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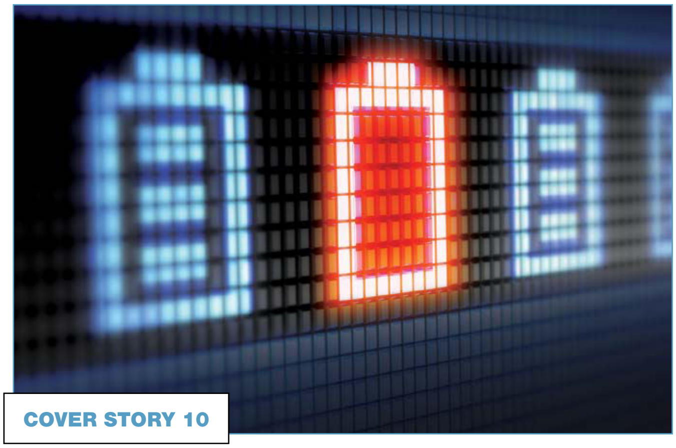

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Without fanfares: The UK's new financial regulators arrive

As the UK tries to chart a recovery whilst avoiding a triple-dip recession, something of a quiet revolution is occurring in the world of financial regulation. Gerard Kelly assesses the emerging regulatory landscape and examines how the new regime stands up to scrutiny

As the continuing Eurozone recession and sovereign debt emergencies show, the turbulent impacts of the financial crisis crises of recent years are far from over. Yet 1 April, if the coalition government is correct, was supposed to represent a new start in UK financial services regulation. And no, that wasn't an April Fool's joke. Two new bodies, the Financial Conduct Authority (FCA) and the Prudential Regulatory Authority (PRA) have taken up the regulatory reins in the most radical restructuring of financial regulation since the reforms of Blair's first term. Gone is the tripartite system of old which we were told in 1997 would harness the combined strengths of the Bank of England (BoE), Financial Services Authority (FSA), and HM Treasury (Treasury).

Perhaps unfairly the blame game following the early phases of the Great Recession has focused attention on the perceived lax regulatory approach of the FSA. Much of this criticism centred on the FSA's principles-based approach to regulation, the notion that broad ethical principles could be implemented by individual firms in a bespoke way. This approach should facilitate customised compliance and avoid the morass of regulatory rules which characterise, say, the US approach. But textbook theories do not always transition perfectly to practice.

Of course, principles-based regulation is not a distinctly British approach. Indeed, the blueprint for this regulatory style lies largely with the EU's Lamfalussy process of integration which, in a nod to Member State objections to harmonisation of financial regulation, developed a scheme based on guiding principles. The EU would set principles but Member States, unconvinced of the arguments for enhanced integration, would retain considerable autonomy to fill in the detail. Unsurprisingly, as in the UK, significant reform is now also occurring at the European level.

The new structures

The Financial Services Act 2012 (2012 Act) has radically overhauled the Financial Services and Markets Act 2000 (2000 Act) and represents something of a step-change in financial services regulation. It has brought with it a new regulatory vocabulary focusing on twin peaks regulation (prudential regulation and conduct regulation) where once tripartite regulation was in vogue. Aside from this promiscuous proliferation of terms, the new framework represents a clearer delineation of functions and responsibilities. The new twin peaks are:

- The FCA, which will take on the vast majority of the regulatory functions previously assigned to the FSA, particularly with respect to regulated firms' conduct of business obligations; and
- The Prudential Regulation Authority (PRA), which is now responsible for the micro-prudential regulation of financial institutions of systemic importance, such as banks, building societies, and insurers.

The relationship between the FCA and PRA will be important. Whilst the tripartite system has been severely criticised for splitting responsibilities between three bodies, a question remains as to whether this approach was doomed by faulty design or simply wasn't up to the mark in practice. A disjointed regulatory framework came into being, but perhaps more so due to its operation in practice rather than inherent structural failings, where the Chancellor, the Governor of the Bank of England, and the head of the Financial Services Authority never met. This framework, characterised by little communication between the Treasury and the FSA, contributed to a complacent confidence that failed to take stock of accumulating risks.

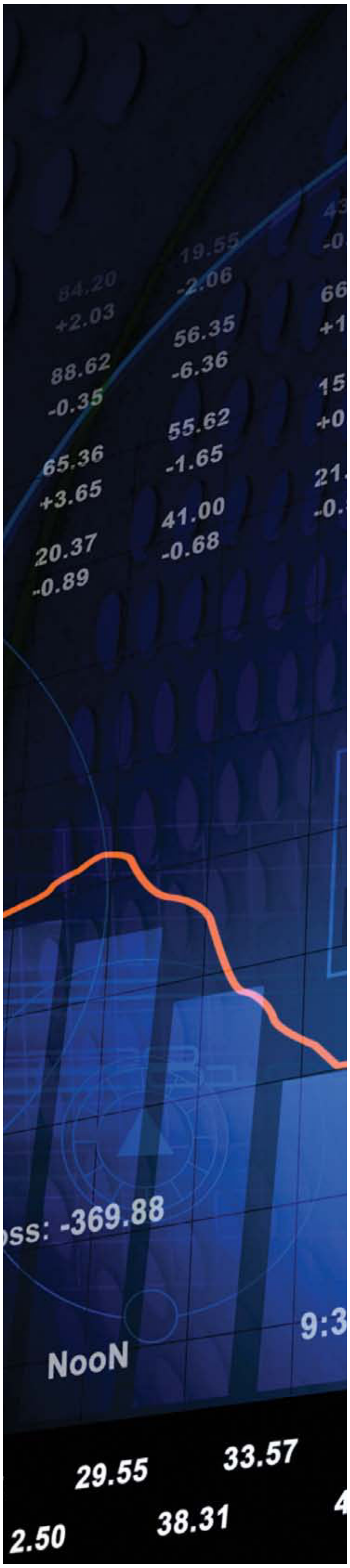
In fact, a picture has since emerged of institutional star-gazing during the critical window before the onset of the crisis. In 2006 the Bank of England's Financial Stability Report specifically identified the dangerous funding gap in British banking. A simulation at the FSA in the same year concluded that the deposit guarantee scheme was not adequate to prevent bank runs. Yet there was no response to these flashing amber lights and the relationship between the key actors in tripartite regulation continued to remain a distant one. As a result, there's a very important distinction to be drawn between design failure and operational failure: attributing too much blame to the tripartite model alone, rather than the performance of and relationship between key actors, might well miss the bigger picture. It is not just structures which are important, but processes too.

The new objectives of the FCA

The 2012 Act establishes a hierarchical structure of objectives, replacing in its entirety the statutory objectives of the 2000 Act. The Brown government had tinkered with these objectives during the depths of the crisis amending the 2000 Act by inserting a new "financial stability" objective, but at that point such changes appeared more as closing the stable door after the horse had bolted.

The 2012 Act represents a far more coherent overhaul of financial regulation. The new statutory architecture is guided by a core strategic objective of "ensuring that the relevant markets function well". Originally the Bill contained a strategic objective of protecting and enhancing confidence in the UK financial system. However, after criticism that such language could encourage misplaced confidence, the objective was redefined to impose a positive obligation on the FCA to ensure that the markets function "well". Perhaps unsurprisingly Parliament has shied away from any clear expression of what represents a well-functioning market. However, this is possibly best understood by contrasting the much clearer image of a poor-functioning market. Clearly this is far from a scientific metric, but it would not be helpful to constrain the interpretative autonomy of the FCA. It is welcome that, for the first time, financial regulation is now guided by a clear undiluted objective.

Regrettably, the secondary operational objectives and the interrelationship between these objectives lack the same clarity. The three operational objectives are to secure an appropriate degree of protection for consumers; to promote efficiency and choice in the financial services market; and to protect and enhance the integrity of the UK financial system. There is a singular lack of guidance as to how each operational objective should be balanced with respect to the others. As the 2012 Act provides that the FCA must discharge its general functions in a manner which is compatible with the strategic objective and which advances one or more operational objective, it may well transpire that, in practice, one of the operational objectives will predominate. For example, the 2012 Act also grants new powers to the FCA to ban certain financial products, powers which are particularly consistent with promoting the consumer protection objective. Indeed, in recent years, the increasing emphasis in EU and UK financial services regulation on consumer protection is perhaps one of the most marked trends and an argument could certainly be advanced that the promotion of competition and the integrity of the UK financial system further



enhances consumer protection.

The new statutory objectives also represent a departure from the prominent emphasis which the 2000 Act placed on the reduction of financial crime. This concern is no longer afforded "objective" status, but the 2012 Act continues to impose an obligation on the FCA to "minimise the extent to which it is possible for a business to be used for a purpose connected with financial crime". The third operational objective of integrity explicitly also entails a concern that the UK financial system is not used for purposes connected with financial crime. However, it is hard to deny that the 2012 Act has introduced a clear difference in emphasis.

Whilst the FCA must remain cognisant of financial criminality, particularly since any significant increase in financial crime would undermine the integrity objective, it is a smaller piece of the statutory mosaic than has previously been the case. In any event, given the proliferation of financial crime statutes in recent years, the Fraud Act 2006 and Bribery Act 2010 being obvious examples, it is positive that the opportunity for restructuring financial regulation has not been unduly influenced by financial crime concerns to the detriment of the full range of challenges confronting financial regulation. The successes of the FSA in the past year in prosecuting instances of insider dealing, notably R v Mustafa and R v Ammann, are especially welcome. In the past, it has proven notoriously challenging for the FSA to secure convictions in the realm of insider dealing and these high-profile cases show that market participants who facilitate financial crime run very real risks of detection and conviction. In practice, it is unlikely that the FCA will be less rigorous in protecting investors from financial crime, irrespective of this statutory re-ordering of priorities.

Looking ahead

There are certainly valid concerns that the complexity of the new statutory objectives, and particularly the challenge of reconciling these objectives, could cause some headaches for the FCA. Ascertaining when the markets are not functioning well may not be straightforward, but the new strategic objective should provide a much clearer focus to regulatory energies. The role of the FSA was always ambiguous, with Parliament expecting the FSA to be a policeman in the financial markets, the promoter of these same markets, and the guardian of the UK's competitiveness. This was exacerbated by the lack of communication and collaboration which characterised the tripartite system.

The new regulatory authorities, the PRA and the FCA, have different statutory objectives, but a close regulatory dialogue between both actors will be critical to the success of the twin peaks formula. The 2012 Act goes some way to compelling such collaboration. The legislation expressly requires both the PRA and FCA to cooperate with the Bank of England. In addition, the Financial Policy Committee, located within the Bank of England and tasked with macro-prudential regulation of the UK financial system, may also provide directions to the PRA or FCA. In such circumstances, both the PRA and FCA are under a statutory duty to comply or explain any shortfall in compliance.

Whilst the new framework is certainly not light-reading, it has introduced a structure where close cooperation between regulatory actors should become the norm. This normative change will be as important as the structural overhaul which the 2012 Act represents. The promise of the new framework is a much more stable foundation for financial services regulation. However, it will be some time before we can judge whether the PRA and FCA have fulfilled this promise.

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