focus of micro-prudential supervision. As Clive Briault, the former FSA director of retail markets, has argued, there are potential synergies with conduct of business supervision, so the case for separating the 'twin peaks' is not necessarily watertight.⁷³ But the evidence of the recent financial crisis suggests that mixing functions can contribute to a lack of focus on rising macro-prudential risk and difficulties in moving to a 'war footing' when that risk becomes substantial. In addition, the incentives are different. For example consumer protection can be well served by keeping a bank open, while stability is well served by closing it.

84. The current proposals combine both aspects of prudential policy within the monetary policy institution. That goes beyond the Australian twin peaks arrangement, where Australian Prudential Regulation Authority (APRA) combines the two aspects of prudential policy outside the central bank, the Reserve Bank of Australia (RBA). The reasons for this separation of prudential regulation from the central bank were:

The combination of deposit taking, insurance and superannuation regulation is unlikely to be carried out efficiently and flexibly by a central bank whose primary operational relationships are with banks alone and whose operational skills and culture have long been focused on banking;

73 Briault, Clive (1999): *The Rationale for a Single National Financial Services Regulator 6* (Fin. Servs. Auth., Occasional Paper No. 2)

Separation will clarify that, while the central bank may still provide support to maintain financial stability, there is no implied or automatic guarantee of any financial institution or its promises in the event of insolvency; and

Separation enables both the RBA and APRA to focus clearly on their primary objectives and will clarify the lines of accountability for the regulatory task.⁷⁴

The arrangements proposed for the United Kingdom also differ from the arrangements in countries such as Finland and France, where the central bank has close connections with the supervisory authority but no longer has direct and sole responsibility for monetary policy.

85. Nevertheless, a case can be made for a close relationship between monetary and prudential policy-makers because of the impact of a central bank's policy interest rate on financial conditions and the impact of regulatory tools on the monetary transmission mechanism. That case is stronger in a setting where regulatory tools are adjusted more frequently as a means of mitigating macro-prudential risk, as the reform proposals currently suggest they will be (although much remains to be done to understand precisely how changing bank capital ratios and liquidity requirements might affect the monetary transmission mechanism).

86. That is not, however, the case advanced by the consultation, which argues that combining prudential regulation and responsibility for financial stability within a single organisation means:

There will no longer be a gap in which responsibilities are unclear, and regulatory powers uncertain. The FPC will be able, within the remit of macro-prudential policy, to require the PRA to take regulatory action with respect to all firms.⁷⁵

However, the FPC is to have the authority to direct the CPMA, which is a free standing organisation. **Further consultations should give a fuller explanation of the reasons for making the PRA a subsidiary of the Bank of England.**

Non-zero failure = regulatory success?

87. In evidence to us the Governor said:

The purpose of prudential regulation, unlike the regulation in either market enforcement or consumer protection, is not about checking whether the individual institution has or has not done something, will or will not fail, it's about the risks to the system as a whole. That's the sole purpose of prudential regulation. We will not be setting out to ensure that institutions never fail. Institutions will fail. The crucial

74 *The integration of financial regulatory authorities – the Australian experience*, Paper presented by Jeremy Cooper, Deputy Chairman Australian Securities and Investments Commission to the Comissão de Valores Mobiliários (Securities and Exchange Commission of Brazil) 30th Anniversary Conference, 'Assessing the Present, Conceiving the Future'

75 Cm 7874, para 1.5

point, as Paul [Tucker] said, is that they can fail without causing disruption to the rest of the system.⁷⁶

During his appearance before the Committee, Hector Sants concurred:

[The PRA] should not be judged on stopping firms failing for idiosyncratic reasons, firm-specific reasons: it should be judged on whether those failures then carried costs to the system. [...] We are not trying to take idiosyncratic failure out of the system. If you do that, you do not get innovation and you do not get economic growth and a vibrant economy. So, the PRA should be judged by whether it can avoid failure which comes with a cost to the system, not whether it can avoid failure. Orderly failure should not be seen as poor performance by the PRA.⁷⁷

88. In a recent speech, Mr Sants has appeared to move away from this position:

[...] the PRA is likely to spend a relatively higher proportion of its resources on reducing the impact of firm failure than the FSA has done, and relatively less on reducing the probability of failure. Supervision of low-impact firms will likely centre on resolvability, on monitoring compliance with rules and reacting to any issues that may arise. This is an extension of the model currently employed by the FSA for smaller insurers and credit unions.

In the case of medium-impact firms, the PRA will also be prepared to tolerate failure. Given the failure of such firms may have a non-negligible impact on the financial system (or be resolved at non-negligible cost), the PRA will seek to reduce both the probability and the impact of failure through its supervisory strategy.

For high-impact firms, given that—even with resolution tools—the impact of failure is uncertain, the PRA will have a low tolerance for such events. It will focus supervisory resource, particularly senior management resource, on delivering intensive, intrusive, judgement-based supervision focusing on issues that really matter to the safety and soundness of the firm.⁷⁸

89. **While there may be circumstances in which public authorities need to prop up a particular firm to avoid systemic risk, we are concerned by the implicit acceptance that any failure of a high-impact firm should be avoided.** In a recent working paper for the Peterson Institute, Nicolas Veron and Morris Goldstein have identified the following problems if institutions are “too big to fail” (TBTF):

First, such institutions exacerbate systemic risk by removing incentives to prudently manage risks and by creating a massive contingent liability for governments [...]

76 Q 779

77 Q 707

78 *Reforming regulatory practices: progress to date*, Speech given at Thomson Reuters, 13 Dec 2010, http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/1213_hs.shtml

Second, TBTF institutions distort competition. According to Moody's, the 50 largest banks in 2009 benefited from an average three-notch advantage in their credit ratings, which has been understood to be at least partly related to official support (BIS 2010). [...]

Third, the treatment of TBTF institutions lowers public trust in the fairness of the system and undermines the framework of responsibility and accountability that is supposed to characterize capitalist economies if and indeed when it boils down to the privatization of gains and socialization of losses.⁷⁹

We note that in its recent financial stability report the Bank of England identified an implicit subsidy of £100bn in 2009 for those firms considered too big to fail.⁸⁰ A statement that the regulator will have “low tolerance of failure” for certain firms both reduces market discipline on such companies and risks distorting the market further in their favour.

90. We note that conduct of business issues may on occasion lead to systemic risk and that the CPMA is also expected to identify behaviour which may give rise to systemic risk. In evidence, the Financial Secretary to the Treasury agreed that the PRA would take a “fairly active supervisory role” and that he was:

very clear [...] that we want both the PRA and the CPMA to engage much earlier in the process, to identify risks at an earlier stage and to be proactive in trying to tackle those risks.⁸¹

91. We are also concerned about the suggestion that the PRA's efforts will be focused on what it considers to be medium and high-impact firms. As the case of Northern Rock demonstrated, the failure of a company which was apparently 'low-impact' engendered a systemic loss of confidence. The PRA will need to have a strong justification for reducing the supervisory effort for such 'low-impact' firms.

92. We agree that regulatory success does not and should not mean that no firm will fail. The Prudential Regulation Authority's aim should be, not to prevent firm failure, but to protect taxpayers and the wider economy from the consequences of such failure. Hector Sants' suggestion that the PRA will have a low tolerance for the failure of high impact firms is a source of concern. The assumption that certain firms cannot be allowed to fail results in market distortion, entrenches the market power of large incumbents and thereby stifles competition. That lack of market discipline may, over the long term, itself engender systemic instability. Although there may be combinations of circumstances in which individual firms require support to limit systemic risk, we reiterate our predecessor Committee's recommendation that no firm should be too important to fail. Competitive markets need both freedom to exit and freedom to enter.

79 Peterson Institute for International Economics, *Too Big to Fail: The Transatlantic Debate*, Morris Goldstein and Nicolas Véron, January 2011

80 Table 5.9, *Bank of England Financial Stability report*, 17 December 2010

81 Q 866

Away from ‘tick-box, light-touch regulation’: a more judgement-led approach

93. The consultation paper notes “The PRA will be established as a subsidiary of the Bank, so that it will benefit from the Bank’s judgement-driven culture.”⁸² Hector Sants has also signalled that the PRA will carry out a more judgement-led style of prudential regulation than the FSA used before the crisis.⁸³ In effect, this means supervisors spending more time understanding firms’ business models and strategies, and using their judgements to investigate and tackle risks and vulnerabilities within individual firms.

94. Making judgements is always difficult, and can have an element of the subjective. The industry is concerned that this new regulatory approach will bring uncertainty to firms. It has also raised concerns whether the existing FSA staff are equipped to move away from the ‘tick-box’ approach to exercise judgements on supervision and making regulatory decisions. The Financial Services Practitioner Panel told us that ‘judgement led regulation is only acceptable on the basis of clear and transparent principles which are applied on an equal basis.’⁸⁴

95. AFME agreed that the quality of the supervisors would be crucial in this judgement-led approach:

[...] the success of more judgement-led regulation will ultimately rest on the quality and competence of the staff that take individual, firm-specific decisions. To ensure consistency and fairness, the authorities will need to have streamlined and clearly articulated procedures, which are transparent, provide reasons for a decision and give firms wishing to challenge a decision a fair hearing.⁸⁵

96. Angela Knight explained the importance of having the right people:

[...] if you have higher calibre people, higher quality supervision, you will get a better outcome. Judgements, I think, do have to be exercised and that means that you need people who can exercise those judgements. [...] whatever regulatory structure you have has to be attractive to people as part of their career; attractive to people of a seniority and of a type that may have not been attracted certainly in sufficient numbers to the FSA.⁸⁶

97. The Investment Management Association agreed that “the key to this will be to ensure that only staff with the highest levels of skills, training and experience—including experience in the industry—are entrusted with such judgements.”⁸⁷

82 Cm 7874, para 3.29

83 *Reforming regulatory practices: progress to date*

84 Ev 232

85 Ev 212

86 Q 118

87 Ev 209

98. **Judgement-based regulation can cover a number of approaches, from challenging a company about how it would perform under a variety of market conditions, to substitution of the regulator’s judgement for that of the company management. The aim should be to ensure that companies can fail without undue adverse impact, rather than to attempt to second guess management approaches. We are also concerned about how the PRA will manage situations in which members of the board of a supervised firm, who have personal legal responsibilities, do not agree with its judgment.**

Regulation and auditors

99. Practice Note 19 of the Auditing Practices Board, dated January 2007 stipulates:

the auditor of a regulated entity should bring information of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditor's audit responsibilities to the attention of the appropriate regulator without delay when:

- (a) the auditor concludes that it is relevant to the regulator's functions having regard to such matters as may be specified in statute or any related regulations; and
- (b) in the auditor’s opinion there is reasonable cause to believe that it is or may be of material significance to the regulator.⁸⁸

100. The House of Lords Economic Affairs Committee is currently inquiring into auditors. Amongst its questions is “Can auditors now contribute to better regulation of banks?” We note that on 17 January 2011 the Financial Reporting Council and the FSA agreed a memorandum of understanding on the relationship between the Audit Inspection Unit of the FRC. It states:

The FSA and AIU will maintain a close working relationship to deal with relevant issues arising in relation to the conduct of audits of authorised persons. Those issues include policy issues and issues arising in relation to particular authorised persons or their auditors.

The FSA and AIU will meet regularly, and at least four times a year. The timing of the meetings will be aligned with their work programmes, to enable them to inform each other of topics or issues of mutual concern or interest and to enable them to take account of such discussions in planning their future work.⁸⁹

We welcome the memorandum of understanding between the FRC and the FSA on audit. The regulator needs to be confident that auditors will share their concerns directly and they should have a duty to do so. The regulator should also be able to obtain any audit information it needs from the auditors.

88 The Auditing Practices Board, Practice Note 19, The Audit of Banks and Building Societies in the United Kingdom, Revised

89 See <http://www.frc.org.uk>

5 Consumer protection and markets regulation

101. Besides the PRA, the Government will also legislate to create a new conduct of business regulator, provisionally named as the Consumer Protection and Markets Authority (CPMA). Unlike the PRA, it will be separate from the Bank, regulating the conduct of all financial firms, including those prudentially regulated by the PRA. The CPMA will also “be responsible for making rules in respect of industry funding of the FOS [Financial Ombudsman Scheme], FSCS [Financial Services Compensation Scheme] and CFEB [Consumer Financial Education Body]”. It is anticipated that the remaining two-thirds of the FSA staff will join the CPMA.

Can the CPMA be a true ‘consumer champion’?

102. The Government is keen to brand the CPMA as a ‘strong consumer champion’. During our inquiry, we have received a great deal of evidence suggesting that it is problematic to call a regulator a ‘consumer champion’, with the industry fearing that regulatory decisions will be biased towards consumers, causing confusion and unfairness to firms. The BBA argued that, rather than being a champion, the CPMA should create a regulatory environment where consumers can make informed decisions and be responsible for the consequences:

We are concerned about the CPMA being described as a consumer ‘champion’. This, to our mind, has the potential of creating an imbalance in its objectives from the outset and also reinforces the concern that we have of the CPMA somehow being detached from responsibility for its actions. We would prefer therefore a description based more on the development of a marketplace in which consumers are provided with clear and understandable product information from which they can make informed choices. This involves placing consumers in a position where they can take responsibility for their financial decisions. The implication that the new authority will somehow become their advocate does not help this.⁹⁰

103. Other trade bodies decried the champion idea as emotive and ill-defined. The Financial Services Practitioner Panel argued that ‘there may be further consumer costs if the CPMA’s role as consumer champion is interpreted too narrowly. If it restricts firms from developing new products and working the market effectively, there may be less choice available, with consumers paying more for products which are less suited to their requirements’.⁹¹ The ABI also told us that “it is entirely inappropriate for an independent regulator to act as a ‘champion’. It should instead take an evidence based approach to policy-making and supervision taking account of the views of all stakeholders.”⁹²

90 Ev 196

91 Ev 233

92 Ev 216

104. Angela Knight of the BBA denied that the banks were scared of having a consumer champion, but drew a distinction between a regulator and a consumer champion:

[...] A regulator should be a regulator and a consumer champion should be a consumer champion. The regulator is there to produce rules and requirements. Let's say on the consumer side to ensure that the rules are right for consumers; open, transparent and understandable. They get redress when redress is due if something has gone wrong. That's the role of a regulator. We think a consumer champion is an entity that is separate from a regulator and takes on the consumer issues and really brings them to the forefront, whether it is with a regulator, governments, industry or whatever. We don't run away from there being a consumer champion. We think that it is confusing if you put it in with a regulator.⁹³

105. Tony Boorman, Decisions Director and Principle Ombudsman from the Financial Ombudsman Service (FOS), believed that calling the CPMA a consumer champion could compromise FOS's impartiality, as the FOS would be linked to the CPMA:

[...] our role is not to be a consumer champion. We are an important part of the safeguards set up in the FSMA structure but our role is not consumer champion. One of our perhaps rather esoteric concerns about a link with a CPMA that is a consumer champion is to continually make that point, that our role is independent of championing of consumer interests or championing of industry interests.⁹⁴

106. Martin Lewis told us that the CPMA should certainly be pro-consumer, but giving it the title of a champion could go too far, and questioned "whether, in reality, a regulator can truly be 'the' consumer champion".⁹⁵ As Mr Lewis said, there are organisations, such as Which?, which are already widely regarded as consumer champions. Mr Adam Philips, the Chairman of the Financial Services Consumer Panel, told us that he regarded his panel as a consumer champion.⁹⁶

107. Not surprisingly, consumer groups were more supportive of the 'champion' idea. Citizens' Advice explained that:

The governance of the CPMA should reflect its stated role as a consumer champion rather than a referee trying to balance the interests of consumers and the financial services industry. The interests of industry would of course be represented through both what the consultation describes as the 'have regards' principles of good and proportionate regulation and through continuing practitioner panels. But the CPMA board should be constituted primarily with the view to ensure that the Authority meets primary consumer protection (and we would argue inclusion) objectives.⁹⁷

93 Q 151, see also Q 154

94 Q 211

95 Q 274

96 Q 632

97 Eww 57

108. Given the strong opinions from both sides, we pressed the Financial Secretary on whether calling the CPMA a consumer champion was a good idea. He reiterated that the CPMA will focus on conduct of business issues, and because of this pure focus, it will act as a champion for consumers. We are not convinced by this argument, because, by definition, a consumer champion lobbies for consumers, while a regulator ensures that people comply with rules.

109. There is a wider regulatory issue here. It would be possible to have a regulatory system which was so tightly controlled that the risks to the consumer were minimal. However, such a system would be highly costly to the consumer, stifle innovation and would eliminate any individual choice as to the level of risk, and consequently of likely returns, an individual could take. It would have knock-on effects for the wider economy. It would not increase overall welfare. The converse of this, a system in which there was no regulation and abusive behaviour was tolerated, would also reduce welfare.

110. The debate about whether the CPMA should be a consumer champion demonstrates the importance of making sure that definitions are clear. We have no doubt that effective conduct regulation should be in consumers' best interests and will involve a high degree of consumer protection. Nonetheless, branding the CPMA as a consumer champion would be inappropriate, confusing, and potentially dangerous. The job of the regulator is to ensure that regulation is effective and proportionate. That requires a balance between preventing abusive behaviour and ensuring that regulation does not impose excessive costs and restrictions, in order to optimise economic efficiency. Financial markets manage and price risk; they do not remove it. If a regulator is promoted as a consumer champion, consumers may falsely believe that all financial products are risk free, creating moral hazard. It is simply not possible to protect every interest at all times. We strongly urge the Government to drop the title of 'consumer champion' from the CPMA. There are other organisations which campaign for consumers; the regulator's task is to be alert to abuse, and to ensure that consumers are appropriately protected in an open and fair marketplace with the minimum of moral hazard.

Promoting competition and innovation

111. Under section 2 of the Financial Services and Markets Act 2000, the FSA, in discharging its general functions, must have regard to:

- i. the need to use its resources in the most efficient and economic way;
- ii. the responsibilities of those who manage the affairs of authorised persons;
- iii. the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction;
- iv. the desirability of facilitating innovation in connection with regulated activities;

- v. the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom;
- vi. the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions;
- vii. the desirability of facilitating competition between those who are subject to any form of regulation by the Authority.

112. As noted above, the FSA needs to have regard to facilitating competition in the financial sector. However, evidence from the last decade suggests that the existence of the FSA did not lead to any increase in competition in financial services. The creation of the new regulatory bodies presents an opportunity to review regulation's role in promoting competition, in particular, as the consumer champion, whether the CPMA should have a primary objective in promoting competition.

113. The industry is broadly in favour of the CPMA having a competition objective, but stops short of endorsing a primary responsibility for the regulator. For example the BBA argued that there is a need "for the authorities to be given responsibility for maintaining a competitive marketplace"⁹⁸, but did not elaborate on whether a primary or 'have regards' objective should be given. The Financial Services Practitioner Panel was more explicit, noting that "it is vital that all the new proposed bodies should have to pay regard to the need to maintain competitiveness in the banking and financial services sector." but "It is not a regulator's role to promote competition."⁹⁹ The Small Business Practitioner Panel echoed its views, and stressed that "market forces should be allowed to create healthy competition, but as the regulator is intervening in that market, it must have regard to the impact of its actions on competitiveness. However, we do not believe that it is the role of the regulator to actively promote competition."¹⁰⁰

114. However, since the Government has proposed the CPMA as a consumer champion, a primary competition mandate seems to fit in well with the champion idea, as greater competition will ultimately benefit consumers by lowering prices and increasing choice. The Financial Services Consumer Panel believed that "the CPMA's primary objective should be to champion consumers of financial services and to ensure wholesale market integrity, promoting effective competition in retail and wholesale markets wherever possible and ensuring good consumer outcomes."¹⁰¹ Peter Vipond from the ABI believed "it is very important [...] [that] both the PRA and CPMA [have] a remit to look at competition and the competitiveness of the sector."¹⁰² Which? also believed that both the PRA and CPMA should have a duty to promote competition, alongside the OFT and Competition Commission:

98 Ev 199

99 Ev 236

100 Ev 241

101 Ev 231, see also Q 273

102 Q 273

Whatever its primary objective, we believe the CPMA should have a duty to promote effective competition. It should be given the necessary powers to regulate the sector to achieve this, including the ability to apply specific licence conditions to banks and exercise competition and consumer protection legislation. Its competition powers would be concurrent with the competition powers of the OFT and will enable the regulator to make market investigation references to the competition commission.¹⁰³

The PRA should have a specific duty to promote competition. This would help support its focus on not preserving the status quo or existing institutions, but creating a market with the realistic prospect of failure. It would also ensure that the PRA does not impose excessive barriers on new entrants, by making them carry higher levels of capital or liquidity than existing banks.¹⁰⁴

115. The Treasury Committee is currently undertaking a separate inquiry into choice and competition in banking, and will report in the following months. However, given the importance of this area to financial regulation more broadly, we asked the Financial Secretary whether the new authorities should ‘have regard’ to competition, as in the case of the FSA, or whether a primary competition mandate should be given to the PRA or the CPMA.

116. The Financial Secretary reiterated the importance of having competitive markets in financial services, and said that the Government would consider carefully the regulatory boundary between the new authorities and the OFT on competition. He stressed that the CPMA will have a primary objective to enhance confidence and integrity of markets, but seemed to suggest that competition will not be one of its primary objectives, as the regulator would lose focus:

Michael Fallon: [...] What would be wrong with just putting in, as one of its primary objectives, a duty to promote and secure competition at all times? What would be wrong with doing that?

Mark Hoban: I believe it will be reflected in its objectives, but I think we need to be very careful that we don’t end up having a series of objectives that means that the regulator loses focus on its primary responsibility. What we have said when it comes to the CPMA is that it must ensure there is confidence in markets and integrity in those markets.

Michael Fallon: So competition would be a secondary objective?

Mark Hoban: I think it flows from those objectives.¹⁰⁵

117. Mr Fingleton, Chief Executive of the Office of Fair Trading, told us that while “If we go down the road of thinking the regulator sets prices in the market, we would probably

103 Ev 244

104 Ev 250

105 Q 843

have a very inefficient sector, and it might be worse than it is now”, he was supportive of “giving [the CPMA] a competition objective, and making sure it has the tools to nudge the transparency issues in the right direction, that it is really forcing the market to sort this issue [of competition] out”.¹⁰⁶

118. Competition is a highly effective means of protecting consumers’ interests. The response given by the Financial Secretary when we pressed him on whether promoting competition should be treated as a primary objective for the new authorities was disappointing. The CPMA should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation. Greater competition should also help prevent firms becoming too big to fail. We do not, however, believe that the regulator should have a remit to facilitate innovation—a properly functioning market will do that.

‘Have regards’ clauses

119. More generally, the Government asks whether the regulators should have a single remit, or whether they should be given secondary objectives, or enjoined to “have regard” to particular matters.

- Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors? [...];
- If you support the idea of secondary factors, what types of factors should be applied to the FPC?
- How should these factors be formulated in legislation—for example, as a list of ‘have regards’ as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance? [...];
- whether the PRA should have regard to the primary objectives of the CPMA and FPC;
- whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;
- whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and

¹⁰⁶ *Competition and Choice in Banking*, Uncorrected oral evidence taken before the Committee on 20 January 2011, HC612-viii, Q814

- whether there are any additional broader public interest considerations to which the CPMA should have regard.¹⁰⁷

120. Too narrow a remit may restrict the effectiveness of regulation. **We have already proposed that the CPMA should have a primary objective of promoting competition, and there may be other places where regulators need a spread of objectives. However, we are unconvinced that ‘have regards’ provisions are effective in directing a regulator. The regulator will have to decide what trade-offs to make when desirable objectives compete: secondary statutory objectives are likely to be a more satisfactory way to specify such objectives for all but the most general provisions.**

Consumer protection versus markets regulation

121. While the thrust of the reform is to separate responsibilities more clearly, the creation of the CPMA will leave two rather different areas of the FSA under one roof— consumer protection and markets regulation. The Government believes that consumer protection can be achieved through a strong consumer division within the CPMA, with the markets division responsible for promoting confidence in the integrity and efficiency of the financial markets. However the industry is less comfortable with this arrangement. For example, the Financial Services Practitioner Panel believed that markets should be part of the PRA, rather than the CPMA:

We have found it difficult to identify what the government is trying to achieve with the changes proposed for markets. It seems it would be better to have Markets in a stand-alone regulator, or as part of the PRA, rather than the CPMA.¹⁰⁸

122. The London Stock Exchange argued that this new arrangement could be made to work, but would need a clearly defined set of responsibilities between the two areas:

The CPMA retail and wholesale responsibilities must be operationally distinct and run by separate CEOs who report into an overarching Chairman. This will ensure appropriate regulation for each division of the CPMA and that each is run by a specialist champion. A strong and cohesive markets division within the CPMA will need to maintain a strong link between the primary market (where companies raise capital) and subsequently where shares in companies are traded (in the secondary market). This is necessary to maintain investor protection, ensure effective real time market supervision, tackle market abuse and execute enforcement activities.¹⁰⁹

123. The CPMA will have a dual remit between consumer protection and markets regulation. The Government believes that a strong consumer division is required to deliver protection for consumers, while the industry believes there is a need for a strong markets division. It has also been suggested that market supervision might fit more naturally within the PRA. We urge the Government to give more detail about its

107 Cm 7874, pages 57-58

108 Ev 233, see also Q 598

109 Ev 203

thinking on this subject in the next consultation paper, and, in particular, what structure it proposes to ensure that both market regulation and consumer matters receive the attention they need. Further consideration may need to be given to the name of the new organisation—we note that the Government has described the title as provisional.

UK Listing Authority

124. The Treasury’s consultation document stated that “the Government is considering whether the UK Listing Authority (UKLA) should be merged with the Financial Reporting Council (FRC) under the Department for Business, Innovation and Skills, or whether it should remain within the CPMA markets division.¹¹⁰ The Government believed that there would be synergies from merging the UKLA’s regulation of primary market activity with the FRC’s functions relating to company reporting, audit and corporate governance. Also, this would help create a “powerful companies regulator”, with responsibilities ranging from regulating corporate governance, corporate information, disclosure and stewardship of companies by institutional shareholders.

125. The industry raised significant concerns over this proposed combination between the FRC and the UKLA. The London Stock Exchange, as the world’s leading fund raising marketplace, undoubtedly has an interest in this debate. It strongly believed that the UKLA should be located in the CPMA:

To ensure effective regulation, the UKLA must be part of the CPMA markets division. Our strong view is that CPMA markets division, as the main UK securities regulator, would be the appropriate place for the UK Listing Authority (UKLA). The proposed merger of the UKLA and Financial Reporting Council (FRC) offers little by way of synergies and would serve to fragment the regulation and supervision of primary and secondary markets, to the detriment of investors and issuers. The regulation of the UK’s capital markets requires experience on a global scale and sophisticated real-time monitoring and response capabilities to ensure preservation of the market quality for issuers and investors. Only the CPMA markets division can provide this.¹¹¹

126. The FRC believed that the proposal could be made to work, but argued that a better option would be to create a new separate securities regulator, combining the FRC, UKLA and the existing markets division of the FSA. It explained that:

A new Securities Regulator would [...] secure the synergies of an FRC/UKLA merger without the same boundary problems. The market monitoring issues would be reduced. The EU problem would be largely eliminated as the new body would closely match ESMA.¹¹²

¹¹⁰ Cm 7874, paras 5-21

¹¹¹ Ev 203

¹¹² Ev 253

127. Having considered the industry's responses, the Financial Secretary announced on 18 November 2010 that the UKLA will be located within the CPMA. Writing in the *Financial Times*, he explained that "some suggested a new standalone securities regulator would provide a better fit with Europe. But we concluded this risks fragmenting the domestic architecture, while also increasing the burdens on regulated firms. A third new regulator may also have not been economically viable. [...]"¹¹³

128. We welcome the Government's decision to put the UK Listing Authority in the CPMA, rather than splitting responsibility for markets regulation between three bodies, as first proposed. However, there are still issues to be resolved, such as the concern about the UK's corporate governance position within Europe, where the CPMA will represent the UK in the European Securities and Markets Authority, although many corporate governance issues remain with the Financial Reporting Council. The success of the London markets underpins the success of the United Kingdom financial services industry; the markets division within CPMA must be adequately resourced, and may need a wider focus than pure conduct of business.

Financial stability versus consumer protection—an inferior CPMA?

129. As we describe above, the new authorities will need to work closely together. There may be occasions however when authorities disagree with one another, for example the CPMA may carry out a conduct of business investigation which would cause a firm-specific financial stability risk. The Treasury's consultation stated that:

the CPMA will be required to consult the PRA in advance of taking any decision that could cause a firm-specific financial stability risk, and to take the PRA's advice in such matters. The PRA's decision will be final, reflecting the important role of prudential judgement in the delivery of regulation.¹¹⁴

130. Angela Knight saw no problem with the PRA having the final say, arguing that "somebody's [decision] has to be final; so the PRA, fine. It has to be somewhere."¹¹⁵ Which?, on the other hand, argued that the PRA should not be given primacy over the CPMA:

[...] We do not believe that the PRA should be given primacy over the CPMA. To permit the PRA to prevent the CPMA taking a firm-specific conduct decision sends a dangerous message to the industry that only firms which are small enough to fail without causing damage to financial stability will be forced to bear the full consequences of mistreating consumers.¹¹⁶

This assumes that large firms will not be allowed to fail, a proposition which we have already discussed in paragraph 89 above.

¹¹³ The right path for British financial regulation by Mark Hoban, *Financial Times*, 18 November 2010

¹¹⁴ A new approach to financial regulation, July 2010, HM Treasury, Box 3.B, p 26

¹¹⁵ Q 125

¹¹⁶ Ev 244

131. Hector Sants, who will become the head of PRA, believed that it was appropriate that the PRA's decision over the CPMA should be final, but stressed that the CPMA should not be seen as a secondary authority:

[...] conduct risk can evolve into prudential risk. For example, [...] mis-selling can obviously lead to prudential risk through the build-up of poor quality assets on the balance sheet, and it can also be a very important lead indicator of poor cultures, which can lead to prudential mismanagement. So there is a clear interaction between conduct regulation and prudential regulation.

[...] it is right that the CPMA should have to consult before taking an action with the PRA and, if the action it was taking was deemed by the PRA to have systemic implications, it is reasonable that the PRA should have an override. We all know that the cost of this crisis has been multiples of any single mis-selling event and therefore, in terms of the impact on society as whole, systemic failure is the most costly.¹¹⁷

132. Given that it is the Government's intention for the CPMA to be a consumer champion, it may be seen peculiar that its decisions can be overruled by the PRA, even on the grounds of financial stability. Mr Sants argued that 'systemic failure is [also] a failure that affects consumers',¹¹⁸ and that:

this is not about a structure where consumers are second choice or coming off second best. It's about creating a structure where consumers are at the forefront and that is designed to give the best possible result for consumers.¹¹⁹

133. In principle the consequences of financial crises could pose more threats to consumers than individual cases of detriment. However, if the new arrangements work properly, choices between financial stability and consumer protection should be rare. If the FPC and PRA can produce a system in which companies can fail without financial instability, then CPMA decisions should not pose systemic risk. We welcome the Treasury's reassurance that the PRA's veto over the CPMA can only be used as a last resort. To ensure that this is so, cases when the power is exercised should be made public. It may not be possible to do so immediately, without threatening stability. In such circumstances the authorities should write to the Chancellor in confidence to notify him, explaining the reasons that the two authorities differed. We expect almost all such reports to be made public at the earliest opportunity, recognising that there may be exceptional circumstances. In such cases arrangements should be made to inform the Chair of this Committee.

134. In the summary of consultation responses, the Treasury stated that "The Government also considers that it would be important for each authority to establish its own distinct identity and supervisory culture. In developing legislation, the Government will seek to ensure that the PRA and CPMA have equal status, with the use of the PRA's veto only

117 Q 727

118 Q 728

119 Q 729

where necessary to protect financial stability.”¹²⁰ If the PRA has the power to require the CPMA not to take regulatory action, there is a danger that the CPMA will be perceived as an inferior regulator. This could lead to problems in attracting high-quality staff and gaining respect from the industry. It is unfortunate that the individual expected to head the CPMA has yet to be appointed, while Mr Sants’ role at the PRA has been confirmed. **It is important that the PRA and CPMA work closely together on both prudential and conduct of business issues; the absence of a Chief Executive designate of the CPMA risks regulatory thinking being developed only by those responsible for the parts of the regulatory structure which are or will be directly related to the Bank of England. We are likely to return to the relationship between the CPMA and the Bank of England in future work.**

¹²⁰ A new approach to financial regulation: summary of consultation responses, HM Treasury, November 2010, para 2.28

6 Cost of regulation

135. During our inquiry, it became apparent to us that the cost of regulation remains a major concern for the financial sector. Almost all witnesses told us that the cost of regulation has risen in the last few years, and is expected to rise further as the reform in the structure of regulation gets under way.¹²¹

136. There are broadly two types of cost of regulation to the firm—direct and indirect. Direct costs are the fees and levies paid by the industry, such as the fees to the FSA and the levies for running the FOS and the Financial Services Compensation Scheme (FSCS). These are relatively easy to calculate and readily available, for example in the FSA annual report. The ABI told us that the insurance industry paid £138m in fees and levies in the year 2010/11.¹²²

137. The indirect costs of regulation are much more difficult to define and quantify. Indirect costs may include the incremental costs of compliance, including the costs to firms of activities required by regulators which would not have been undertaken in the absence of regulation. All witnesses agreed that indirect costs are considerable. For example, the ABI told us that the average cost of running a compliance programme for existing regulation is over £10m per annum for a firm. The costs to firms appears to be increasing: Nomura has increased its headcount on risk and compliance by 77% in the last 2 years.¹²³ Such compliance programmes will, of course, engage with other parts of the company, and place demands upon them. As a result, the full cost may go well beyond the visible cost of running compliance departments, consultancy and other fees.

138. Nearly all respondents pointed to a study published in June 2006 by Deloitte on the cost of regulation, commissioned by the FSA and the Financial Services Practitioner Panel. Many believe that, although out of date, it is still the most relevant piece of work carried out in the UK on this topic.¹²⁴

139. As part of our inquiry into *Competition and Choice in Retail Banking*, witnesses have also suggested that the costs of regulation and of fulfilling regulatory requirements may reduce competition. Ms Gadhia, Chief Executive, Virgin Money, noted “that the regulatory capital regime, understandably in some cases, clearly differentiates between the big incumbents and the smaller providers, and for smaller providers, therefore, there’s a requirement to hold more equity”.¹²⁵ The scale of the difference is substantial:

If I look at the capital requirement for a mortgage, as Virgin Money launches mortgages, we treat mortgages at the 35% risk-rating level to provide capital against

¹²¹ See, for example, Q 120, 242, 299-302

¹²² Ev 293

¹²³ Ev 311

¹²⁴ Deloitte, *The Cost of Regulation Study*, 28 June 2006

¹²⁵ *Competition and Choice in the Banking Sector*, Uncorrected evidence taken before the Committee on 18 January 2011, to be published as HC 612, Q 636

that. When I worked at RBS and was running a mortgage business there, because of the scale of the business and the history of the customer, the 35% is a much lower number—as low as 17% or less in some cases.¹²⁶

140. Given the urgency of the Government’s reform programme and the resources and time needed to produce a further full study of the costs of regulation, it will be impractical for the FSA to devote resources to such a review at this stage. Once the new architecture has been set up, we recommend that the PRA and the CPMA revisit the whole issue of cost of regulation, in the light of the financial crisis and the changes in regulatory structure.

141. Under FSMA, the FSA is required to undertake a cost-benefit analysis of any proposed regulatory changes. However, the full costs—always ultimately borne by consumers—need to be shown. Cost-benefit analysis must be improved within the PRA and the CPMA. New regulatory requirements should only be introduced if a full cost-benefit analysis has been conducted. The authorities also need to be certain and demonstrate that the benefits are justified by any additional costs to consumers that might be caused by restrictions to competition.

Transition cost

142. There will be transition costs in moving to the new regime—the impact assessment in the Treasury’s consultation suggested they would amount to £50m spread over 3 years. The document does not explain how the Treasury came up with this figure of £50m, nor does it suggest whether it is the industry or the taxpayers who will have to pay. We asked the Financial Secretary to clarify who will pay for the transition cost:

Mr Umunna: How much will the transition to the new system cost?

Mark Hoban: The estimate put forward by the Bank and the FSA is for about £50 million.

Mr Umunna: Right. What comfort can you give us that those costs are not going to be automatically passed on to the consumers?

Mark Hoban: The costs will be borne by the levy pay[er] in the first instance. So it’s the financial services businesses that currently fund the regulatory arrangements that will pick up those costs.

Mr Umunna: How can you be sure that they won’t pass it on to the consumer?

Mark Hoban: Inevitably, the costs of regulation are borne either by the consumer or by the shareholders of these organisations. I’m not sure whether you are suggesting that the taxpayer should pick up these costs.

¹²⁶ Competition and Choice in the Banking Sector, Uncorrected evidence taken before the Committee on 18 January 2011 to be published as HC 612, Q 638

Mr Umunna: No, what I'm asking you is what comfort can you give that the industry won't pass on the costs? That is what I was getting to.

Mark Hoban: I think if we have competitive markets, where there is pressure on price, the industry won't be able to pass on those costs to consumers.¹²⁷

143. The City of London Corporation suggested that the Government might have underestimated the transition costs, given the complexity of the restructuring and the possible duplication from the co-existence of the PRA and CPMA:

[...] the new structure does create the possibility of duplication, not taken into account in the impact assessment attached to the consultation paper. This includes the proposals to separate out the FSA's existing authorisation, enforcement, and rule-making functions between both the PRA and CPMA. There is a clear need to examine more closely the level of benefit gained against costs incurred. If the supervisory duplication within the new structures materialises, there is a risk that the costs of these proposals may exceed those set out in the assessment. The estimate in the impact assessment of transitional costs of £50 million spread over three years seems low in view of the scale of the reorganisation required.¹²⁸

144. We are unconvinced by the Financial Secretary's explanation that the £50m transition costs will be borne by the industry alone. His contention that a competitive market means that the industry will not be able to pass on the costs to consumers begs the question as to the degree of competitiveness in the market. We urge the Treasury to give more detail about the assumptions underlying the £50m transition cost. It should also report regularly over the transition period on the level of actual costs being incurred.

From underlap to overlap—cost of duplications?

145. The new regulatory structure has gone some way to avoid the 'underlap' phenomenon in the previous Tripartite regime, where no one single body was responsible for macro-prudential regulation. There is likely to be overlap between the FPC and PRA, especially on financial stability areas. Paul Tucker told us:

You may be surprised that I say I hope to overlap, but, as I've said before, I feel very strongly about one of the problems in the previous system was that there was underlap [...] We need to tolerate a little bit of overlap, while being careful about efficient use of resources for the obvious reason[...]¹²⁹

The Treasury's consultation stated that there may need to be overlapping powers and functions between the PRA and CPMA. According to the consultation, whenever there is

127 Q 851-2

128 Ev 242

129 Q 800

overlap, arrangements will be put in place to ensure that the authorities coordinate actions to minimise costs.¹³⁰

146. Given the potential greater costs for the sector under the new structure, Hector Sants believed that strong coordination will be important between the PRA and CPMA at all levels, including common interfaces for communicating with firms:

[...] We need to make sure as well, of course, that firms don't feel we're building an inefficient process, [...] because we need to have common interfaces for collecting data, a common data stance and so on. So we'll need a set of structural processes as well as hard-working communication at the senior management level.¹³¹

147. We appreciate the importance of avoiding the regulatory underlap that we have seen under the Tripartite system. However, removing the underlap should not result in an overlap of responsibilities between the new bodies. Overlap, like underlap, can lead to confusion and paralysis. Careful planning and consideration needs to be given to the remits and boundary of responsibilities, especially between the PRA and CPMA.

Wider issues

148. There is a danger that the urge to respond adequately to the financial crisis will result in an assumption that more regulation is required. We believe that one of the tasks of the new bodies will be to analyse the existing regulatory structure and identify those regulatory requirements which are truly effective, and those which impose unnecessary costs. When we sought to gather evidence on the cost of regulation we were repeatedly told that those costs were unquantifiable because many regulatory requirements simply mirrored what good companies would do anyway.¹³² We consider this lack of precision tells its own story. **The move to new regulatory arrangements should be accompanied by better analysis of the cost of regulation, both one-off and ongoing, for all kinds of financial firms, by sector and by size. The aim should be to produce a better, more effective and more cost efficient regulatory system.**

¹³⁰ See QQ 128, 645-6

¹³¹ Q 733

¹³² Q 181, Ev 293, 301

7 International regulation

International Initiatives

149. In the summary of responses to the consultation, the Government notes that one of the strongest themes emerging was “the importance of the European and international agenda, both during the transition phase and in steady state.”¹³³ While the initial consultation acknowledged this, it was extremely thin on the way in which the United Kingdom would influence such regulation, both in the EU, and in wider spheres.

150. This is an extremely important issue. For example, FPC measures to contain credit growth by increasing banks’ minimum capital ratios would be ineffective if foreign banks simply filled the gap. Rules set at international level can also have an effect on individual firm supervision. **Effective participation in international regulation is both a central part of macro-prudential policy and key to ensuring that micro-prudential policy can be conducted effectively.**

151. At the global level, the G20 has taken a lead, producing broad principles which are now being worked through by the Financial Stability Committee. The topics under consideration include:

- Building high quality capital and liquidity standards and mitigating procyclicality;
- Reforming compensation practices to support financial stability;
- Improving over-the-counter derivatives markets;
- Addressing systemically important financial institutions and cross-border resolutions;
- Strengthening adherence to international supervisory and regulatory standards.
- Strengthening accounting standards .

152. The detailed work on the new capital and liquidity standards for the banks is being conducted by the Basel Committee on Banking Supervision. It is working on “Basel III”:

a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:

- improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source
- improve risk management and governance
- strengthen banks' transparency and disclosures.

133 HM Treasury, *A new approach to financial regulation: summary of consultation responses*, para 2.4

The reforms target:

- bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress.
- Macro-prudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.¹³⁴

European regulation

153. At the same time as this work is being done, the European Union has established a new regulatory structure consisting of three ‘supervisory authorities’, a banking regulator, the EBA, an insurance and pension regulator, the EIOPA, a markets regulator, and the ESMA. In addition the European Systemic Risk Board (ESRB), composed largely of representatives of the central banks, will monitor and report on systemic risk across Europe.

154. The previous Treasury Committee reported on this in November 2009.¹³⁵ The new system came into effect on 1 January 2011. The ESRB recently held its first meeting; it is chaired by Mr Trichet of the European Central Bank, and the Governor of the Bank of England is the Deputy. The chairs and vice chairs of the supervisory authorities have been elected, but there has been no announcement as yet about their Executive Directors.

155. The ESRB will have power to report on financial stability and make recommendations. The three supervisory authorities will be responsible for:

- Developing a ‘single European rule book’ through drafting draft technical standards, which will then be adopted by the European Commission as EU law.
- issuing guidance and recommendations with which national supervisors and firms must make every effort to comply.
- Investigating cases where a national supervisory authority is failing to apply EU law properly;
- providing EU-wide coordination in a crisis. If an emergency is declared, the ESAs may make decisions that are binding on national supervisors and on firms. However, these would be subject to certain conditions and would be limited to ensuring compliance with EU law.
- mediating where national supervisory authorities disagree, if necessary making a decision that is binding on both parties to ensure compliance with EU law.¹³⁶

134 <http://www.bis.org/bcbs/basel3.htm>

135 Sixteenth report of Session 2008-09, *The Committee’s Opinion on proposals for European financial supervision*, HC 1088

136 See <http://www.fsa.gov.uk/Pages/About/What/International/european/esas/index.shtml>

156. In addition to the creation of the new European authorities, there is an ambitious legislative programme taking place at the European level. Commissioner Barnier supplied us with a list of 39 initiatives, the majority of which were legislative proposals. Although in oral evidence the Commissioner had assured us that “my agenda is essentially the G20 agenda”¹³⁷, this list indicated that only 14 of these initiatives were directly related to that agenda.

157. Mr David Benson of Nomura emphasised the need to avoid regulatory arbitrage, and the part that EU regulation could play in this:

There is no question but that we need a consistent frame for regulation. So in that context, it’s appropriate that the EU should try to establish that consistency across Europe, and it needs to influence the rest of the world, otherwise we’ll have regulatory arbitrage, which we all know is potentially extremely damaging and indeed was the feature of the events of 2007 and 2008.¹³⁸

158. Implementing the G20 priorities alone will place a heavy legislative burden on the EU. The lion’s share of action will need to be taken at a global level if it is to be effective. The economic welfare added by regional action therefore requires particularly careful scrutiny. We are concerned about the scale of the EU agenda, particularly given that the European Supervisory Authorities, which should at least be able to help the Commission prioritise its work, have only just been established. The focus of European effort should be on explicit commitments by the G20 for reform. These should be implemented in close cooperation and after careful consultation with other jurisdictions.

159. While many of our witnesses welcomed the principle of a consistent regulatory framework across Europe, they were also concerned that failure to get such regulation right would damage the financial services industry, and those who used it.¹³⁹ Our witnesses emphasised that although the damage would be felt first in the United Kingdom, it would potentially affect the entire European Union. Mr Rolet told us that if misplaced regulation led to the gradual relocation of financial services “it is unlikely to migrate to Frankfurt or Milan or Paris or Madrid. It is going to go to Asia.”¹⁴⁰

160. The first danger is political pressure may lead to bad regulation, or to regulatory uncertainty. Mr Andrew Baker, Chief Executive of the Alternative Investment Management Association, warned “there is a danger at the moment, and it’s not confined to Europe, that there is too much political interference in the regulatory process and it’s not helpful for market operators because they don’t feel that they understand the rules.”¹⁴¹ Some of that pressure could come from European centres seeking to advance their own interests: Mr Rolet spoke about the “long-standing rivalry between the two financial

137 HC (Session 2010-11) 658, Q 75

138 HC 658-i Q22

139 See, for example, Qq 379-384, 470

140 Q 380

141 HC (Session 2010-11) 658, Q 42

centres, Paris and London” and the danger that some people might see “opportunity through the regulatory harmonisation process to claw back some business”.¹⁴² Some may come from a general political wish to take action, for example against short-selling, which may lead to regulations being made without an adequate evidence base.¹⁴³

161. Witnesses stressed that effective regulation required deep knowledge of the market being regulated, and that there were many technical differences between markets.¹⁴⁴ They were confident that the FSA had the technical expertise required for effective regulation. Mr Abbott of the London Metal Exchange, where 90 per cent of the world’s metal trading takes place, considered:

having a regulator that really understands the business is quite critical and is recognised by other global regulators as being critical. The problem that we have, therefore, with the concept of another layer or a different type of regulation coming from Europe is that it will necessarily come from countries that have no expertise in regulating our type of market.¹⁴⁵

Commissioner Barnier considered that the United Kingdom should have confidence in its influence and its ability to convince on European regulation.¹⁴⁶ David Benson of Nomura told us that “the UK regulators, the Bank of England and the FSA, are taking a leadership role, which is definitely influencing events in Brussels and Europe more generally”.¹⁴⁷ However, he noted “it’s hard to know exactly whether they’re taking sufficient account of British expertise”.¹⁴⁸

162. A further criticism was that particular European proposals had been produced without adequate consultation or impact assessments, and that processes could be rushed. While Commissioner Barnier stressed that European law required such assessments, and that he took consultation seriously, we were told that the Alternative Investment Fund Managers Directive (produced before Commissioner Barnier took up his post) had suffered from a lack of consultation at the outset, and as a result many technical issues still remained to be resolved.¹⁴⁹

163. If the European Supervisory Authorities focus on improving coordination between regulators, and drawing up technical standards which are based on a deep understanding of the markets regulators have to deal with, they can add value. However we are concerned at the sheer scale and pace of the reforms taking place at European level. The Commission needs to ensure its reforms are technically sound, and only brought forward after consultation. It also needs to avoid the danger that political

¹⁴² Qq 373-4

¹⁴³ HC 658-i, Q 42, see also Q 360, Q 364

¹⁴⁴ Qq 48-50, Q 360

¹⁴⁵ HC 658—i, Q15

¹⁴⁶ HC 858-ii, Q 147

¹⁴⁷ HC 658-i Q22

¹⁴⁸ *ibid*

¹⁴⁹ HC 658-i, Q9

pressure may lead to poor regulation. Inappropriate regulation will not only damage the United Kingdom, but the European Union as a whole.

UK engagement with European regulators

164. We note that the FSA and the Bank of England have been playing a leading role in discussions on European regulation. That must continue. However, the new regulatory structure in the EU will be very different from the one being implemented in the UK. The ESAs will deal with both prudential regulation and conduct of business issues, and be focused on specific sectors. In the UK, prudential regulation across most sectors will be carried out by the PRA, with the CPMA focusing on conduct of business regulation.

165. In their written evidence the FSA warned there will be a risk that the UK regulatory voices will be weakened by this misalignment, especially with the ongoing restructuring in the next two years:

There is [...] a risk that the single UK regulatory voice in some cases is weakened by the fact that two or more organisations will share the representational role in the various international regulatory committees. In other cases (especially in Europe) the UK will only have one vote on each committee and will need to resolve conflicting objectives and interests between the various interested UK authorities. [...]¹⁵⁰

166. There will need to be a great deal of consultation between the UK regulators about the approach to be taken within the ESAs—to give one example, the CPMA will need to work with the Bank directly on issues surrounding market infrastructure, as the Bank will have responsibility over exchanges, clearings and settlements, all of which will be in ESMA’s remit. The FSA believes that “[the problem] can be mitigated through clarity in the roles and objectives of, and effective coordination between the PRA and CPMA. Coordination will also need to extend to The Pensions Regulator and potentially other UK authorities.”¹⁵¹ In its response to the consultation, the Government has suggested that “different authorities will participate in sub-committees of the new ESAs—for example, with the CPMA sitting on the conduct committees of the banking and insurance supervisory authorities in Europe.”¹⁵²

167. The Government’s decision to abandon the proposal to transfer the UKLA to the FRC, which we have already welcomed should improve coordination with Europe. The London Stock Exchange had been concerned about the previous proposals, telling us that:

Aligning the UK regulatory structure with the EU regulatory supervisors is vital to the UK maintaining a strong and credible voice in Europe. [...] The removal of the UKLA from the CPMA markets division means that the UK will only be directly represented at European level on secondary markets issues. Primary market

150 Ev 226, see also Q 471

151 Ev 226

152 A new approach to financial regulation: Summary of consultation responses

regulation has historically been a source of competitive advantage to the UK and we would not want to see this eroded in the name of European harmonisation. [...].¹⁵³

168. In its summary of responses to the consultation document, the Government said:

The Government is committed to ensuring that there is continued, focused engagement by HM Treasury, the FSA and the Bank with European and international developments and that the UK's voice on negotiations is as strong and influential as ever. [...]

2.41 In order to provide continuity during the transitional period the UK's institutional representation in international forums will not change until the legislation to create this new structure is enacted. As the reform programme advances, the Bank and the FSA will work closely together to ensure that all relevant views are taken into account and adequately represented in international and EU negotiations.¹⁵⁴

169. Witnesses were concerned that the United Kingdom should be properly represented in European institutions. Mr Andre Villeneuve of the City of London's International Regulatory Strategy Group told us:

I think we have to look very much at the detail I was talking about earlier, about how we're represented on the European bodies. What I didn't say, of course, is that I think we've done a poor job in making sure that we have the right people in the Commission and on these new bodies [...].¹⁵⁵

It is important that the UK, with a particularly large share of the financial services activity of the EU, secures appropriate representation on the EU regulatory bodies.

170. The establishment of the ESAs means the Government and the FSA need to treat engagement in European negotiations as a high priority. The United Kingdom's regulatory framework must be designed to ensure that engagement with Europe is effective.

HM Treasury's role in international negotiations

171. A further difficulty, which is not explicitly addressed in the consultation paper, is that while the supervisory authorities will take the lead in technical discussions at both European and international level, the Treasury and Finance Ministers will also play a leading role. The summary of responses to the Government's consultation notes:

153 Ev 203

154 Paras 2.40-2.41

155 Q 617

The Government will consider how to ensure that effective coordination between authorities, in the European sphere as in all other matters, is supported in legislative and practical terms.¹⁵⁶

Not only will there be problems of co-ordination; the Government will need to ensure that HM Treasury retains the technical capacity to play a leading role in such negotiations.

172. At national level the Government is proposing to devolve a great deal of power to independent regulators. We do not oppose this, but many of the actions to prevent a recurrence of the crisis depend on actions which must be negotiated at an international level. Both the regulators and the Government may be involved in such negotiations. There are two potential dangers. The first is that international regulation becomes the preserve of technocrats, and Governments may become dangerously disengaged. The second is that political pressure results in bad regulation. The Government should provide greater clarity about the way in which negotiations will be handled and co-ordinated, what role the Government will play, and how it proposes to minimise these risks.

8 Responsibilities in times of crisis?

173. The Government intends to make the regulatory system more robust. However, no system can eliminate all risks, and the new arrangements need to be clear about responsibility in a time of crisis. As the previous Treasury Committee explored in its report on *The Run on the Rock*, the previous arrangements resulted in regulatory ‘underlap’ and lack of clarity about who was in charge in crisis. There is a consensus that, in normal circumstances, regulation is best conducted independently of government, within a framework set up by government and Parliament. In times of crisis, however, when decisions have to be taken quickly, and public money may need to be spent, democratic legitimacy is vital.

174. The Government has developed a new crisis management framework which assigns particular responsibility to the Treasury and the Bank of England from ‘peacetime’, to ‘emerging risks’ and finally ‘crisis management’ mode. The split in responsibility is described in figure 2 below.

Figure 2 - transition from peacetime to crisis

Authority		‘Peacetime’	Emerging risks	Crisis management
HM Treasury		Economic and financial policy.	Contingency planning	Overall responsibility for decisions affecting public funds and international obligations
Bank of England	Bank	Monetary policy, central banking, and key infrastructure	Operation of liquidity insurance	Emergency liquidity
	FPC	Monitoring risks, vulnerabilities and imbalances; use of macro-prudential tools	Possible use of macro-prudential tools in response to emerging threat.	
	PRA	Normal prudential regulation of firms	Heightened supervision and intervention	Triggering SRR and crisis interventions
	SRU		Contingency planning	Operating the SRR

SRU=Special Resolution Unit

Source: *A new approach to financial regulation*, HM Treasury, Table 6.A, page 48

175. The consultation notes:

Currently, the Chancellor of the Exchequer is accountable to Parliament for decisions involving the use of public funds, for compliance with the UK’s international obligations, and for the exercise of certain powers, including the power to transfer a bank or a bank holding company into temporary public ownership and the power to amend the law to enable a power under the regime to be used effectively. The Bank is the lead resolution authority, responsible for the bridge bank and private sector purchaser stabilisation options.

6.23 It is important to ensure that appropriate safeguards are in place to ensure that conflicts do not arise between the Bank's role as lead resolution authority and the Bank's new responsibilities in relation to the PRA, which will be responsible for pulling the trigger to put a failed institution into the SRR [Special Resolution Regime]. The Government will therefore put in place arrangements to ensure that contingency planning and resolutions are managed distinctly from the Bank's functions in relation to the PRA. Specifically, resolution will be managed by the Deputy Governor for financial stability, and not the Deputy Governor for prudential regulation (the CEO of the PRA).¹⁵⁷

176. In his speech on 13 December, Mr Sants suggested that the authorities involved will co-operate closely:

There will need to be a strong underlying cooperation between the PRA, the FPC, the Special Resolution Unit and the rest of the Bank.

When supervising firms, in order to decrease the probability of failure and ensure orderly resolution, our goal is to introduce a formal, proactive intervention framework for the PRA and the Special Resolution Unit so that concerns about individual firms are elevated and remedial actions taken at an early stage. The framework will have two purposes—firstly, it will require firms to take appropriate remedial action to reduce the probability of failure. Secondly, it will flag the need for actions to be taken by the authorities so that the failure or resolution of a firm can occur in an orderly manner with minimum disruption and cost to the financial system and to individual customers.¹⁵⁸

177. Insofar as functions can be divided, the Bank of England will be responsible for the design and execution of most regulatory policies and the resolution regime, the PRA will decide whether to put an institution into resolution, while the Treasury will have the control of any use of public funds. The Governor will report to the Chancellor on financial stability every six months as a matter of routine. As soon as taxpayers' money may be required, the Governor will be under an obligation to notify the Chancellor to give him/her sufficient time to consider and discuss all options. The Chancellor will have the final say on whether public funds should be deployed to maintain financial stability. The Financial Secretary told us:

I think we have moved from a situation where there's lack of clarity about who is responsible under the previous architecture to one, I think, where there is much greater clarity because it is the PRA that will be responsible for prudential supervision of an institution. It will be responsible for pulling the trigger for the special resolution regime. The Bank of England is responsible for determining which of those tools is appropriate-whether it is a bridge bank, or whether there is a sale to

157 Cm 7874, paras 6.22-6.23

158 *Reforming regulatory practice: progress to date*

the private sector-but where public money is used in the resolution, ultimately the Chancellor will have to decide whether or not to use public money to do that.¹⁵⁹

178. The Governor told us that this new arrangement would keep the Chancellor informed on financial stability issues and the risks of using public funds:

Part of the new framework is a very clear statutory obligation on the Governor to keep the Chancellor informed about any developments that might have implications for the use of public funds precisely so that we should avoid the position, which I gather distant memories can recall, but none of us can, when there were situations when a chancellor felt he was asked to commit public funds, but had no opportunity to influence the course of events that led to that.¹⁶⁰

179. No one can predict what form the next crisis will take. It is therefore essential that a well-defined crisis management plan is in place to minimise the disruptions caused by financial instability, and ultimately the pain suffered by the public purse. **We have some doubts about a system in which one authority decides whether or not to put an institution into resolution, another related institution decides what form that such a resolution arrangement should take and a third is responsible for the decision to use public funds. We also note that the decision to allow an individual firm to fail might contribute to a systemic loss in confidence.**

180. One aim of the reforms should be to increase the likelihood that individual companies can be resolved without recourse to public money, and without threatening the stability of the wider system. Firm collapse should not be conflated with financial crisis, and the resolution of individual firms should not normally be a matter for the Government. It may be there are occasions when the Government is approached with a request to provide funds to help resolve an individual institution where the decision is relatively straightforward. The problems come when public funds may be required to secure system stability—and in identifying the cases in which systemic risk is involved.

181. **We accept that the Governor will keep the Chancellor up-to-date with developments in the markets which may have an impact on financial stability. However, if a systemic crisis occurs which the Bank considers public money is required to resolve, it is hard to see how the Government could assess such a request while remaining at arm's length from the process. As we have seen recently, rescuing the financial system may have significant effects on public finances. Only a democratically elected Government should make such decisions. It will bear the responsibility for any errors; it must have the information and freedom it needs to choose its position. In times of crisis, it has to be the Government that is in charge. Once it appears likely that intervention beyond a single firm is necessary, and where public funds are put at risk the authorities should take decisions together, led by Treasury Ministers, and where appropriate, the Chancellor, chairing any crisis management meetings.**

159 Q 835

160 Q 1

Veto power?

182. When the Bank of England was given independent control of monetary policy in 1997, the Treasury retained the power to take over monetary policy by giving the Bank directions if it was deemed to be in the public interest to do so, mainly because of extreme economic circumstances. The Bank of England Act 1998 gave the Treasury the following Reserve Power:

(1) The Treasury, after consultation with the Governor of the Bank, may by order give the Bank directions with respect to monetary policy if they are satisfied that the directions are required in the public interest and by extreme economic circumstances.

(2) An order under this section may include such consequential modifications of the provisions of this Part relating to the Monetary Policy Committee as the Treasury think fit.

(3) A statutory instrument containing an order under this section shall be laid before Parliament after being made.

(4) Unless an order under this section is approved by resolution of each House of Parliament before the end of the period of 28 days beginning with the day on which it is made, it shall cease to have effect at the end of that period.

(5) In reckoning the period of 28 days for the purposes of subsection (4), no account shall be taken of any time during which Parliament is dissolved or prorogued or during which either House is adjourned for more than 4 days.

(6) An order under this section which does not cease to have effect before the end of the period of 3 months beginning with the day on which it is made shall cease to have effect at the end of that period.¹⁶¹

183. The boundary between ‘emerging risks’ and ‘crisis mode’ is often unclear. As we saw in the banking crisis, major financial institutions, such as RBS and HBOS, had to be rescued over a short time frame, such as a weekend. There has to be some mechanism that will allow the Government to intervene if, in its view, a crisis is developing, and other authorities are unwilling to act.

184. Despite granting the Bank of England independence in monetary policy, the Treasury retains an emergency power to give the Bank directions in setting monetary policies, when it considers it is in the public interest to do so and under extreme economic circumstances. A similar ‘reserve power’ should be given in the new legislation. It is important that the Government retains the power to take control over actions for which it will ultimately be held responsible whilst recognising that the use of such draconian powers would be an extreme step and would prejudice the perceived independence of the regulatory institutions.

¹⁶¹ Bank of England Act 1998 S.19

9 Transparency and accountability of the new bodies

Transparency and the Bank of England

185. While the Crown appoints the Governor and Deputy Governors, they can only be removed by the Court of the Bank, with the consent of the Chancellor, and the grounds for removal appear limited to non attendance at meetings, bankruptcy or being “unable or unfit” to continue as a member.¹⁶² Such a powerful guarantee of independence increases the need for clear, transparent criteria against which the Bank’s performance can be judged.

186. The monetary policy process in the United Kingdom has several elements within its design to ensure its transparency. For example, the MPC produces a quarterly Inflation Report, providing analysis of the current macro-economic conjuncture, as well as several forecasts, including the so-called ‘fan charts’ of forecast inflation and GDP . The minutes of the MPC meetings are published, and provide full disclosure of the votes of its members, as well as an insight into the discussion that took place in the meeting. MPC members also undertake public speeches, outlining their views on the issues currently facing the UK economy, and their thinking on the outlook for inflation.

187. Previous Treasury Committees have engaged with the Monetary Policy Committee, their recommendations for further improvements to transparency have been readily accepted. The Bank implemented the recommendation that the minutes of MPC meetings should be published earlier than was previously the case, and they are now published a fortnight after the meeting. Another previous Treasury Committee’s Report encouraged the Bank’s plans to ensure “a structured set of discussions between professional economists and staff members of the Bank.”¹⁶³ This Committee has decided to continue the previous Committee’s practice of holding hearings on the Inflation Report and appointment hearings.

188. The Treasury Committee provides an appropriate process for disagreements between members of the Monetary Policy Committee to be aired.¹⁶⁴

189. Both the previous Treasury Committee and this one have called upon the Governor, and other Bank staff, to appear to give evidence as part of our work on financial regulation and the banking crisis. **The Monetary Policy Committee and the Bank of England have repeatedly demonstrated their commitment to transparency. They have seen their**

¹⁶² Bank of England Act 1998, Schedule 1

¹⁶³ Treasury Committee, *The Monetary Policy Committee of the Bank of England: Ten years on*, HC 299-I, Session 2006-07, para 113; The Bank has initiated alongside the Centre for Economic Policy Research a programme of Monetary Policy Roundtables, the last one being held on 14 December 2010.

¹⁶⁴ For example, see oral evidence given to the Treasury Committee by members of the MPC on the November 2010 Inflation Report Oral Evidence on Thursday 25 November 2010, Session 2010-11, HC 634

engagement with the Treasury Committee as a means of securing accountability. That has been a key reason for the system's success and we warmly welcome it.

Accountability under the new arrangements

190. The combination of functions within with the Bank of England raises the issue of how that institution is to be called to account. This is particularly acute in the case of the macro-prudential and monetary policy decisions made by the FPC and the MPC. The FSA's regulatory proposals are potentially open to judicial review, and have, on occasion, been so reviewed. The policy decisions of the FPC and the MPC are of a different nature, and we would be dismayed if they became subject to judicial review. Moreover FSA proposals are consulted on openly before they are implemented. The FPC will have access to some information which must be held in confidence. Many of the decisions it is to take would be undermined if prior warning were given.

191. One of the historical responses to the question, "who shall guard the guards themselves?" has been to argue for the separation of powers, but the whole thrust of the reform proposals is away from such a separation. As the Governor has stressed in his evidence to the Committee, each member of the FPC and of the MPC should make up his or her own mind about proposed decisions, so there is no sense in which the external members should be thought of as overseeing the decision-making of Bank staff. In the economic sphere, competition is usually argued to be the appropriate discipline to punish poor decision-making, but that is inapplicable for regulation within a single national jurisdiction. In the long run, competition among jurisdictions might help to drive out poor regulatory arrangements, but there is also the danger that shorter-run location decisions by regulated entities would undermine the effectiveness of national prudential policy tools.

192. Hence attention needs to be paid to how the Bank of England's considerable economic policy powers are to be monitored and appropriate incentives set to encourage good decision-making. The Governor has pointed out that the Bank of England is a public body, subject to the scrutiny of Parliament, and has welcomed regular hearings into the Bank's work by the Treasury Committee. Scrutiny of the conduct of monetary policy has already been helped by such hearings (prior to the granting of operational independence to the Bank of England in 1997, there had been hardly any parliamentary debate or effective parliamentary scrutiny of this important part of economic policy-making). The Government consultation encourages such engagement with the Treasury Committee. It also considers there is a need for direct accountability to the Treasury, and proposes:

As well as internal accountability (through Court) and external accountability to Parliament, given its important role in economic policy, the Government believes that the FPC must also have a direct line of accountability to the Treasury.

Therefore, the Governor, in his capacity of chair of the FPC, will brief the Chancellor on a six-monthly basis, after the publication of each FSR. These briefings will serve to update the Chancellor on the prevailing and emerging risks to financial stability and the action proposed by the FPC to address them. The Governor will also use these meetings to inform the Chancellor of any other financial stability issues in the Bank's

wider remit—including the PRA. The meetings will provide an opportunity for the Chancellor to comment on the risks to financial stability, and action being taken to address them. A high-level record of these conversations will be published.¹⁶⁵

193. Even with these proposals, the new proposals for financial regulation have raised concerns about a possible democratic deficit. For example, the evidence of the British Bankers' Association suggested that there were insufficient safeguards to ensure democratic accountability:

When you consider the breadth of the Bank's new remit it is easy to see why many consider the proposed accountability to Ministers and Parliament to be undemanding [...]. Few would argue with the need for a strong, independent central bank. In view of the broad responsibilities now being assigned to the Bank, however, we would see a greater need for a more interactive engagement between the Bank and the Government and Parliament.¹⁶⁶

The MPC versus the FPC

194. As we have already noted, there is a significant level of transparency around the workings of monetary policy in the United Kingdom. But transparency and accountability are two different, but linked, concepts. Monetary policy is conducted in a highly structured accountability framework. As the Bank of England Act 1998 sets out:

In relation to monetary policy, the objectives of the Bank of England shall be –

- (a) to maintain price stability, and
- (b) subject to that, to support the economic policy of Her Majesty's Government, including its objectives for growth and employment.¹⁶⁷

195. The responsibility of the Treasury is then set out by the Act:

The Treasury may by notice in writing to the Bank specify for the purposes of section 11 –

- (a) what price stability is to be taken to consist of, or
- (b) what the economic policy of Her Majesty's Government is to be taken to be.¹⁶⁸

Such 'remit letters' are produced every 12 months.¹⁶⁹ The remit is currently defined as a target for inflation of 2 per cent as measured by the 12-month increase in the Consumer Prices Index (CPI) at all times. Deviations of CPI from this target by 1 percentage point in either direction lead to the Governor writing an open letter to the Chancellor explaining:

¹⁶⁵ Cm 7874, paras 2.61-2.62

¹⁶⁶ Ev 194, see also Q 163

¹⁶⁷ Bank of England Act 1998, section 11

¹⁶⁸ Bank of England Act 1998, section 11

¹⁶⁹ Bank of England Act 1998, section 12

- why inflation moved away from target;
- the period within which the MPC expects inflation to return to target;
- the policy action being taken to deal with it; and
- how this approach meets the Government's monetary policy objectives.

The Chancellor then responds to such letters he receives from the Governor.

196. **The performance of the inflation targeting regime in the UK is measurable, with explicit and well-defined roles for the Treasury and the Monetary Policy Committee of the Bank of England as to overall policy remit, decision taking and implementation. Deviations from the target are obvious, to both the participants, and the wider public. By a one person, one vote system on the MPC, alongside vote publication in the minutes, decision making is transparent. The Treasury Committee takes an active part in this process, pursuing both transparency and accountability, using our hearings to draw out MPC members' thinking on key topics, and appointment hearings to assess their competence and independence. We can also question the Chancellor as to the remit set by the Treasury for the MPC. Independence is maintained by the strict separation between remit setting at the Treasury, and decision making over interest rates at the MPC.**

197. While the FPC appears to be in some ways modelled on the MPC, several sections of the accountability and transparency system present in the MPC model have not been confirmed by the Government. A number of them may not work as well for the FPC, even if they were. As we have discussed previously in this Report, financial stability is not an easily defined, or measurable target. In the absence of a better description, it will be difficult for outside observers, such as this Committee, or the wider public, to assess the level to which the FPC is achieving its targets. **The Treasury and the FPC must provide far more detailed criteria against which the achievements of the new regime can be assessed. Without this accountability will be considerably weakened.**

198. The remit letter provided to the MPC provides an opportunity, such as over the change from RPI to CPI, for the Treasury to alter the target for monetary policy, without affecting the independence of the MPC in its decision making on interest rates. In monetary policy, regular remit changes are unwanted, as part of the monetary policy targeting regime is to anchor inflation expectations of consumers to a set inflation level. Repeated changes would undermine that process.

199. However, in the case of the FPC, we question whether the same logic stands. Financial firms would not like the uncertainty of regular remit changes. However, changes to the remit may be required in response to the development of macro-prudential tools and the suitability of the way in which the target has been defined. **The MPC is given its target in a regular, published remit letter from the Treasury. We recommend that this be the case for the FPC. We would not be surprised if the remit changed as more information and further research becomes available about the operation of the macro-prudential tools, and about how financial stability can usefully be defined. Such remit letters provide the**

political authority for the operation of such independent bodies. Their publication allows for scrutiny by this Committee, as well as other interested parties. We will take a close interest in the Financial Policy Committee, and its relations with government, and we will hold regular hearings.

200. While the measures above are parallel to the MPC process, there remain a number of differences. In particular, some of the actions of the FPC, and the information it receives, will be damaging if placed in the public domain at the time of the FPC's consideration of it. The transparency of the MPC bolsters its accountability, allowing this Committee and others to engage with it, assess how it intends to meet its target in the future, and provide accountability to Parliament. The need for the FPC to occasionally act secretly, and regularly receive information of a confidential nature, makes replication of such a system impossible.

201. The Committee will give further consideration to the accountability of the new regulatory structure in the light of the Government's second consultation document, due to be published shortly. Meaningful proposals on accountability cannot be made without more detail.

Conclusions and recommendations

1. We are concerned that the current proposals for reform say relatively little about some key segments of the UK financial sector. Inappropriate regulation of non-banking sectors could cause serious and unintended damage to companies within those sectors, and to the UK more widely. As the Treasury's consultation evolves, it is important that the Government clarifies the regulatory impact of its proposals on the non-bank sectors. (Paragraph 15)

The Government's timetable

2. We welcome the establishment of the Independent Commission on Banking. The Government should pay full regard to Vickers before coming to conclusions. Once Vickers has reported it will be equally important to maintain the political will to act on the Commission recommendations, if, after scrutiny, action is needed. This has implications for the timetable for the reforms set out in the current consultation paper. (Paragraph 23)
3. The Government needs to take the time required to get its reform of financial regulation right. We note there was a year between the first publication of draft clauses on the Financial Services and Markets Bill, and the appearance of a further draft. Although the Joint Committee which scrutinised the Bill was given only eight weeks for the task, it subsequently took from 17 June 1999, when the Bill was presented in the Commons, to 14 June 2000 to become law. The Bill was very heavily amended in Committee in response to widespread criticism after its initial publication. It is one of the longest and most complex pieces of legislation on the statute books. The Government's current proposals include a suggestion that FSMA could be revisited in its entirety. We urge the Government to ensure that this is done, and present a new Bill only after full consideration has been given to responses to initial consultation. Drafting the legislation will then be likely to secure a more coherent final product and may eventually be quicker, given the complexities involved in comprehensive amendment of FSMA. (Paragraph 25)
4. The legislation to establish the new regulatory structure should be subject to pre-legislative scrutiny, over a reasonable timescale; the eight weeks allowed for the Joint Committee on the Financial Services and Markets Bill was inadequate. Even with proper pre-legislative scrutiny, once introduced, the timetable for the Bill should be generous enough to allow proper parliamentary consideration, using carry-over if necessary. (Paragraph 26)
5. However, scrutiny of the legislation will not be possible without fuller discussion of what financial stability might look like and how the democratic responsibilities of government can be combined with the delegation of significant economic policy making powers to an independent body. There also needs to be greater clarity about the wider regulatory framework; the major decisions on the structure of financial regulation should not be taken until there has been time to consider the recommendations of the Independent Commission on Banking. Whether or not it is possible to produce the final legislation within the two year time frame the

Government envisages, the aim of introducing the legislation in “mid-2011” appears optimistic and, if pursued too rigidly, runs the risk of compromising its quality. (Paragraph 27)

6. The FSA will divide internally, in preparation for the new arrangements. The Bank of England will continue to publish the Financial Stability Report, which is likely to be more influential in the interim period. While the draft legislation is being thought through, clear non-statutory interim arrangements will need to be in place. The Treasury should consider the preparation of an Memorandum of Understanding with the Bank of England and the FSA setting out those arrangements. (Paragraph 29)

A super regulator—the Bank of England (Paragraph 3)

7. Until now, such policies have been seen as the responsibility of the elected Government. If the Financial Policy Committee is to be given lead responsibility for securing financial stability there needs to be clarity about what such stability means. The overall stability of the financial system should certainly not mean that no firm will ever fail. However, there is room for debate about how frequent and severe firm failures may be before it is considered that the system is unstable. Moreover, in the short term, there could be trade-offs between some types of stability and growth if, for example, regulation restricts free entry and exit of firms or discourages innovation in other ways; there are trade-offs between the stability of the individual firm and growth. Unlike the MPC, which has a clear inflation target and the well-defined tool of interest rates and now quantitative easing to achieve its target, the remit for the FPC is difficult to define rigorously. Nonetheless, the Government needs to give a view, and a detailed one, of what the financial stability ‘target’ should be, how it should be assessed, and how any trade-offs that financial stability policy requires are to be managed. (Paragraph 38)
8. The independent members of the FPC will play a crucial role, at least as important as that of the equivalent members of the MPC. Given the close links between the internal members, the external members will play an essential role in ensuring that the Committee does not succumb to organisational “groupthink”. They will need adequate support from the Bank. They should be given the right to commission any information and analysis they feel they need. (Paragraph 43)
9. Whilst the MPC has four external members out of a total of nine, the FPC would have four external members out of eleven. A better balance between internal and external members of the FPC seems desirable. It could be achieved by increasing the number of external members on the FPC, to say six. That would increase the committee’s size to thirteen, so that it would become rather unwieldy. The alternative would be to reduce the Bank’s representation. The Treasury has given no explanation of the rationale for having Bank executives on markets and financial stability as full members of the FPC, rather than non-voting participants, when their respective bosses are already present, or for including such executives rather than staff of the PRA. (Paragraph 44)

10. At least some of the external members of the FPC should have a recent senior background in the financial services industry. (Paragraph 47)
11. However prestigious a regulator may be, it will always lose many of its best staff to the industry it regulates. This is why the experience and credibility of the external members will be particularly important in ensuring the success of the FPC, and its credibility in the industry. The Committee must contain someone with recent experience of risk management at the highest level from the regulated sector. It would be wrong to require that the FPC contain members with experience in particular industries; the task of the FPC is to look at the financial system as a whole. However there must be no room for accusations that it is overly focused on banking nor that it lacks the expertise to look at important sectors, such as insurance. (Paragraph 49)
12. Conflicts of interest will be hard to avoid, even if external members have retired from the industry. They will need to be managed carefully. Some have made a case for those with current experience serving on the FPC, and we do not exclude that possibility. However, if the Government is considering this, it should set out clearly how those conflicts of interest will be dealt with. (Paragraph 50)
13. The interim FPC is intended to have an important role in carrying out preparatory work and analysis for the permanent FPC. Its work may well result in fine tuning or even substantial amendment of the Government's proposals. It should be engaged in developing proposals for macro-prudential tools, and ways in which they might be adjusted. Given that this body has yet to be established, the current restructuring timetable, where the new regulatory system will be in place by the end of 2012, may be too challenging. We note that the Government has been unable to avoid delay on this, despite its desire for speed and the considerable control it had over this part of the process. (Paragraph 54)
14. While in the long-term effective macro-prudential tools should increase economic welfare overall, particular individuals and companies find their access to credit affected, even though they are confident they could service the debt they seek. Many macro-prudential tools are only now being developed, and their effectiveness will need to be monitored. As the consultation paper notes, quantitative credit controls, which were used until the early 1980s, led to distortions. Moreover, financial innovation can be redirected to get around new regulations. (Paragraph 65)
15. The Government has proposed that the tools available to the FPC should be set out in secondary legislation so that they can be 'fine tuned' if necessary. Given the impact that the use of macro-prudential tools may have, we recommend that secondary legislation used to introduce or alter them require the approval of Parliament. This raises wider scrutiny issues, to which we shall return. Parliament needs to assess the nature of the powers which it is to devolve to the FPC, and the extent to which these can be satisfactorily encapsulated in legislation. This means that the bulk of the secondary legislation should be available before the House begins detailed examination of any Bill. (Paragraph 66)

16. Once appropriate tools are defined, we understand the rationale for giving the FPC discretion—in ‘peacetime’—on when to use such tools, without reference to the Treasury. “To take away the punch bowl just as the party gets going” is easier said than done: it will be far harder if the FPC first has to identify a problem and then get the Chancellor to agree to the use of the tools which might mitigate it. However, only the Government and the House of Commons have the power to authorise the expenditure of public money. As we discuss further below, the accountability issues raised by the Government’s proposals are complex, and hard to resolve and are discussed further in Chapter 9. (Paragraph 67)
17. In its consultation document, the Government states that “the objectives of price stability and financial stability should generally be consistent and complementary”. However, in acting to achieve their respective objectives, the MPC and the FPC will employ tools that may interact in unexpected ways. These interactions may mean the actions of one committee could affect the achievement of the other committee’s objective. (Paragraph 72)
18. The Government’s proposals divide responsibility, but address coordination by having cross membership between the committees. At least three Bank officials will be members of both committees, giving them immense influence on monetary and macro-prudential policy making. Given this cadre of Bank cross-members, ensuring that adequate resources and support are available to the external members of each committee will be extremely important. (Paragraph 73)
19. One of the ways to monitor the influence of the Bank cadre will be through the transparency of the minutes of the two committees. We will expect full disclosure of voting within the FPC on the use of the macro-prudential tools. External members of either committee will always have the ability to write to this Committee with any concerns they may have. Other aspects of accountability are discussed in Chapter 9. (Paragraph 74)
20. The consultation paper proposes “Meetings of the MPC and the FPC will be carefully sequenced in order to ensure that both committees are able to fully take into account the most recent decisions of the other.” This presumably means that one committee will not meet until the minutes of the other have been published. We support this, as likely to strengthen the position of the independent members. (Paragraph 75)
21. Cross membership and sequencing of meetings may be sufficient in times of stability. However, in crisis periods the committees may need to work together more closely. Provision for joint MPC/FPC meetings so that policies on financial stability can be coordinated more effectively may be required. (Paragraph 76)
22. Risks to financial stability may evolve, and may change in response to regulation. We welcome the proposal to give the FPC responsibility for monitoring the regulatory boundary. (Paragraph 79)
23. The FPC should also have the power and the responsibility to recommend changes to the wider legal and regulatory framework, including arrangements that go across national boundaries, such as those for the resolution of cross-border banks. Any such recommendations should be copied to us. (Paragraph 80)

Micro-prudential Regulation

24. Further consultations should give a fuller explanation of the reasons for making the PRA a subsidiary of the Bank of England. (Paragraph 86)
25. While there may be circumstances in which public authorities need to prop up a particular firm to avoid systemic risk, we are concerned by the implicit acceptance that any failure of a high-impact firm should be avoided. (Paragraph 89)
26. We are also concerned about the suggestion that the PRA's efforts will be focused on what it considers to be medium and high-impact firms. As the case of Northern Rock demonstrated, the failure of a company which was apparently "low-impact" engendered a systemic loss of confidence. The PRA will need to have a strong justification for reducing the supervisory effort for such 'low-impact' firms. (Paragraph 91)
27. We agree that regulatory success does not and should not mean that no firm will fail. The Prudential Regulation Authority's aim should be, not to prevent firm failure, but to protect taxpayers and the wider economy from the consequences of such failure. Hector Sants' suggestion that the PRA will have a low tolerance for the failure of high impact firms is a source of concern. The assumption that certain firms cannot be allowed to fail results in market distortion, entrenches the market power of large incumbents and thereby stifles competition. That lack of market discipline may, over the long term, itself engender systemic instability. Although there may be combinations of circumstances in which individual firms require support to limit systemic risk, we reiterate our predecessor Committee's recommendation that no firm should be too important to fail. Competitive markets need both freedom to exit and freedom to enter. (Paragraph 92)
28. Judgement-based regulation can cover a number of approaches, from challenging a company about how it would perform under a variety of market conditions, to substitution of the regulator's judgement for that of the company management. The aim should be to ensure that companies can fail without undue adverse impact, rather than to attempt to second guess management approaches. We are also concerned about how the PRA will manage situations in which members of the board of a supervised firm, who have personal legal responsibilities, do not agree with its judgment. (Paragraph 98)
29. We welcome the memorandum of understanding between the FRC and the FSA on audit. The regulator needs to be confident that auditors will share their concerns directly and they should have a duty to do so. The regulator should also be able to obtain any audit information it needs from the auditors. (Paragraph 100)
30. The debate about whether the CPMA should be a consumer champion demonstrates the importance of making sure that definitions are clear. We have no doubt that effective conduct regulation should be in consumers' best interests and will involve a high degree of consumer protection. Nonetheless, branding the CPMA as a consumer champion would be inappropriate, confusing, and potentially dangerous. The job of the regulator is to ensure that regulation is effective and proportionate. That requires a balance between preventing abusive behaviour and ensuring that

regulation does not impose excessive costs and restrictions, in order to optimise economic efficiency. Financial markets manage and price risk; they do not remove it. If a regulator is promoted as a consumer champion, consumers may falsely believe that all financial products are risk free, creating moral hazard. It is simply not possible to protect every interest at all times. We strongly urge the Government to drop the title of ‘consumer champion’ from the CPMA. There are other organisations which campaign for consumers; the regulator’s task is to be alert to abuse, and to ensure that consumers are appropriately protected in an open and fair marketplace with the minimum of moral hazard. (Paragraph 110)

31. Competition is a highly effective means of protecting consumers’ interests. The response given by the Financial Secretary when we pressed him on whether promoting competition should be treated as a primary objective for the new authorities was disappointing. The CPMA should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation. Greater competition should also help prevent firms becoming too big to fail. We do not, however, believe that the regulator should have a remit to facilitate innovation—a properly functioning market will do that. (Paragraph 118)
32. We have already proposed that the CPMA should have a primary objective of promoting competition, and there may be other places where regulators need a spread of objectives. However, we are unconvinced that ‘have regards’ provisions are effective in directing a regulator. The regulator will have to decide what trade-offs to make when desirable objectives compete: secondary statutory objectives are likely to be a more satisfactory way to specify such objectives for all but the most general provisions. (Paragraph 120)
33. The CPMA will have a dual remit between consumer protection and markets regulation. The Government believes that a strong consumer division is required to deliver protection for consumers, while the industry believes there is a need for a strong markets division. It has also been suggested that market supervision might fit more naturally within the PRA. We urge the Government to give more detail about its thinking on this subject in the next consultation paper, and, in particular, what structure it proposes to ensure that both market regulation and consumer matters receive the attention they need. (Paragraph 123)
34. We welcome the Government’s decision to put the UK Listing Authority in the CPMA, rather than splitting responsibility for markets regulation between three bodies, as first proposed. However, there are still issues to be resolved, such as the concern about the UK’s corporate governance position within Europe, where the CPMA will represent the UK in the European Securities and Markets Authority, although many corporate governance issues remain with the Financial Reporting Council. The success of the London markets underpins the success of the United Kingdom financial services industry; the markets division within CPMA must be adequately resourced, and may need a wider focus than pure conduct of business. (Paragraph 128)

35. In principle the consequences of financial crises could pose more threats to consumers than individual cases of detriment. However, if the new arrangements work properly, choices between financial stability and consumer protection should be rare. If the FPC and PRA can produce a system in which companies can fail without financial instability, then CPMA decisions should not pose systemic risk. We welcome the Treasury's reassurance that the PRA's veto over the CPMA can only be used as a last resort. To ensure that this is so, cases when the power is exercised should be made public. It may not be possible to do so immediately, without threatening stability. In such circumstances the authorities should write to the Chancellor in confidence to notify him, explaining the reasons that the two authorities differed. We expect almost all such reports to be made public at the earliest opportunity, recognising that there may be exceptional circumstances. In such cases arrangements should be made to inform the Chair of this Committee. (Paragraph 133)
36. It is important that the PRA and CPMA work closely together on both prudential and conduct of business issues; the absence of a Chief Executive designate of the CPMA risks regulatory thinking being developed only by those responsible for the parts of the regulatory structure which are or will be directly related to the Bank of England. We are likely to return to the relationship between the CPMA and the Bank of England in future work. (Paragraph 134)

Cost of regulation

37. Given the urgency of the Government's reform programme and the resources and time needed to produce a further full study of the costs of regulation, it will be impractical for the FSA to devote resources to such a review at this stage. Once the new architecture has been set up, we recommend that the PRA and the CPMA revisit the whole issue of cost of regulation, in the light of the financial crisis and the changes in regulatory structure. (Paragraph 140)
38. Under FSMA, the FSA is required to undertake a cost-benefit analysis of any proposed regulatory changes. However, the full costs—always ultimately borne by consumers—need to be shown. Cost-benefit analysis must be improved within the PRA and the CPMA. New regulatory requirements should only be introduced if a full cost-benefit analysis has been conducted. The authorities also need to be certain and demonstrate that the benefits are justified by any additional costs to consumers that might be caused by restrictions to competition. (Paragraph 141)
39. We are unconvinced by the Financial Secretary's explanation that the £50m transition costs will be borne by the industry alone. His contention that a competitive market means that the industry will not be able to pass on the costs to consumers begs the question as to the degree of competitiveness in the market. We urge the Treasury to give more detail about the assumptions underlying the £50m transition cost. It should also report regularly over the transition period on the level of actual costs being incurred. (Paragraph 144)
40. We appreciate the importance of avoiding the regulatory underlap that we have seen under the Tripartite system. However, removing the underlap should not result in an

overlap of responsibilities between the new bodies. Overlap, like underlap, can lead to confusion and paralysis. Careful planning and consideration needs to be given to the remits and boundary of responsibilities, especially between the PRA and CPMA. (Paragraph 147)

41. The move to new regulatory arrangements should be accompanied by better analysis of the cost of regulation, both one-off and ongoing, for all kinds of financial firms, by sector and by size. The aim should be to produce a better, more effective and more cost efficient regulatory system. (Paragraph 148)

International regulation

42. Effective participation in international regulation is both a central part of macro-prudential policy and key to ensuring that micro-prudential policy can be conducted effectively. (Paragraph 150)
43. Implementing the G20 priorities alone will place a heavy legislative burden on the EU. The lion's share of action will need to be taken at a global level if it is to be effective. The economic welfare added by regional action therefore requires particularly careful scrutiny. We are concerned about the scale of the EU agenda, particularly given that the European Supervisory Authorities, which should at least be able to help the Commission prioritise its work, have only just been established. The focus of European effort should be on explicit commitments by the G20 for reform. These should be implemented in close cooperation and after careful consultation with other jurisdictions. (Paragraph 158)
44. If the European Supervisory Authorities focus on improving coordination between regulators, and drawing up technical standards which are based on a deep understanding of the markets regulators have to deal with, they can add value. However we are concerned at the sheer scale and pace of the reforms taking place at European level. The Commission needs to ensure its reforms are technically sound, and only brought forward after consultation. It also needs to avoid the danger that political pressure may lead to poor regulation. Inappropriate regulation will not only damage the United Kingdom, but the European Union as a whole.
45. It is important that the UK, with a particularly large share of the financial services activity of the EU, secures appropriate representation on the EU regulatory bodies. (Paragraph 169)
46. The establishment of the ESAs means the Government and the FSA need to treat engagement in European negotiations as a high priority. The United Kingdom's regulatory framework must be designed to ensure that engagement with Europe is effective. (Paragraph 170)
47. At national level the Government is proposing to devolve a great deal of power to independent regulators. We do not oppose this, but many of the actions to prevent a recurrence of the crisis depend on actions which must be negotiated at an international level. Both the regulators and the Government may be involved in such negotiations. There are two potential dangers. The first is that international regulation becomes the preserve of technocrats, and Governments may become

dangerously disengaged. The second is that political pressure results in bad regulation. The Government should provide greater clarity about the way in which negotiations will be handled and co-ordinated, what role the Government will play, and how it proposes to minimise these risks. (Paragraph 172)

Responsibilities in times of crisis?

48. We have some doubts about a system in which one authority decides whether or not to put an institution into resolution, another related institution decides what form that such a resolution arrangement should take and a third is responsible for the decision to use public funds. We also note that the decision to allow an individual firm to fail might contribute to a systemic loss in confidence. (Paragraph 179)
49. We accept that the Governor will keep the Chancellor up-to-date with developments in the markets which may have an impact on financial stability. However, if a systemic crisis occurs which the Bank considers public money is required to resolve, it is hard to see how the Government could assess such a request while remaining at arm's length from the process. As we have seen recently, rescuing the financial system may have significant effects on public finances. Only a democratically elected Government should make such decisions. It will bear the responsibility for any errors; it must have the information and freedom it needs to choose its position. In times of crisis, it has to be the Government that is in charge. Once it appears likely that intervention beyond a single firm is necessary, and where public funds are put at risk the authorities should take decisions together, led by Treasury Ministers, and where appropriate, the Chancellor, chairing any crisis management meetings. (Paragraph 181)
50. The boundary between 'emerging risks' and 'crisis mode' is often unclear. As we saw in the banking crisis, major financial institutions, such as RBS and HBOS, had to be rescued over a short time frame, such as a weekend. There has to be some mechanism that will allow the Government to intervene if, in its view, a crisis is developing, and other authorities are unwilling to act. (Paragraph 183)
51. Despite granting the Bank of England independence in monetary policy, the Treasury retains an emergency power to give the Bank directions in setting monetary policies, when it considers it is in the public interest to do so and under extreme economic circumstances. A similar 'reserve power' should be given in the new legislation. It is important that the Government retains the power to take control over actions for which it will ultimately be held responsible whilst recognising that the use of such draconian powers would be an extreme step and would prejudice the perceived independence of the regulatory institutions. (Paragraph 184)

Transparency and accountability of the new bodies

52. The Monetary Policy Committee and the Bank of England have repeatedly demonstrated their commitment to transparency. They have seen their engagement with the Treasury Committee as a means of securing accountability. That has been a key reason for the system's success and we warmly welcome it. (Paragraph 189)

53. The performance of the inflation targeting regime in the UK is measurable, with explicit and well-defined roles for the Treasury and the Monetary Policy Committee of the Bank of England as to overall policy remit, decision taking and implementation. Deviations from the target are obvious, to both the participants, and the wider public. By a one person, one vote system on the MPC, alongside vote publication in the minutes, decision making is transparent. The Treasury Committee takes an active part in this process, pursuing both transparency and accountability, using our hearings to draw out MPC members' thinking on key topics, and appointment hearings to assess their competence and independence. We can also question the Chancellor as to the remit set by the Treasury for the MPC. Independence is maintained by the strict separation between remit setting at the Treasury, and decision making over interest rates at the MPC. (Paragraph 196)
54. The Treasury and the FPC must provide far more detailed criteria against which the achievements of the new regime can be assessed. Without this accountability will be considerably weakened. (Paragraph 197)
55. The MPC is given its target in a regular, published remit letter from the Treasury. We recommend that this be the case for the FPC. We would not be surprised if the remit changed as more information and further research becomes available about the operation of the macro-prudential tools, and about how financial stability can usefully be defined. Such remit letters provide the political authority for the operation of such independent bodies. Their publication allows for scrutiny by this Committee, as well as other interested parties. We will take a close interest in the Financial Policy Committee, and its relations with government, and we will hold regular hearings. (Paragraph 199)
56. The Committee will give further consideration to the accountability of the new regulatory structure in the light of the Government's second consultation document, due to be published shortly. Meaningful proposals on accountability cannot be made without more detail. (Paragraph 201)

Formal Minutes

Thursday 27 January 2011

Members present:

Mr Andrew Tyrie, in the Chair

John Cryer	Mr George Mudie
Michael Fallon	David Ruffley
Stewart Hosie	John Thurso
Andrea Leadsom	Mr Chuka Umunna
Mr Andrew Love	

Draft Report (*Financial Regulation: a preliminary consideration of the Government's proposals*), proposed by the Chair, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 201 read and agreed to.

Summary agreed to.

Resolved, That the Report be the Seventh Report of the Committee to the House.

Ordered, That the Chair make the Report to the House.

Ordered, That embargoed copies of the Report be made available, in accordance with the provisions of Standing Order No. 134.

Written evidence was ordered to be reported to the House for publishing with the Report (in addition to that ordered to be reported for publishing on 12 and 26 October and 16 November 2010).

[Adjourned till Tuesday 1 February at 9.45 am

Witnesses

Wednesday 28 July 2010

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Mervyn King, Governor, **Paul Tucker**, Deputy Governor (Financial Stability), and **Andrew Bailey**, Executive Director, Banking and Chief Cashier, Bank of England

Ev 1

Tuesday 14 September 2010

Professor Charles Goodhart CBE, Programme Director, Regulation & Financial Stability, Financial Markets Group and London School of Economics Professor Emeritus of Banking and Finance, and **Lord Myners of Truro CBE**, former Financial Services Secretary

Ev 11

Tuesday 12 October 2010

Angela Knight, Chief Executive, British Bankers' Association, **Adrian Coles**, Director-General, Building Societies Association and **Peter Beales**, Head of Policy and Advocacy, Association for Financial Markets in Europe

Ev 22

Thursday 14 October 2010

Natalie Ceeney, Chief Executive and Chief Ombudsman, and **Tony Boorman**, Decisions Director and Principal Ombudsman, Financial Ombudsman Service, **David Hall**, Chairman, and **Mark Neale**, Chief Executive, Financial Services Compensation Scheme

Ev 39

Richard Saunders, Chief Executive, Investment Management Association and **Peter Vipond**, Director, Financial Regulation and Taxation, Association of British Insurers

Ev 48

Tuesday 19 October 2010

Martin Lewis, moneysavingexpert.com

Ev 56

Robert Sinclair, Director, Association of Independent Financial Advisers, **Dr Tim May**, Member of the Board, Association of Private Client Investment Managers and Stockbrokers, and **Steve Gazzard**, Operations Director, Institute of Financial Planning

Ev 65

Tuesday 26 October 2010

Jacques Aigrain, Chairman, LCH.Clearnet, and **Xavier Rolet**, Chief Executive, London Stock Exchange Ev 76

Baroness Sarah Hogg, Chair, Financial Reporting Council, and **Stephen Haddrill**, Chief Executive, Financial Reporting Council Ev 87

Thursday 11 November 2010

Sean McGovern, Director and General Counsel, Lloyd's of London Ev 95

Stephen Sklaroff, Director General, Finance and Leasing Association Ev 103

Tuesday 16 November 2010

Mike Bowron, Commissioner, and **Detective Chief Superintendent Steve Head**, Strategic Management Board, City of London Police Ev 109

André Villeneuve, Chairman, International Regulatory Strategy Group, City of London Ev 118

Thursday 18 November 2010

Iain Cornish, Chairman, Financial Services Practitioner Panel, **Roger Liddell**, Member of the Financial Services Practitioner Panel and Chief Executive of LCH.Clearnet Group Limited, **Guy Matthews**, Chairman, Smaller Businesses Practitioner Panel, and **Adam Phillips**, Chairman, Financial Services Consumer Panel Ev 125

Peter Vicary-Smith, Chief Executive and **Dominic Lindley**, Principal Policy Adviser, Which?, **Philip Cullum**, Deputy Chief Executive, and **Sarah Brooks**, Head of Financial Services, Consumer Focus Ev 133

Tuesday 23 November 2010

Lord Turner of Ecchinswell, Chairman, and **Hector Sants**, Chief Executive, Financial Services Authority Ev 140

Thursday 25 November 2010

Mervyn King, Governor, **Paul Tucker**, Deputy Governor (Financial Stability), and **Andrew Bailey**, Executive Director, Banking and Chief Cashier, and **Andy Haldane**, Executive Director, Financial Stability, Bank of England Ev 160

Tuesday 30 November 2010

Mark Hoban MP, Financial Secretary to the Treasury, and **Emile Lenendoglu**,
Team Leader, Financial Regulation Strategy, HM Treasury Ev 160

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1	Professor Charles Goodhart	Ev 184
2	Financial Ombudsman Service	Ev 185, 281
3	Consumer Focus	Ev 187
4	British Bankers' Association	Ev 192
5	Lloyd's of London	Ev 199
6	London Stock Exchange	Ev 203
7	Investment Management Association	Ev 207, Ev 293
8	Association for Financial Markets in Europe	Ev 210, Ev 309
9	Association of British Insurers	Ev 214, Ev 298
10	Building Societies Association	Ev 217, Ev 311
11	Finance and Leasing Association	Ev 222, 291
12	Financial Services Authority	Ev 224
13	Financial Services Consumer Panel	Ev 227
14	Financial Services Practitioner Panel	Ev 232
15	Smaller Businesses Practitioner Panel	Ev 237, Ev 303
16	City of London Corporation	Ev 241, Ev 305
17	Which?	Ev 243
18	Financial Reporting Council	Ev 253
19	Institute of Financial Planning	Ev 253
20	Association of Private Client Investment Managers and Stockbrokers	Ev 257, 268
21	Association of Independent Financial Advisers	Ev 269
22	City of London Police	Ev 288, Ev 306
23	Consumer Focus, Age UK, Citizens Advice, and Which?	Ev 308
24	Nomura	Ev 310

List of additional written evidence

(published in Volume III on the Committee's website www.parliament.uk/treascom)

1	Office of the Complaints Commissioner	Ev w1
2	Association of British Credit Unions Ltd	Ev w5
3	Chartered Institute of Bankers in Scotland	Ev w9
4	Panacea IFA	Ev w11
5	Black Rock	Ev w12
6	Aviva Plc	Ev w13, w62, w64

7	Plus Markets Group	Ev w15
8	Peter Bonisch, MD, Paradigm Risk, and PJ Di Giammarino, CEO, JWG	Ev w18
9	Investment and Life Assurance Group	Ev w26
10	Shelter	Ev w30
11	Futures and Options Association	Ev w31
12	Berwin Leighton Paisner	Ev w40
13	Council of Mortgage Lenders	Ev w44
14	Royal Bank of Scotland Group plc	Ev w45
15	Intellect	Ev w47
16	Highclere Financial services	Ev w53
17	Citizens Advice	Ev w55
18	Alan Fiber	Ev w58
19	Chris Hulme	Ev w60
20	World Development Movement	Ev w60
21	Brewin Dolphin	Ev w63
22	Stephen Mason and Nichols Bohm	Ev w65

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Second Report	Appointment of Dr Martin Weale to the Monetary Policy Committee of the Bank of England	HC 195
Third Report	Appointment of Robert Chote as Chair of the Office for Budget Responsibility	HC 476
Fourth Report	Office for Budget Responsibility	HC 385
Fifth Report	Appointments to the Budget Responsibility Committee	HC 545
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