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Treasury Committee

Financial Conduct Authority: Report on the Government Response

Twenty-eighth Report of Session 2010–12

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The current staff of the Committee are Chris Stanton (Clerk), Lydia Menzies (Second Clerk), Jay Sheth, Renée Friedman, Adam Wales, Antonia Brown (on secondment from the Bank of England), David Sewell (on secondment from the NAO) and Lara Joseph (on secondment from the FSA) (Committee Specialists), Phil Jones (Senior Committee Assistant), Steven Price and Lisa Stead (Committee Assistants) and James Abbott (Media Officer).

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Introduction

1. The Treasury Committee published its report on the Financial Conduct Authority on 10 January 2012.[1] On 20 February 2012 the Committee received the Government's response. It is published alongside this Report. The Financial Services Bill is currently in Public Bill Committee in the House of Commons. This response, with a commentary on some of the more important issues, can assist the Public Bill Committee and the House as the Bill is considered and amended. A companion Report, on the Government response to the Treasury Committee's conclusions of the inquiry into accountability of the Bank of England, was published on 23 January 2012.

The FCA's strategic and operational objectives

2. The Government has recast the FCA's former efficiency and choice operational objective several times. It is now "promoting effective competition in the interests of consumers". This is a significant improvement on the Government's initial proposals. The promotion of competition must be put at the heart of the new regulatory regime.

3. The Bill retains a competition duty on the FCA, namely that it should:

> so far as is compatible with acting in a way which advances the consumer protection objective or the integrity objective, discharge its general functions in a way which promotes effective competition in the interests of consumers.[2]

This is in line with the Independent Commission on Banking, who called on the Government to retain a competition duty.[3] The Government says that this will drive the FCA to seek competition-led solutions to conduct issues when acting in pursuit of its other operational objectives—consumer protection and integrity—and will help embed a pro-competition culture at the FCA.

4. The Government has amended its original strategic objective for the FCA from "protecting and enhancing confidence in the UK financial system" to "ensuring that relevant markets function well". The Committee was concerned that the original formulation risked encouraging the FCA to pursue a course of seeking to enhance confidence in markets when that confidence might, at times, be misplaced. That said, the objectives of the FCA should be framed with a view to ensuring simplicity and clarity. The

1 Twenty–sixth report of the Treasury Committee, Session 2010–12, *Financial Conduct Authority,* HC 1574

2 Financial Services Bill

3 Final Report of the Independent Commission on Banking, September 2011, p 241

Committee remains concerned about the effect that an 'umbrella' objective, sitting above the three operational objectives. The Government argues that:

> the strategic objective has a valuable role in supplementing the operational objectives. It provides a single, albeit high level, 'umbrella' objective or 'mission statement' for the FCA.
>
> As such the Government believes it serves a useful purpose in focusing the new regulatory culture of the FCA. In addition, it operates as a check and balance on the operational objectives and helps to ensure that the FCA does not pursue any single operational objective in a manner that undermines the functioning of the market.[4]

On the one hand the Government argues the strategic objective merely supplements the operational objectives. On the other hand it argues the strategic objective will act as "a check and a balance" on the operational objectives. The stance therefore appears contradictory. Furthermore, the Government also appears confused as to whether it is a strategic objective or a "mission statement", which are not the same thing. A "mission statement" has no place in primary legislation. At best the supplementary objective adds nothing. It may be harmful. Multiple tiers of objective risk adding to complexity and diffusing the focus within the FCA. It will not assist in "focusing the regulatory culture of the FCA" and could have the opposite effect.

Competition law powers

5. Whether the FCA should have specific competition powers, by transferring the OFT's powers with respect to competition law to the FCA, has been an issue of some controversy. The Committee argued that the case for such a transfer had not been made. It welcomed the Government's chosen approach, which will allow the FCA to make referrals to the OFT. It also recommended that this issue should be reconsidered once the new regulatory regime has bedded down.

6. The Government's agreement with the Committee's recommendation is welcome. However, the Government's proposal that such a review take place five years after the date at which the FCA begins its operations appears unnecessarily long. The Committee asks the Government to explain why it has opted for such a long period, rather than a shorter period of, say, three years.

Accountability

7. The Committee's Report on the Financial Conduct Authority proposed a number of measures to enhance the accountability framework within which the FCA will operate:

- that the board of the FCA publish full minutes of each meeting;
- that the legislation provide that the Chief Executive of the FCA be subject to pre-appointment scrutiny by the Treasury Committee;

4 Government Response to paragraph 34

- that the legislation provide that the FCA Board be responsible for responding to requests for factual information and papers from Parliament, and
- that the legislation provide that Parliament, through the Treasury Committee, may request retrospective reviews of the FCA's work.

8. The Committee is disappointed that the Government does not intend to take forward these proposals. It has merely said that accountability mechanisms for the FCA "should be at least as rigorous as those placed on the FSA". It is widely accepted that accountability mechanisms for the FSA have been deficient and are in need of considerable strengthening. They require statutory definition.

9. The Government argues that publication of Board minutes is a matter for the Board of the FCA. We disagree. Placing this requirement in legislation would signal the Government's determination to ensure a more transparent conduct regulator than has been the case in the past. There is precedent for a statutory requirement on bodies to publish minutes of their meetings. The Bank of England Act 1998 states that the Bank "shall publish minutes of the [MPC] meeting before the end of the period of 6 weeks beginning with the day of the meeting". The Committee therefore calls upon the Government to reconsider its view.

10. The Government agrees that the FCA Chief Executive should be subject to a hearing before the Treasury Committee. However, it argues that this should be a pre-commencement hearing rather than a pre-appointment hearing as the Committee recommended. This, it argues, is necessary because, as with the MPC and the FSA Chair, it is a market-sensitive appointment. The Government has not supported its assertion with any further explanation, nor have we seen one in evidence. A pre-appointment hearing is appropriate for the CEO of the FCA.

11. The Government has rejected the Committee's recommendation that legislation provide that Parliament, through the Treasury Committee, may request retrospective reviews of the FCA's work. It argues that such a requirement "is clearly an executive responsibility". The Committee is unconvinced by this argument. Nor is it borne out by practice. The FSA eventually produced a full and detailed report on the failures at RBS, but only after Treasury Committee and public pressure to do so. The ability of Parliament, through the Treasury Committee, to require reviews would provide an important check and balance on a Government which might have an interest in not pursuing a certain inquiry, even when such an inquiry would clearly be in the public interest. The Committee's recommendation, or something similar, is an essential part of arrangements to arrive at adequate parliamentary scrutiny. Parliament should not be forced to rely on improvised and ad hoc arrangements between the Treasury Committee and the Authority to deliver the necessary accountability.

12. The Government has proposed subjecting the FCA to NAO audit; the NAO will also be able to launch value for money reviews of the FCA. Both are sensible. The Government adds, however, that "this will support parliamentary scrutiny by the Public Accounts Committee". This will create confusion. It could lead to the fragmentation of parliamentary

scrutiny, with the consequence of diminished FCA accountability. The FSA has correctly concluded that "we are accountable to Treasury Ministers and, through them, Parliament". Prime responsibility for holding the Treasury to account lies with the Treasury Committee, and the evidence that the Committee took suggested that it should remain there. The FCA's certified accounts and report, as audited by the NAO, should be remitted to the Treasury Committee.

PRA veto over the FCA

13. The Government has proposed giving the PRA a veto over the FCA where, in the opinion of the PRA, an action by the FCA may either threaten the stability of the UK financial system or result in the failure of a PRA-authorised person in a way that would adversely affect the UK financial system. The Treasury Committee's Report on the FCA argued that the case for the PRA to hold a veto over the FCA's powers had yet to be made. Furthermore, it argued that, if the Government persisted with veto powers in this area, such a power should be granted to the FPC rather than the PRA. This would be appropriate given the Government's contention that the veto should be exercised "where the PRA believes that an FCA action would result in a PRA-authorised person failing in a way that would adversely the financial system, or would threaten financial stability".[5] The maintenance of financial stability is, of course, the responsibility of the Financial Policy Committee.

14. The Treasury Committee notes the Government's argument that it has constructed a high threshold for the use of the veto as well as accountability mechanisms for its use and, as a result, "expects the veto to be used in exceptional circumstances".[6] Whilst the Committee agrees with the Government that the veto is only likely to be used in exceptional circumstances and accepts the need for the accountability mechanisms proposed in the Bill, it believes that the Government has missed the point. The issue of principle of a PRA veto over FCA actions is not dependent upon how often the veto is exercised. The Committee still considers that the veto should be granted to the FPC rather than to the PRA. If the Government were to proceed with the introduction of a veto power for the PRA it should be subject to a statutory requirement for retrospective review at a later date.

Cost benefit analysis of financial regulation

15. Considerable disquiet has been expressed by the financial services sector about the cost of financial services regulation. Many have questioned whether the benefits of many new regulations outweigh the costs. For this reason, the Treasury Committee recommended that, once the new regulatory architecture of the FCA was established, the PRA and FCA should revisit the tools they use to examine the costs and benefits of regulation with a fundamental review. The Committee called on the Government to include in the Bill

5 Government response to paragraph 95

6 *Ibid.*

requirements for far more extensive cost-benefit analysis and consultation with firms, representative bodies and panels prior to the introduction of the new regime.

16. The Government's response is a step forward. It says that it will encourage the FCA to consider the Committee's recommendations in this area carefully in its work on setting up the new regulators. The Government has also said that the Bill amends the cost benefit requirements "so that regulators will be required in future to provide an analysis of costs and benefits and estimates of both costs and benefits where it is reasonably possible to do so".[7] However, neither statement provides adequate assurance of an improvement in current inadequate practice. Further explanation is needed to show how these changes will result in a more robust cost-benefit analysis of financial regulation. Furthermore, periodic review of the costs and benefits of financial regulations, once implemented, is also required. The implementation of regulation tends to add to the burden over time, rendering the initial assessment of its putative impact of little value. Such periodic reviews require a statutory base.

The Government's timetable

17. We reiterate our concern that the Government's reform of financial regulation is being rushed. As we said in 2011, the Government need to take the time required to get its reforms right.

7 The current FSMA requirement is to produce an estimate of costs and analysis of benefits

Appendix: Government Response

1. The Government welcomes the report of the Treasury Committee, published on 13 January 2012, on the Financial Conduct Authority (FCA) and thanks the Committee for its work.

2. This response addresses the recommendations for Government. The FSA will consider the TSC's recommendations in the context of the passage of the Financial Services Bill through Parliament, and has committed to publishing a further document on the FCA's intended approach towards the end of the year.

How the FCA fits into the proposed new regulatory structure

We have been encouraged by the willingness of the Financial Secretary to reconsider the objectives as set out in the draft Bill and by the Chancellor's assurances that competition would be an objective of the FCA. Competition should be central to the culture of the FCA. This is not for competition's own sake, but because effective competition benefits consumers. We agree with the substance of the recommendation of the Joint Committee, and recommend that it is best achieved by giving the FCA an additional primary objective "to promote effective competition for the benefit of consumers". (Paragraph 28)

3. The Government is grateful for the Treasury Committee's close scrutiny of the FCA's statutory objectives, and has listened carefully to its recommendations. In line with the Treasury Committee's recommendations, and those of the Independent Commission on Banking (ICB), and of the Joint Committee on the draft Financial Services Bill ("the Joint Committee"), the Government is recasting the FCA's efficiency and choice operational objective as "promoting effective competition in the interests of consumers". The Government believes that these changes deliver the outcomes the Treasury Committee and the Joint Committee wish to see.

4. The Bill also retains the competition duty, as the ICB recommended, recognising the important effect this will have in driving the FCA to seek competition-led solutions to conduct issues when acting in pursuit of its "consumer protection" and "integrity" operational objectives.

We agree with the concerns put to us that the strategic objective as set out in the draft Bill risks creating the conditions for the FCA to pursue a course of seeking to enhance confidence in markets when that confidence may, at times, be misplaced. There is also a risk of confusion created by multiple tiers of objectives and duties. We agree that the FSA's own suggestion for the strategic objective "to ensure fair, efficient and transparent markets in financial services" is an improvement. We welcome the Government's open mindedness in relation to the strategic objective, but urge the Government to re-examine the need for it. The revised strategic objective is already largely embodied in the current operational objectives. With the addition of the proposed competition objective, the objectives would cover all that is required. The absence of a further strategic objective would avoid the problems

inherent in creating a complex hierarchy of purposes, and would more closely reflect the Government's original aim of simplicity. (Paragraph 34)

5. The Government understands the Treasury Committee's concerns and has accepted the need for greater clarity around the FCA's strategic objective. That is why the Government has recast the strategic objective so that it now refers to 'ensuring that the relevant markets function well'. The Government believes that this new objective addresses the concerns the Treasury Committee expressed about the strategic objective included in the draft Bill.

6. The Government does not, however, accept that the FCA should not have a strategic objective at all or agree that such a change would add to the FCA's clarity of purpose. The Government continues to consider that the strategic objective has a valuable role in supplementing the operational objectives. It provides a single, albeit high level, 'umbrella' objective or 'mission statement' for the FCA. As such the Government believes it serves a useful purpose in focusing the new regulatory culture of the FCA. In addition, it operates as a check and balance on the operational objectives and helps to ensure that the FCA does not pursue any single operational objective in a manner that undermines the functioning of the market.

While we recommend that the FCA be given a formal competition objective, requiring it to consider where financial services and markets are operating in a way which is consistent with competition, we were not convinced of the need to transfer the OFT's powers with respect to competition law to the FCA. We were, on balance, persuaded of the merits of the approach whereby the FCA can refer issues of competition law to the OFT. The staff at both the FCA and the OFT are already adjusting to rapid institutional change. We recommend that this issue be revisited once the FCA has bedded down, and with a track record both of the use of its powers and its ability to refer cases to the OFT on which to draw. The effectiveness of these arrangements, which would be less disruptive than transfer to the FCA, can then be reassessed. (Paragraph 38)

7. Throughout the course of consultation on the proposals for reform and the draft Bill the Government has carefully considered whether the FCA needs to have access to more specific competition powers, operating concurrently to those of the Office of Fair Trading (OFT). In particular it has carefully considered the proposal of the Joint Committee that the FCA should be able to make a Market Investigation Reference (MIR) to the Competition Commission.

8. The Government is grateful to the Treasury Committee for its detailed consideration and evaluation of this issue. The Government has considered both the position of the Joint Committee and the position of the Treasury Committee very carefully. On balance, it agrees with the conclusion of the Treasury Committee that the tailored mechanism provided for in the draft Bill, which allows the FCA to make a referral to the OFT is preferable to MIR powers. The mechanism allows the FCA to draw on the expertise of the OFT, which can then decide on the appropriate use of competition powers. This will be particularly important in the early years of the FCA when it is adjusting to its new responsibilities. Over time, as the FCA builds competition expertise and experience of using its powers to promote competition it will be important to review the arrangements.

The Government therefore accepts the recommendation of the Treasury Committee and proposes to review the issues of whether the FCA should have specific competition powers five years after the date at which the FCA begins its operations.

We recommend that the Government examine the scope for differentiating between retail consumers and wholesale consumers in the Bill, and clarify the balance of protection and consumer responsibilities that attach to these different groups. (Paragraph 45)

9. The Committee correctly notes that the definition of 'consumers' used in the draft bill is very broad- it encompasses retail consumers such as individuals and small businesses, wholesale firms and counterparties, and corporates seeking to access London's markets. As such, the definition reflects the various participants in the financial system which the FCA may seek to protect by virtue of an exercise of its general functions. This definition is deliberately broad to ensure that these powers are not constrained.

10. However, the Bill also makes clear that there should not be a 'one size fits all' approach. The consumer protection objective (clause 5 new section 1C) requires the regulator to secure an *appropriate degree* of protection for consumers, and the matters to which the FCA must 'have regard' in determining what degree of protection is appropriate make it explicit that the regulator must, where appropriate, differentiate between the various types of consumers, for example, by considering the differing degrees of experience and expertise they may have, and the type of transaction and associated risks involved.

11. The Government therefore does not think it is necessary to provide more detailed differentiation between different types of consumers on the face of the bill, and stresses that the regulator's rulebook is the right place to set out the balance between protection and consumer responsibilities appropriate for the different types of consumers. However, while the Government notes that very detailed provision in primary legislation could prove detrimental if it led to an inflexible and unresponsive regime, it will nevertheless continue to consider during the passage of the Bill whether it would be helpful to make it more explicit in statute that the regulator should, where appropriate, take a different approach to the protection of retail and wholesale consumers.

We sympathise with the need for balance as reflected in the recommendation of the Joint Committee and believe that the lack of clarity about the principle of consumer responsibility needs to be rectified in good time to allow for further scrutiny of the proposals. (Paragraph 52)

12. As set out in *A new approach to financial regulation: securing stability, protecting consumers*, the Government believes that the consumer responsibility principle, alongside the principle of senior management responsibility, serves an important purpose in framing the regulator's responsibilities. It should be noted that the principles of regulation do not place burdens or requirements on consumers or firms themselves— they apply to the regulators, and set out behaviours the public and regulated firms can expect from both PRA and FCA.

13. However, the Government does acknowledge that information and capability asymmetries exist between firms and their existing or potential customers, and accepts the

Committee's recommendation that statutory clarity recognising this would be helpful. To help address this imbalance, the Government has therefore added a new principle to the FCA's consumer protection objective which requires the FCA to have regard to 'the general principle that those providing regulated financial services should be expected to provide an appropriate level of care' in deciding what constitutes an appropriate degree of protection for consumers. In addition, the Government is replacing the current have regard covering the need for accurate information with one setting out explicitly consumers' needs for advice and information that is accurate, timely and fit for purpose.

14. In addition, the Government has made a small change to the senior management responsibility principle, making it clearer that the responsibilities of senior management of regulated firms in relation to compliance with regulatory requirements include those relating to consumers.

15. The Government believes that these changes, together with the comprehensive regulatory regime to be established by the FCA setting out the specific responsibilities of firms towards their existing and potential customers, are the right way to address information and capability imbalances and to ensure that consumers are treated fairly by industry.

Recognising that an effective regulatory system can attract business, it is important that the new regulatory bodies established by the Government do not ignore the impact of their actions on the competitiveness of the UK. The relationship between competitiveness and the means by which the Chancellor's assurances that competition will be an objective of the FCA will need to be carefully scrutinised. We may return to this issue. (Paragraph 56)

16. The Government is fully committed to ensuring that the UK remains a competitive world leader in financial services. This Bill helps to do that by providing for properly a focused regulatory system in which the individual regulators and other authorities will have clear roles and responsibilities, and the right tools to carry out the tasks they are given. The Government recognises the importance of the regulatory framework to a competitive UK financial sector—in particular that there is a need to balance competitiveness and wider economic considerations against financial stability and regulatory considerations such as consumer protection. However, it does not consider it appropriate to require either regulator to have regard to competitiveness, because this could potentially lead to undesirable conflicts for the regulator when deciding how to act in pursuance of its objectives.

17. The FCA, like the PRA, will have to have regard principle of proportionality—namely that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result. Proportionality also means that the regulator must tailor its actions to the specific characteristics of the sector being regulated. This principle will be supported by the requirement on both regulators to carry out cost-benefit analysis when proposing new rules. These requirements will operate as a check and balance on the PRA and FCA and their ability to impose inappropriate and disproportionate regulatory requirements and so will help to ensure that the UK remains a competitive place to carry on business in the financial sector.

18. In addition, a well regulated financial services sector will enhance the UK's competitiveness as firms and consumers will want to do business in a country where they can have confidence in the markets they are engaging in. The FCA will play a vital role for example in promoting the fair and efficient markets, again in a proportionate manner, that make London a world-leading location for financial services activity.

We recommend that the Government reach a conclusion soon to give an early indication of its thinking and in good time to include any changes [to the regulatory regime for consumer credit] in the forthcoming Financial Services Bill. (Paragraph 62)

19. The Government welcomes the Committee's interest in the regulatory regime for consumer credit. The Government believes that fundamental change is necessary to ensure that regulation of consumer credit is able to keep up with a rapidly changing market and to tackle detrimental practices more swiftly. The Government also believes that this change can best be achieved by bringing consumer credit into the same regulatory regime as other financial services (FSMA), while retaining the existing consumer rights and protections in the Consumer Credit Act 1974 (CCA). The Government agrees decisive action is needed and that the Financial Services Bill represents an excellent opportunity to legislate for the necessary changes.

20. The Government is therefore in full agreement with the recommendation of the Treasury Committee and the Financial Services Bill includes provisions enabling a full transfer of consumer credit regulation to the FCA, with retention of substantive CCA provisions. The Government will exercise these powers if and when it has identified a model of FCA regulation that is proportionate for the different segments of the consumer credit market. The exercise of these powers will be subject to impact assessment and the approval of both Houses of Parliament.

21. The Government is confident that a proportionate and effective consumer credit regime in the FCA will be deliverable. However, the Government retains the option to improve consumer protection by enhancing the regulatory powers and approach under CCA, should it conclude that a model for consumer credit regulation under FSMA cannot be delivered in a way that improves consumer protection while delivering good regulatory outcomes.

Accountability

The FCA's accountability to industry should be supported by a duty on both parties to a high level of engagement and exchange of information. (Paragraph 78)

22. The Government agrees that provision of information can be an important way of enhancing the FCA accountability to industry. Where legislation is necessary or appropriate it is provided for in this Bill. The FCA will be required to have regard to the regulatory principle that it should exercise its functions as transparently as possible, which is designed to ensure that firms and consumers have appropriate information about the decisions that affect them. However the Government does not consider that FSMA is the right place to impose a duty on firms. In keeping with the approach of FSMA in other

areas, it is the regulator itself, via rules or firm-specific requirements, which should determine what standards are appropriate for the regulated community. The Government notes that, under FSA rules, firms are already subject to the principle of business stating that 'A firm must deal with its regulators in an open and co-operative way and must disclose to the FSA anything relating to the firm of which the FSA would reasonably expect notice'. The Government expects the FCA to continue to apply a principle of this kind.

23. The FCA governance arrangements are also designed to ensure a high level of engagement with industry through the practitioner panels. Provisions in the Financial Services Bill put two additional panels—for smaller businesses and market practitioners—on a statutory basis.

The Current legislative proposals do not provide adequate accountability, nor the framework for sufficient scrutiny of, and explanation by, the regulator. We therefore recommend:

- **That the board of the FCA publish full minutes of each meeting.**
- **That the legislation provide that the Chief Executive of the FCA be subject to pre appointment scrutiny by this committee.**
- **That the legislation provide that the FCA Board be responsible for responding to requests for factual information and papers from Parliament.**
- **That the legislation provide that Parliament may request retrospective views of the FCA's work. (Paragraph 80)**

24. The Government agrees that it is very important that there should be clear mechanisms for public and Parliamentary accountability and believes that these should be at least as rigorous as those placed on the FSA. The Government has already taken steps to ensure that the new regulators are more accountable to Parliament than previously. The Government believes the Treasury Committee itself can play an important role in holding the FCA to account. The Government has considered its proposals carefully, and responded to them in turn below.

25. The Government agrees that transparency and accountability must be key features of the new regime. The Government sees the issue of the publication of board minutes as a matter for the FCA board. It does not feel it would be appropriate to fix the detail of board procedure in legislation.

26. The Government also agrees that the FCA Chief Executive should be subject to a hearing before the Treasury Committee. However the Government proposes that the appointment be subject to a pre-commencement hearing by the Treasury Committee according to the process appropriate for market-sensitive appointments, such as those of appointees to the Monetary Policy Committee of the Bank of England and the FSA Chair, rather than a pre-appointment hearing. Under these arrangements, after the appointment of the Chief Executive has been approved, the Treasury Committee will be invited to convene a hearing before the CEO takes up their post. In the case of the CEO-designate, the Treasury Committee will be invited to convene a hearing following his formal appointment once the Bill has received Royal Assent. Recognising the Treasury Committees interest in the area the Government will also invite the TSC to convene a pre-

commencement hearing for the position of Chair of the FCA. This does not need to be provided for in legislation.

27. The Government also agrees that it is important that the Treasury Committee has access to the information it needs, authorised at an appropriate level within the FCA. However, it does not believe that additional legislation is necessary. The Treasury Committee is able to request papers from the FCA under its own powers, and can call members of the board to account for the content of those papers. It is for the FCA as an independent body to decide the processes by which they prepare statements and information for Parliament and the public.

28. The Government believes it is important to enhance the ability of Parliament to hold the FCA to account, and the Bill includes significant new measures which support this. The FCA will be subject to NAO audit, and the NAO will be able to launch Value for Money reviews of the FCA. This will support Parliamentary scrutiny by the Public Accounts Committee. In addition, the FCA will be required to conduct an investigation and report on possible regulatory failure. This is supplemented by a power of the Treasury to order an investigation where the Treasury consider an investigation would be in the public interest. The Treasury must (subject to limited exceptions) then lay such a report before Parliament. As the Joint Committee noted, when exercising these powers both the regulator and the Treasury would be expected to consider the potential impact of an investigation on ongoing regulatory action. Given the potential operational impact, the decision to initiate an investigation is clearly an executive responsibility. The Government therefore does not propose to give Parliament powers to initiate reviews. But it will of course be open to Parliamentarians to suggest to the Treasury or the FCA that an investigation on a particular issue would be appropriate. The Treasury Committee will have an important role to play by highlighting areas for the FCA to consider investigating. It will of course remain open to relevant Parliamentary Committees, including the Treasury Committee, to conduct their own inquiries into the actions of the FCA.

The FCA's place in the wider regulatory architecture

Given previous unsatisfactory experience of regulators operating within a Memorandum of Understanding, we recommend that the relationship between the FCA, PRA and FPC be set out more explicitly in primary legislation and in as much detail as possible in secondary legislation. This can help to avoid regulatory gaps or overlap. This will also provide greater clarity and should limit the scope for institutional bickering about obligations under the MoU, although with the risk of some loss of flexibility. With that in mind, and given that the shape of the financial services industry and the market conditions is fast-moving, the relationship between the regulators needs to be kept under constant review. It is also important that full consultation takes place. We recommend that the Government's proposals be aired early for scrutiny, and certainly in time for the Committee stage of the Financial Services Bill. (Paragraph 90)

29. The Government agrees that it is vital that there are clear and distinct roles and responsibilities. The previous Government's "tripartite" system gave the Treasury, Bank and FSA collective responsibility for financial stability – an unclear system, in which none

of the bodies could be properly held to account. The FSA was given five separate objectives, and required to carry out both prudential and conduct regulation – meaning that it could focus on neither.

30. The Financial Services Bill addresses these failings directly. The roles, powers and responsibilities of the PRA, FCA and FPC and the relationships between them are will be clearly and appropriately defined in legislation. In particular:

- the Bill will provide clear and separate objectives for the PRA and FCA, which among other things will define the scope of their rulemaking, and will inform their general supervisory approach;
- the scope of the PRA's prudential responsibilities will be set out in an order designating particular regulated activities for prudential regulation by the PRA. The Government has published an indicative draft of this order;
- using secondary legislation, the Government will set out clear and separate threshold conditions which the PRA and FCA must assess as part of the authorisations process, and then consider in relation to individual firms on an ongoing basis. These threshold conditions will be a clear articulation of which aspects of firms' business each regulator will scrutinise;
- the Bill sets out clear and separate roles for the regulators in relation to the approval of persons to perform controlled functions. For firms solely regulated by the FCA, the FCA will be responsible for all approval decisions and for running the approved persons process. For dual-regulated firms, there will be a jointly-run single administrative process for approvals. The FCA will have to give its consent before the PRA approves any person holding significant influence in a dual-regulated firm;
- the Bill makes clear that certain functions are only exercisable by one regulator – for example, only the FCA can make product intervention or financial promotions rules, or refer a matter to the Office of Fair Trading (OFT), and
- for every regulatory process under FSMA, the Bill explicitly provides for a separate role for each regulator. For example, the Bill confers the roles and functions under Part 7 (Control of business transfers) on the relevant prudential regulator of the firm from which the business is being transferred (i.e. the PRA for dual regulated firms, and the FCA for others). There are also requirements, again in primary legislation, for the two regulators to consult each other about specified matters.

31. The statutory coordination Memorandum of Understanding (MOU) required by new section 3D of FSMA provides further clarity about the distinct role of each regulator in relation to the functions under the legislation, and how the regulators will deliver the statutory coordinate in relation to those functions. A draft of this MOU has been published by the Bank and FSA to assist with scrutiny of the Bill.[8]

8 Available from the FSA website (www.fsa.gov.uk/about/what/reg_reform/mou-fca-pra) and the Bank of England website (www.bankofengland.co.uk/financialstability/overseeing_fs/mou.htm)

32. The Bill sets out that the FPC has both a power of direction and a power of recommendation over the regulators. The FPC's responsibility for macro-prudential regulation is clearly defined in the Bill, and the Bill prevents the FPC from interfering in micro-prudential or conduct-related judgements.

33. The Treasury Select Committee recommends that the relationship between the regulators should be kept under review. The Government agrees that this will be important. The Bill therefore requires that the regulators review the coordination MOU annually; and any revisions to it must be laid before Parliament. The PRA and FCA are also required to include in their annual reports an account of how they have complied with the duty to coordinate their actions over the year.

34. The Government notes that the current position has been reached through three rounds of public consultation, and consideration of points made by the Joint Committee. However, if there are specific recommendations about how further clarity and definition could be achieved, the Government will consider these during the passage of the Bill through Parliament.

We do not believe that the case for a veto over the FCA's powers has yet been made. The Government should publish persuasive evidence to support the need for it if it wishes to proceed with the proposal. If it were to persist with this proposal, we recommend that the Government set out in more detail in legislation the circumstances in which a veto could be used. The veto's use, or threat of use, would be appropriate candidates for retrospective review under the arrangements we recommend in paragraph 78. (Paragraph 95)

35. The PRA veto can only be used where the PRA believes that an FCA action would result in a PRA-authorised person failing in a way that would adversely affect the financial system, or would threaten financial stability. Disorderly failure and financial instability are not in consumers' interests, and damage confidence in financial markets.

36. The high threshold for the PRA veto enables the FCA to focus exclusively on delivering its objectives, while providing a safeguard for the PRA to intervene where its expertise leads it to conclude that financial stability might be threatened. A number of measures in the Bill designed to make the PRA properly accountable for the use of the veto further help ensure it is used appropriately:

- before using the veto the PRA must consult the FCA, and when using the veto it must be accompanied by a statement of the reasons for using it;
- the PRA must give Treasury a copy of the direction and accompanying statement whenever the veto is used;
- unless the PRA considers it would not be in the public interest to do so, Treasury must lay the above documents in Parliament, and the PRA must publish the documents, and
- the PRA is required to report on its use of the veto in its annual report.

37. Considering the high threshold, and the accountability measures around the use of the veto, the Government expects the veto to be used in exceptional circumstances.

38. The coordination MOU, which has been published in draft form by the Bank of England and FSA, makes clear that the PRA will not inappropriately interfere with the FCA's delivery of its objectives. It also makes clear that there is only a very narrow set of circumstances in which the PRA can use its veto. And as the MOU says, ahead of any PRA Board decision to use the veto, a meeting would be held with the FCA CEO/Deputy CEO/Chair.

39. The MOU also sets out how the regulators will coordinate to avoid getting to the point at which the exercise of the veto is necessary. In relation to policy development, the MOU makes clear that the FCA and the PRA will consult each other at an early stage in relation to deliberations which might have a material effect on the other's objectives, and that if there is a serious prospect of conflict, the issue will be escalated to the CEOs and Boards of both authorities if necessary. In relation to enforcement action, the MOU sets out clearly the cases where the regulators will consult with each other in advance. And as with policy and rule-making, the PRA and the FCA will seek to avoid taking regulatory actions that are incompatible or in conflict. Where such an instance arises in pursuit of the regulators' different objectives, it will be escalated through the management and governance structures of each organisation.

40. The Government believes there is already a very strong legislative framework surrounding the use of the veto. However the Government has noted the TSC's concerns and will consider whether further improvements could be made during the passage of the Bill through Parliament.

The Financial Policy Committee will have an overall mandate to consider systemic issues and powers to direct both the PRA and FCA, so it is logical for the FPC rather than the PRA to hold such a veto power which aligns to the existing proposals with its right to direct the FCA on systemic issues. We recommend that if the Government were to maintain its commitment to a veto, it amend the draft Bill to ensure that the veto power lies with the FPC and may only be used in exceptional circumstances. We also recommend that the Government make provision for the PRA to make referrals in this area to the FPC. (Paragraph 97)

41. The Government does not agree that the FPC should hold the veto instead of the PRA. This would not be consistent with the FPC's role. The FPC will be responsible for issues of macro-prudential policy, and its role is not to have a detailed understanding of particular firms, or become involved in firm-specific decision making. Neither is its role to act as 'referee' between the PRA and FCA.

42. As explained above the Government believes that there should be transparency and accountability around use of the veto, and the legislation provides for this.

A Memorandum of Understanding is unlikely to be the appropriate method to establish the basis of co-ordination between the PRA and FCA in respect of their seats at the EBA, ESMA and EIOPA. We recommend that the Government consult on the appropriate level of co-ordination and set this out in secondary legislation in order to ensure both adequate scrutiny of the basis on which the two regulatory authorities will co-ordinate, and legal clarity about how they should do this. We

further recommend that the Treasury take steps to ensure that the impending change to the FSA does not lead to a fragmentation of UK representation in the EU, and that the UK's market position in the provision of European financial services be given an appropriate level of consideration within each of the ESAs. (Paragraph 106)

43. The Government agrees that it is essential that the UK continues to be a strong voice on financial services. The Government will continue to make the case at the European Commission and elsewhere for well-regulated and stable markets that support a flourishing international financial services industry.

44. In relation to the European Supervisory Authorities (ESAs), members of the Board of Supervisors are required to act independently and objectively in the sole interest of the Union as a whole when performing their duties. UK representatives will coordinate and consult with the other relevant UK authorities to ensure the UK is an effective participant in these forums.

45. However, the participants' engagement in the ESAs must remain a matter for the regulators. It would be inappropriate (and highly inflexible) for the Government to prescribe detailed arrangements in legislation, for example about objectives for coordination, or the mechanisms by which UK participants should share information and expertise. Prescribing rigid arrangements in legislation would risk limiting the ability of the regulators to develop their approach over time to pursue the most effective strategy for engagement. The Government believes that the right approach is to require the regulators to set out in high level terms through the coordination MOU how they intend to approach any necessary coordination in this area. The regulators will be held to account by the Government and Parliament for delivering their commitments effectively. The regulators will be required to include in their annual reports an account of how they have complied with the duty to co-ordinate (under new section 3D of FSMA) – which will of course cover their functions as members of the ESAs.

46. The Government has also accepted the Joint Committee recommendation that the separate international coordination MOU should create a committee to facilitate the process of international coordination. This will provide a further level of strategic coordination.

47. The Government therefore does not intend to make further provision in legislation about coordination in respect of the ESAs. The Government expects that Parliament will take an interest in the relevant section of the draft MOU during the passage of the Bill, and will hold the regulators to account properly once they are up and running.

How the FCA should approach its work

While it would be impracticable and inefficient to seek to legislate for the detailed regulation for every subsector, there is an opportunity to consider a more explicitly differentiated regulatory approach between the broad classes of regulated activity and specifically between retail, professional and wholesale financial services. We recommend that the Government examine the scope for differentiating between classes of financial services activity, for example by distinguishing between the FCA's

mandate and powers for retail financial services, services for professional clients and wholesale financial services. (Paragraph 110)

48. As noted in response to recommendation 4 above, the Government believes that the regulatory rulebook should set out the regimes applying in respect of different types of financial services, and that setting this out in primary legislation would be complex and could have negative unintended consequences if the regulator's ability to respond quickly and flexibly to a changing market were curtailed. However, the Government notes that where certain FCA powers or requirements are only intended to apply to certain classes of institution or types of activity, this is set out in primary legislation. For example:

- The FCA will operate the Part VI FSMA regime concerning the official listing of securities.
- The FCA will operate the Part 18 FSMA regime for recognised investment exchanges.
- The new product intervention power has been linked to the FCA's consumer protection and effective competition operational objectives only, which reflects the Government's desire to see the power used to secure better outcomes for consumers. This provides the industry with certainty that the FCA will not use the product intervention power to advance its integrity objective. However, where in exceptional circumstances there is a need for the power to be exercised in pursuit of market integrity, the Treasury may make an order enabling this to happen.

We reiterate the recommendation in our report on the Government's initial proposals that, once the new regulatory architecture has been set up, the PRA and the FCA should revisit the tools it uses to examine the cost and benefits of regulation. In doing this the FCA will need to challenge current FSA practices. It should consider how it ensures that the cost of regulation is examined at an early stage in policy development. Subsequent reassessment should not be treated as a tick-box exercise or afterthought. The FCA should design cost-benefit assessments that increase the level of engagement between the regulator and the regulated and improves the quality of the information that the FCA receives in undertaking their cost-benefit analyses. The Government should include in the Bill requirements for far more extensive cost-benefit analysis and consultation with firms, representative bodies and panels prior to the introduction of new regulation. (Paragraph 124)

49. The Government agrees with the Treasury Committee on the importance of high quality cost-benefit analysis (CBA) where the introduction of any new regulation is concerned. FSMA already contains extensive consultation and CBA requirements and these will apply in broadly similar terms to both the PRA and FCA in future. The Financial Services Bill amends the CBA requirements so that the regulators will be required in future to provide an analysis of costs and benefits and estimates of both costs and benefits where it is reasonably possible to do so (the current FSMA requirement is to produce an estimate of costs and an analysis of benefits). The Bill also introduces a new requirement for regulators to provide an explanation when they consider that it is not reasonably possible to estimate costs or benefits. The detail of how CBAs are carried out is matter for the FSA

(and in future the PRA and FCA), and the Government encourages the FSA to consider the Committee's recommendations carefully in its work on setting up the new regulators.

New powers

It is crucial that the potential risks and benefits of products are properly understood. The case has not been made that the FCA will necessarily understand a new product better than a firm. We are mindful of the risks that product intervention can pose to competition and innovation. The FSA has been criticised in the past for being too slow to intervene and we welcome the FCA's willingness to respond quickly to issues of consumer detriment. We support the need for judgement-led product intervention by the regulator. We recommend that clear guidance be issued to firms when such powers are used. Their use should be sparing and the merits of each case very carefully considered before intervention. We reiterate our recommendation about the need for greater communication between the regulator and the firm concerned. This should reduce the need for such intervention. (Paragraph 145)

We recommend that the FSA place its more detailed proposals in the public domain and facilitate proper public scrutiny of its plans. (Paragraph 150)

50. The primary objective of the Government's reforms is to fundamentally strengthen the regulatory system by promoting the role of judgement and expertise. To achieve that objective, each authority needs clarity of responsibility, a focused remit, appropriate tools, and the flexibility to use them as they see fit. The new product intervention power will give the FCA the flexibility and the mandate to act more quickly and decisively where it considers that a product or product features could cause significant consumer detriment or impede effective competition, supporting a more proactive and responsive approach to consumer protection and the promotion of competition.

51. The Government recognises, however, that it is important to strike the right balance between enabling the FCA to act quickly to protect consumers and promote competition and providing an appropriate degree of certainty for firms. The Government agrees with the Committee that the new power should be used sparingly, and, where possible, the FCA should look to greater disclosure, transparency and competition to promote better consumer outcomes. The Government also agrees guidance be issued to firms when such powers are used. The Government has therefore included a number of safeguards around the FCA's exercise of the product intervention power to ensure it is used in an appropriate and targeted way that is transparent to both firms and consumers. In particular, new section 138O inserted by clause 22 requires the FCA to publish and consult on a statement of policy with respect to the making of temporary product intervention rules. This statement will describe, among other things, the circumstances under which the FCA will intervene without prior consultation and cost-benefit analysis, and the factors that it will generally consider before doing so. The new regulatory principle that the regulators should exercise their functions as transparently as possible will also apply to the FCA's exercise of the product intervention power.

52. The Government looks forward to a draft statement of policy on the making of temporary product intervention rules being made available to Parliament by the FSA to inform the Committee stage of Parliamentary scrutiny in the House of Commons.

We support giving to the FCA the existing ability of the FSA to issue public warning notices about specific products. However we are concerned that a general rule permitting the FCA to publish early warning notices in respect of specific firms, which in some cases could subsequently prove to be unfounded, risks unreasonable reputational damage to which there may be inadequate redress. We are also mindful of the risk to natural justice, given that in such a case the regulator may be investigator, judge and jury. We therefore recommend that the Government continue to consult on its proposed power for the FCA to issue early warning notices in respect of investigations into specific firms. (Paragraph 160)

53. As already noted the Government believes that greater regulatory transparency and disclosure will be an important tool for the FCA to promote better outcomes for consumers, engender better practice across industry, and provide firms with greater clarity over regulatory expectations and what the regulator considers unacceptable behaviour. The new power in relation to warning notices is an essential pillar of this new approach.

54. The Government recognises concerns expressed by the Committee and during consultation that untimely or inappropriate disclosure can have unintended consequences, including reputational damage for the affected firms and individuals, and has therefore provided for a number of safeguards in relation to the power. Specifically:

- this is a power, not a duty - and the regulator will therefore have discretion on whether to disclose the fact that a warning notice has been issued and will consider each case on its merits;
- the regulator will not publish the notice in full but rather have discretion over what information to disclose;
- the regulator must consider whether disclosure of information about a warning notice would be unfair to the person subject to the warning notice in considering whether to disclose information;
- the regulator must consult the person in question before taking the decision on whether or not to disclose (although consultation does not mean consent is required);
- the FCA must consider the impact of disclosure of information about a warning notice on consumer protection and the stability of the UK financial system, and must not publish if doing so would result in detriment or prejudice to either;
- where the regulator decides to take no further action after it has made public the fact that it has published a warning notice, it will be required to issue a 'notice of discontinuance' and may publish information about this notice with the consent of the person to whom the notice is given, and
- the power only applies in respect of warning notices issued in relation to disciplinary action, rather than warning notices issued in respect of supervisory or judgement based

decisions. The list of matters the power applies to is set out in schedule 9, new paragraph 24 (2)(1ZB).

55. The Government believes that the power as drafted strikes the right balance between making the power usable and providing appropriate safeguards for those affected. The inclusion of a duty to consult the person in question ensures procedural fairness.

56. In addition, it is important to note that a warning notice is only issued by the FSA following a full investigation by its Enforcement Division, an intensive process which can often take many months to complete. While the investigation is ongoing, and therefore prior to the warning notice being issued, the subject will have many opportunities to set out their position, including at scoping meetings, settlement meetings and interviews. Further, it is the FSA's usual practice to send the subject a preliminary investigation report (PIR) which sets out the facts which the investigators consider relevant to the matters under investigation. The PIR contains sufficient detail to enable the subject to review the findings of fact in their context and to confirm whether the facts are complete and accurate. It also sets out the Enforcement Division's provisional views on possible breaches. The subject is invited to comment that those facts are complete and accurate, or to provide further comment. The Enforcement Division will then take into account any response received before deciding whether to issue a warning notice. The FCA will adopt this process.

We recommend that the FCA conduct a review of the merits and costs of a pre-approval scheme for financial products, and publish its findings. We also recommend that the FCA reconsider the scope for distinguishing in regulation between simple products which can be pre-approved for basic needs and more complex products, generally but not always more suited to sophisticated investors, which cannot. (Paragraph 166)

57. The changes to the regulatory framework, including the FCA's new product intervention power, do not represent a move towards widespread pre-approval of products. In *A new approach to financial regulation: building a stronger system*, the Government noted that widespread pre-approval would be very resource intensive, increasing the cost of regulation, and could restrict access to more innovative or high-risk products. It would also represent an unacceptable transfer of responsibility for appropriate conduct of business from firms to the regulator.

58. The Government believes that a new range of simple financial products to help people take responsibility for their finances and to make better choices. In December 2010, the Government set out its initial suggestions for how a new range of simple products could be developed in *Simple financial products: a consultation*. Following the consultation, a Steering Group, chaired by Carol Sergeant, was tasked with developing the idea of simple products and work with industry and consumer groups to bring them to fruition. Responses to the consultation on simple products suggest that the group should initially focus on simple deposit savings and protection insurance products that can meet the basic needs of consumers. Investment products may be considered in the future to help consumers save for the long-term. The Group has been asked to deliver the range of simple products to operate within the current regulatory framework.

There remains confusion about the role of the FCA in price regulation. We recommend that the Government clarifies whether it intends the FCA to play a role as a price regulator, the case for which has yet to be made. There should be adequate public consultation prior to any legislation on the role of the FCA as a price regulator. (Paragraph 170)

59. The Government welcomes the Committee's interest in this area and has clarified the position in the policy document *A new approach to financial regulation: securing stability, protecting consumers* which accompanied the Bill at introduction.[9]

It is important that the work of the MAS is not duplicated but complemented by any work of the FCA in the area of consumer responsibility. We recommend that the MoU between the FCA and MAS be published in time for the introduction of the Financial Services Bill. The FCA and the MAS should work with the Department for Education to help ensure that young people receive at school the basic learning tools and skills required to make sense of financial advice later in life. (Paragraph 179)

60. The Money Advice Service (MAS) will publish a draft of the new memorandum to inform the Committee stage of Parliamentary scrutiny in the House of Commons.

61. The Government welcomes the Committee's recommendation on financial education in schools. The MAS announced before Christmas that they have begun an extensive piece of research aimed at identifying the interventions in schools that are most impactful in terms of fostering better financial habits in later life. The MAS is also mapping the range of education initiatives funded by the financial services industry, to create a single view of the landscape. The MAS expect to conclude this work towards the middle of the year and will be maintaining an ongoing dialogue with the Department for Education as this work develops.

9 HM Treasury, *A new approach to financial regulation: securing stability, protecting consumers,* January 2012, Box 4.B, available from the Treasury's website at: http://www.hm-treasury.gov.uk/fin_financial_services_bill.htm

Formal Minutes

Monday 27 February 2012

Members present:

Mr Andrew Tyrie MP, in the Chair

Michael Fallon MP	David Ruffley MP
Rt Hon Pat McFadden MP	John Thurso MP

Draft Report (*Financial Conduct Authority: Report on the Government Response*), proposed by the Chair, brought up and read.

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

Paragraphs 1 to 17 read and agreed to.

A Paper was appended to the Report as an Appendix.

Resolved, That the Report be the Twenty-eighth Report of the Committee to the House.

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

[Adjourned till Wednesday 29 February at 9.30 am

List of Reports from the Committee during the current Parliament

Session 2010–12

First Report	June 2010 Budget	HC 350
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
Sixth Report	Spending Review 2010	HC 544
Seventh Report	Financial Regulation: a preliminary consideration of the Government's proposals	HC 430
Eighth Report	Principles of tax policy	HC 753
Ninth Report	Competition and Choice in Retail Banking	HC 612
Tenth Report	Budget 2011	HC 897
Eleventh Report	Finance (No.3) Bill	HC 497
Twelfth Report	Appointment of Dr Ben Broadbent to the monetary Policy Committee of the Bank of England	HC 1051
Thirteenth Report	Appointment of Dr Donald Kohn to the interim Financial Policy Committee	HC 1052
Fourteenth Report	Appointments of Michael Cohrs and Alastair Clark to the interim Financial Policy Committee	HC 1125
Fifteenth Report	Retail Distribution Review	HC 857
Sixteenth Report	Administration and effectiveness of HM Revenue and Customs	HC 731
Seventeenth Report	Private Finance Initiative	HC 1146
Eighteenth Report	The future of cheques	HC 1147
Nineteenth Report	Independent Commission on Banking	HC 1069
Twentieth Report	Retail Distribution Review: Government and FSA Responses	HC 1533
Twenty-first Report	Accountability of the Bank of England	HC 874
Twenty-second Report	Appointment of Robert Jenkins to the interim Financial Policy Committee	HC 1575
Twenty-third Report	The future of cheques: Government and Payments Council Responses	HC 1645
Twenty-fourth Report	Appointments to the Office of Tax Simplification	HC 1637
Twenty-fifth Report	Private Finance Initiative: Government, OBR and NAO Responses	HC 1725
Twenty-sixth Report	Financial Conduct Authority	HC 1574
Twenty-seventh Report	Accountability of the Bank of England: Response from the Court of the Bank	HC 1769