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Preparing for UK Regulatory Change: An Overview of the New Framework

In the aftermath of the 2008 financial crisis, all of the major political parties in the UK proposed significant change to the system of financial regulation. On election in 2010, the coalition government set out its belief that the tripartite system of regulation (under which the Bank of England, the FSA and HM Treasury have different responsibilities) had “failed spectacularly in its mission to maintain stability.”

It is commonly said that during the financial crisis the regulatory system did not provide sufficient or adequate leadership and that communication between members of the tripartite system was not good enough. The reforms are intended to address these perceived failures.

The UK government states that its primary objective in reforming financial regulation in the UK is to “fundamentally strengthen the system by promoting the role of judgement and expertise...regulators must be empowered to look beyond compliance, to supervise proactively, and to challenge.”

This Q and A serves as a high-level guide to the changes and how your firm might prepare for them.

What will the new structure look like?

The tripartite system will be abolished. The reforms separate responsibility for prudential and conduct supervision into a new “twin peaks” system of regulation. The FSA will be replaced by three new regulatory bodies: the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

What is the FPC?

The FPC will be a committee of the Bank of England’s Court of Directors. It will have primary responsibility for the oversight of financial stability, and a secondary objective of supporting growth and employment. It is envisaged as being a strong and expert macroprudential authority to better monitor and respond to systemic risks.

The FPC will not have responsibility for particular firms but will monitor the financial system as a whole. The tools at the FPC’s disposal will be macroprudential (such as countercyclical capital requirements). It will be chaired by the governor of the Bank of England and will include the PRA chief executive and FCA chief executive. The FPC may give directions (using its macroprudential tools) and make recommendations to both the PRA and FCA. An interim FPC was created in February 2011.

What is the PRA?

The PRA will be a subsidiary of the Bank of England responsible for promoting the safety and soundness of PRA-authorized persons. Its duty is to promote the stable and prudent operation of the financial system through regulation of all deposit-taking institutions, insurers and investment banks (firms that are considered to be systemically important financial institutions). It will be responsible for microprudential regulation. Firms within the scope of the PRA will also be regulated by the FCA for conduct purposes (i.e., they will be “dual regulated”).

What is the FCA?

The FCA will be responsible for conduct regulation of all firms. Its statutory objective will be to ensure that relevant markets work well. It will have three key operational objectives focused on the integrity of the market, consumer protection and competition. The FCA will also be the prudential regulator for firms that do not fall within the PRA’s scope.

The vision set out for the FCA is “to make financial markets work well so consumers get a fair deal.” The Financial Services Act 2012 gives the FCA various new powers, including the ability to ban financial products, to publish details of misleading financial promotions, and to let people know when the FCA is proposing to take disciplinary action against a firm.

What about the Bank of England?

The Bank of England will also play a more prominent role. It will be responsible for protecting and enhancing the UK’s financial stability with primary operational responsibility for financial crisis management. It is responsible for oversight of payment systems, settlement systems and clearinghouses, and it is the UK’s resolution authority.

What else do we need to know?

- 1) The FSA handbook is currently being designated so provisions are marked as applying to FCA-regulated firms, PRA-regulated firms or dual-regulated firms. Both the FCA and the PRA have indicated that further review of the handbook will be undertaken in due course.
- 2) New crisis management arrangements are expected in which the government will set out the roles of HM Treasury and the Bank of England (as well as the FPC and the PRA). A draft Memorandum of Understanding has established that the Bank has primary responsibility for financial crisis management while the Chancellor and HM Treasury have sole responsibility for any decision on whether and how to use public funds. The Memorandum may be expanded to include provisions relating to the FCA, the FSCS, etc.
- 3) Collaboration and communication between the PRA and the FCA will be essential and, in our view, vital to the success of the changes. The twin peaks system carries an inherent danger in that any communication failures between the PRA and the FCA have the potential to undermine the ability of the institutions to fulfil their respective functions.
- 4) The processes for international collaboration and coordination with the new institutions likely will require further refinement. The remits of the PRA and the FCA and the overlapping nature of conduct regulation will demand close cooperation at the national and international levels, particularly when dealing with institutions including ESMA, EIOPA, EBA, IOSCO and others. Information on how the interaction of European and other policy initiatives (such as Solvency II and CRD IV) will affect the PRA's approach remains forthcoming.
- 5) Threshold conditions will be more specific. Dual-regulated firms will need to meet two sets of conditions (one for the PRA and one for the FCA). The PRA will also set threshold conditions specific to insurers and for all other firms regulated by the PRA.
- 6) The FCA and the PRA have indicated that there will not be substantial changes to the way applications for approved persons are made by dual-regulated firms and that current forms will be retained. Although the PRA and the FCA will try to coordinate their actions to avoid duplication, both regulators have reserved the right to request additional information, which may make applications take longer.

What happens next?

The FSA is still the UK financial regulator and will remain so until the Financial Services Act 2012 has been implemented. An internal twin peaks system was implemented by the FSA in April 2012. The new structure is expected to be operational on 1 April 2013. Firm registration numbers will remain the same.

Regulated firms will be "grandfathered" into the new regime (there is no need to reapply for existing authorisations and regulatory approvals). The most significant change that firms will immediately notice is that systemically important financial institutions will suddenly find themselves subject to dual regulation. No matter how well and effectively the PRA and the FCA coordinate and communicate, there can be no hiding from the fact that such firms will now be dealing with two separate regulators with different objectives and different areas of focus.

The reforms have the potential to make a significant impact on regulated firms' business, and individual circumstances should be carefully considered.

For more information, or to discuss how the reforms will affect your business and how best to prepare for them, please contact any of the following members of Katten's [Financial Services Practice](#).

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