



A Step Forward or Backward? FSA to be Broken Up

In a speech at the Lord Mayor's Dinner on 16 June 2010 (the "Mansion House Speech"),¹ George Osborne, the new Chancellor appointed by the Conservative-led coalition government, unveiled far-reaching changes to the regulatory architecture of the UK financial system. The key feature of the announcement is the dismantling of the Financial Services Authority ("FSA") and the transfer of its current functions (UK macro-prudential regulation, consumer protection and law enforcement) to newly created regulatory bodies and to the Bank of England ("BOE") in the case of macro-prudential regulation. It is intended that the new regulatory structure will be in place by the end of 2012.

In his speech, the Chancellor asserted that the "tripartite system" – whereby regulatory responsibility is currently shared between BOE, FSA and HM Treasury ("HMT") – had "failed spectacularly" in ensuring financial stability and needed to be replaced by a new system "that learns the lessons of the greatest banking crisis in our lifetime." In particular, he stated that FSA became a narrow regulator, almost entirely focused on rules-based regulation whilst BOE was mandated to focus on inflation and HMT saw its financial policy division drift into a backwater. This, he said, resulted in a disjointed regulatory approach with no one controlling the levels of debt and no one knowing who was in charge when the crunch came. Mr. Osborne stated that his belief is that only the BOE as the central bank has the broad macro-economic understanding, authority and knowledge necessary to make the necessary macro-prudential judgments necessary now and in the future.

A number of commentators have drawn comparisons between Mr. Osborne's speech and that of Gordon Brown in his first major speech as Chancellor at the same venue in 1997 announcing the establishment of FSA and an end to the previous regime, which was a fragmented regulatory system with different regulators responsible for different aspects of the UK regulatory structure. Although the new system will be very different from that which was in existence before 1997, concerns have already been voiced that the changes announced by Mr. Osborne will not change much in terms of the personnel and systems responsible for UK financial regulation but will require considerable communication between the various new regulatory bodies to be created and could give rise to confusion as to how those new UK bodies will fit into the new EU regulatory structure involving the establishment of the European Security Markets Authority ("ESMA") and the European Banking Authority ("EBA").

In a related statement to the House of Commons on 17 June 2010,² the Financial Secretary to HMT, Mark Hoban MP, reiterated the Chancellor's message and promised that HMT will publish detailed policy proposals for public consultation prior to the UK Parliament's 3-month summer recess which starts on 29 July 2010.

¹ Speech at the Lord Mayor's Dinner for Bankers & Merchants of the City of London by the Chancellor of the Exchequer, The Rt Hon George Osborne MP, at Mansion House (16 June 2010), http://www.hm-treasury.gov.uk/press_12_10.htm.

² Statement to the House of Commons by the Financial Secretary to the HM Treasury, Mark Hoban MP, on Reforming the Institutional Framework for Financial Regulation (17 June 2010), http://www.hm-treasury.gov.uk/statement_fst_170610.htm.

The New Financial Regulatory Structure

As mentioned above, the changes announced by Mr. Osborne include the establishment of a number of new bodies:

1) Prudential Regulatory Authority (“PRA”)

The macro-prudential regulator in the new regulatory structure will be a newly established subsidiary of BOE, whose chairman will also be a Deputy Governor of BOE.

In addition, within BOE, a new Financial Policy Committee (“FPC”) will be set up and have responsibility for oversight of macro-economic issues which may threaten financial stability.

In this way, the responsibility for macro-prudential regulation will be returned to BOE, which being the central bank, Mr. Osborne regards as a unique repository of the necessary knowledge and understanding of the broad macro-economic situation and of the markets as a whole.

BOE will exercise its new responsibilities for macro-prudential oversight of banks and other financial institutions, in addition to its current responsibilities for monetary policy and financial stability.

However, much of FSA’s current structure and supervisory staff will live on in the new PRA. In particular, its chief executive, Hector Sants, has agreed to be a new Deputy Governor of BOE and to chair the PRA for the first three years. The Current FSA chairman, Lord Adair Turner, will also stay on at FSA for the next two years to assist with the transition.

2) Consumer Protection and Markets Authority (“CPMA”)

CPMA will be created to take a strong, proactive role as the “consumer champion” and police the day-to-day conduct of business by both retail and wholesale authorised firms. Thus, it will assume FSA’s consumer protection and conduct of business functions.

In this capacity, the CPMA will also carry on FSA’s Financial Ombudsman Service (“FOS”) and oversee a newly created Consumer Financial Education Body (“CFEB”).

3) Economic Crime Agency (“ECA”)

ECA will be created to act as a single agency to combat serious economic crime, which is currently handled by FSA and several other governmental bodies, including the Serious Fraud Office and the Office of Fair Trading (“OFT”). As such, ECA will take over FSA’s law enforcement function.

Industry Reaction

The financial services industry’s immediate reaction to the Chancellor’s latest proposals has not been altogether positive. Quite understandably, the industry has grown wary of the barrage of regulatory changes which are being proposed or introduced and are causing prolonged periods of regulatory confusion and uncertainty as well as added business costs.

Some of the immediate comments and concerns include the following:

- there will be regulatory confusion and uncertainty over an extended time, as it could be more than a year before the final report of the new independent banking commission is published and two and a half years before the structural changes are implemented (see below under “Independent Commission on Banking”);

- the Chancellor's focus on reforming the institutional structure of regulation elevates the form over the substance of regulation and is not likely to bring about the much needed upturn in lending or credit conditions in the UK;
- the proposed structural changes are ill-timed and potentially disruptive, when not only the UK economy is struggling to recover from recession, but there is continuing financial turbulence in the Eurozone;
- the creation of new regulatory authorities for different aspects of the UK financial regulatory system is a move back towards the fragmented regulatory system in place before the creation of FSA, which had led to concerns over a lack of a coordinated efforts among different regulatory bodies and the risk of a failure of communication among such bodies leading to a lack of focus in some areas;
- the proposed changes and ensuing uncertainty will undermine the UK's ability to defend its financial services industry at a time when the EU is undertaking wide-ranging regulatory changes, such as introducing new EU regulations on OTC derivatives and hedge funds as well as overhauling the EU financial supervisory framework involving the creation of ESMA, EBA and other new EU supervisory bodies;
- some of the proposals could make London less competitive as a global financial and business centre, coming on top of other recent regulatory changes and tax increases with implications for both UK-headquartered banks and foreign banks operating in the UK;³ and
- the government should take a more long-term, strategic view concerning the significance of the industry to the UK economy and seek to protect the London's competitiveness as a global financial centre (which the Confederation of British Industries ("CBI") surveys have reported as having fallen in recent years, partly attributable to various tax and regulatory changes).⁴

Independent Commission on Banking ("ICB")

On the same days as the Mansion House Speech, HMT launched the ICB⁵ and published its Terms of Reference, pursuant to which the ICB will consider structural issues in the banking sector such as:

- reducing systemic risk, analysing the risk posed by banks of different size, scale and function;
- mitigating moral hazard;
- reducing the likelihood and impact of a bank's failure ("too big to fail"); and
- promoting competition in retail and investment banking, to ensure the customers' and clients' interests are served efficiently.

The aim is for the ICB to formulate and recommend structural (as well as related non-structural) measures to reform the banking system and to promote stability and competition. This will specifically involve examining the complex issue of whether retail and investment banking functions should be separated.

The ICB will be chaired by Sir John Vickers, a former OFT chairman, and report to the Cabinet Committee on Banking (chaired by the Chancellor). Its final report is not due until the end of September 2011.

³ See, e.g., Financial Times article: "UK tax to cost US banks \$2bn" (17 June 2010), http://www.ft.com/cms/s/1c5d267c-79a7-11df-85be-00144feabdc0.Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F1c5d267c-79a7-11df-85be-00144feabdc0.html&_i_referer=http%3A%2F%2Freferyned.

⁴ CBI's Business Surveys are available at

<http://www.cbi.org.uk/ndbs/content.nsf/802737aed3e3420580256706005390ae/31ed571e0d73a30b80257410005ce1c6?OpenDocument>.

⁵ See HM Treasury press release: Sir John Vickers to Chair the Independent Commission on Banking (16 June 2010), http://www.hm-treasury.gov.uk/press_11_10.htm. See also HM Treasury Independent Commission on Banking – Terms of Reference (16 June 2010), http://www.hm-treasury.gov.uk/d/banking_commission_terms_of_reference.pdf.

Other Relevant Public Consultations and Reports

The Coalition: Our Programme for Government (20 May 2010)

HMT's latest proposals build on many of the banking reform measures which the coalition government had set out in the Coalition Programme on 20 May 2010.⁶

In particular, in Section 1 (Banking), the government had asserted that the current financial regulatory system was "fundamentally flawed" and should be replaced with a new framework that promotes "responsible and sustainable banking." To this end, they had pledged that they would, *inter alia*:

- introduce a banking levy;
- bring forward robust measures to tackle unacceptable bonuses in the financial services sector, ensuring they are effective in reducing risk;
- foster diversity in financial services, promote mutuals and create a more competitive banking industry;
- ensure the flow of credit to viable small and medium-sized enterprises ("SMEs");
- reduce systemic risk in the banking system, and establish an independent commission on banking to investigate the complex issue of separating retail and investment banking in a sustainable way;
- reform the regulatory system to avoid a repeat of the financial crisis and bring forward proposals to give BOE "control of macro-prudential regulation and oversight of micro-prudential regulation";
- create the UK's first free National Financial Advice Service, to be funded in full by a "social responsibility levy" on the financial services sector; and
- create a single agency to combat serious economic crime.

OFT Review of Barriers to Entry, Expansion & Exit in Retail Banking (26 May 2010)

In relation to competition in retail banking, the OFT also launched a review on 26 May 2010 of barriers to entry, expansion and exit in retail banking seeking comments from interested parties until 8 July 2010.⁷ The OFT intends to publish its findings in autumn 2010.

*Davis Report: The Future of Banking Commission (13 June 2010)*⁸

Which?, a consumer organisation, launched the Future of Banking Commission ("FBC"), chaired by David Davis MP, in December 2009 to conduct a consumer-focused review aimed at putting "the wider interests of society at the heart of a reformed banking system," and helping to restore the public's trust in banks.⁹

The FBC released an extensive report on 13 June 2010 ("David Report"), setting out a host of recommendations which would require significant reforms to the structure, regulation, culture and corporate governance of the banking sector.

⁶ The Coalition: Our Programme for Government (20 May 2010), <http://programmeforgovernment.hmg.gov.uk/files/2010/05/coalition-programme.pdf> and the related section by section online guide, <http://programmeforgovernment.hmg.gov.uk/>. See also Conservative-Liberal Democrat Coalition Agreement (11 May 2010), <http://conservativehome.blogs.com/files/conlib-agreement-1.pdf>.

⁷ OFT press release: Review of Barriers to Entry, Expansion & Exit in Retail Banking: Call for Evidence (26 May 2010), http://www.of.gov.uk/shared_of/personal-current-accounts/OFT1233.pdf; and Review of Barriers to Entry, Expansion & Exit in Retail Banking: Q&A, <http://www.of.gov.uk/OFTwork/financial-and-professional/review-barriers/qandas>.

⁸ The Future of Banking Commission (13 June 2010), http://commission.bnbb.org/banking/sites/all/themes/whichfobtheme/pdf/commission_report.pdf.

⁹ <http://www.which.co.uk/campaigns/banking-crisis/the-future-of-banking-commission/index.jsp>.

The Davis Report is supportive of a number of regulatory reforms currently at issue (such as “living wills,” exchange trading/central counterparty clearing of derivatives, longer term remuneration policies and better regulation of consumer protection, prudential standards and systemic risk), whilst identifying the “structure of banking” as the first or primary area in need of reform.

Notably, this report goes so far as to actually recommend the break-up of universal banks as well as the extension of the so-called Volcker rule (a provision in the pending US financial reform legislation which prohibits certain banks from engaging in proprietary trading). It also urged the government’s new ICB to examine the merits of formally separating retail banking from investment banking activities.

Conclusion

The UK’s banking industry still awaits further details of the various regulatory proposals. As discussed above, these are expected to be released over the course of the next two years, starting with the emergency budget on 22 June 2010 (in relation to bank levies and other tax changes) and HMT’s promised consultation paper before the end of July 2010 (in relation to the legislative and policy proposals for the structural changes). However, the government’s ultimate decision on certain crucial issues impacting on their business activities (such as the future of universal banking and possible extension of the Volcker rule in the UK) may not become available until the ICB recommendations are released some time next year. In the meantime, uncertainty as to the future size and shape of the banking industry will persist.

We will continue to monitor these regulatory developments and produce further updates on the details of the changes as they are proposed by the UK government.

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