



Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

14 April 2011

Dear Sirs

HM Treasury Consultation Paper – ‘A new approach to financial regulation: building a stronger system’ (the “Consultation Paper”)

PricewaterhouseCoopers LLP (“PwC” or “we”) welcomes the opportunity to comment on the Consultation Paper. As requested, we have responded to the topics we believe are relevant to our business and experience. Our response to certain of the individual questions is included in the attached document.

In addition to our individual question responses, we have taken the opportunity to provide some more general observations on certain aspects of the proposals; these are set out in the letter below. We refer also to our response to the previous HM Treasury Consultation Paper ‘A new approach to financial regulation: judgement, focus and stability’, dated 18 October 2010; many of the comments made in that response remain relevant.

Building a stronger regulatory system

We agree that there were certain failures of the regulatory system during the recent financial crisis and we support the objectives of this and the previous consultation paper to make improvements in order to avoid similar failures in the future.

The proposals represent some of the most significant changes to the UK financial regulatory structure for over a decade. As we highlighted in our last response, we urge the Government to be particularly rigorous when assessing the cost and benefit implications and all potential consequences. These changes will not only impact regulated firms, but also the wider financial services industry and the UK economy. We recommend that the Government be mindful of unintended consequences and learn from previous examples, such as the implementation of the US Sarbanes-Oxley Act in 2002.

Clear governance and accountability

With the proposal to disaggregate the current regulatory architecture, we believe that the overarching governance framework for the Prudential Regulatory Authority (“PRA”) and Financial Conduct Authority (“FCA”) will be critical to the success of the new model. We would encourage HM Treasury to apply the relevant aspects of the recommendations set out in Sir David Walker’s review (November 2009) on the governance of banks and other financial institutions. We highlight in particular the recommendations regarding the need for an institution’s governing body to pay close attention to its

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overall balance and to be evaluated regularly and rigorously. In implementing these recommendations, the regulatory bodies would not only benefit from robust governance but would also set an example of good practice to regulated firms.

In addition to this recommendation, we also highlight three specific observations on the proposals for governance and accountability of the new regulatory bodies:

- **Veto power of the PRA**

The Consultation Paper proposes that the PRA will hold a power of veto over the FCA in order to ensure that disagreements between the two regulatory bodies can be resolved. Granting this veto power implies that the PRA will be the “lead regulator” in the new framework. Given that both the PRA and the FCA are essential parts of the new regulatory framework, we are mindful of the need to retain equivalence of power between the bodies except in very unusual situations. We recommend therefore that the detailed rules surrounding operation of the veto power emphasise that it should only be used in extreme circumstances. We believe that in most circumstances, disagreements between the PRA and the FCA should be resolved through appropriate mediation processes.

We welcome the Consultation Paper’s proposals on transparency, including the requirement to lay the circumstances in which the veto is used before Parliament, subject to considerations of public interest. If the disagreement giving rise to the exercise of the veto is in respect of a policy matter, it will usually be appropriate to disclose the surrounding circumstances. However, we anticipate that in most scenarios involving individual firms, the circumstances in which the veto is used will not be made public prior to the veto being exercised. This means that a clear governance framework surrounding use of the veto is even more critical.

- **Governance structure of the Bank of England**

In the new structure, the Bank of England will have responsibility for regulatory and monetary policy. Therefore a governance structure that ensures that potential conflicts between regulatory and monetary policy are managed appropriately will be necessary. As such, we believe it would be prudent to further clarify governance arrangements relevant to the Financial Policy Committee (“FPC”) and the PRA within the overall context of the Bank of England’s governance structure.

- **Role of the National Audit Office (“NAO”)**

The Consultation Paper proposes a full audit of the PRA and FCA with accountability to the Public Accounts Committee (“PAC”). We welcome this proposal. In addition, we recommend that it would also be prudent for the NAO to review the working relationship and coordination between the PRA and the FCA two years after implementation of the new framework to assess effectiveness and efficiency and to make recommendations for improvement.



International and domestic competition

The financial services sector is unquestionably a key component of the UK economy. The development of an effective, respected and balanced regulatory framework is a key element of maintaining the UK's competitive position as a leading financial market on the global stage.

In our response to the previous HM Treasury Consultation Paper we recommended that the new regulators should be required to "have regard to" the competitiveness of the UK on the international stage; we continue to believe that this recommendation is appropriate.

In line with a desire to maintain a competitive UK financial services market internationally, we believe that competition within the UK market is positive for consumers and the economy. Whilst we do not believe that financial stability should be compromised solely for the objective of competition, we encourage an approach that allows for growth, flexibility and for the UK market to evolve. We support the comments of the Independent Banking Commission in their Interim Report published this week, which cites the FCA as a "vital spur to competition in banking."

The Consultation Paper proposes that the FCA "must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition". We believe that a regulatory body needs to be mindful of evolving market demands and be flexible in allowing markets, products and services to develop, allowing the UK financial services market to maintain a high level of choice for consumers. Therefore we would encourage HM Treasury to include a similar objective for the PRA, ensuring that this regulatory body has regard to its influence on the UK and international markets.

Interaction with the European and global regulators

In the future, financial services regulation within Europe and on the global stage will have an increasing impact on the UK. Market participants generally agree that effective regulation requires communication and coordination between global, regional and national regulators.

The Consultation Paper recognises the importance of international coordination. We agree with this acknowledgement and encourage further cooperation within the regulatory framework to ensure that the UK's influence at the European and global level is maximised. The roles of the PRA and FCA in future European regulatory developments should be included in their objectives to ensure that they are able to participate effectively in shaping any potential changes in the EU and global regulatory frameworks.

We note also that part of European Securities and Markets Authority's remit will cover company and auditor regulation which, in the UK, will remain within the scope of the Financial Reporting Council ("FRC"). It will be important, therefore, to ensure that an appropriate Memorandum of Understanding between the FCA and the FRC is adopted to enable the FRC's perspective on relevant matters to be reflected at a European level.



Coordination between the regulatory bodies

As we discussed in our previous response, the proposed regulatory framework should ensure that duplication is avoided, that no gaps in regulatory coverage exist and that firms have no opportunity for “regulatory arbitrage” through taking advantage of differing regulators’ objectives. In developing our response to this Consultation Paper, we have also considered the coordination between the new regulatory bodies from the perspective of a dual-regulated firm. These firms will need confidence that the approaches of the new bodies are consistent, co-ordinated effectively and do not create unnecessary inefficiencies.

We understand that a Memorandum of Understanding between the PRA and the FPC will be developed to facilitate coordination between the regulatory bodies. We recommend that this memorandum takes account of those areas of regulation likely to fall into an overlap in the scope of the new regulators; for instance, sections of the current FSA handbook such as SYSC, PRIN and APER are relevant to both prudential and conduct regulation. For overlapping areas, it will be particularly important to be clear how rules and regulation in these areas will be developed, implemented and supervised in the new framework.

Moving towards judgement based regulation

As detailed in our previous response, we support a move towards judgement based regulation, and away from a “check box” approach. We believe that a judgement based regime, properly applied, will result in better regulatory outcomes. Given the inherent challenges in the design and application of such a methodology, we note that it must be supported by:

- Creation and maintenance of a principles based culture throughout the organisation(s);
- Active involvement of well trained and experienced individuals in setting principles, supervising and enforcing regulation; and
- Regular training and education of all people and the ongoing review of additional skilled resource required.

If these challenges are not overcome, future regulatory failures could result through the poor application of judgement based regulation, resulting in a worse outcome than would have been achieved through a more regimented, but less thoughtful, “check box” approach. Nonetheless, we support the move towards judgment based regulation, providing that it is supported by the cultural and organisational developments that are required to implement the strategy effectively.

We hope that you find our response to the Consultation Paper useful and we would be happy to discuss our comments further with you. Please contact Pat Newberry (0207 212 4659), Gilly Lord (0207 804 8123) or Anne Simpson (0207 804 2093) should you wish to discuss or clarify any matter in this response.

Yours faithfully,

PricewaterhouseCoopers LLP.
PricewaterhouseCoopers LLP



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1. The Bank of England and the Financial Policy Committee

1. What are your views on the likely effectiveness and impact of these instruments as macro-prudential tools?

Many of the examples of macro-prudential tools given in the Consultation Paper would necessarily operate on a firm-specific basis. Whilst we do not disagree with the use of macro-prudential tools in this way, we believe that the FPC should also develop macro-prudential tools that can be operated market and system wide, rather than at an individual firm level.

3. Do you have any general comments on the proposed role, governance and accountability mechanisms of the FPC?

As detailed in our covering letter, the overarching governance framework applied to all of the new regulatory bodies will be critical to the success of the new model. We would encourage HM Treasury to apply the relevant aspects of the recommendations set out in Sir David Walker's review (November 2009) on the governance of banks and other financial institutions. We highlight in particular the recommendations regarding the need for an institution's governing body to pay close attention to its overall balance and to be evaluated regularly and rigorously. In implementing these suggestions, the regulatory bodies would not only benefit from robust governance but would also set an example of good practice to regulated firms.

With specific reference to the FPC and PRA, we note that in the new structure, the Bank of England will have responsibility for regulatory and monetary policy. Therefore a governance structure that ensures that potential conflicts of interest between regulatory and monetary policy are managed appropriately will be necessary.

2. Prudential Regulation Authority

5. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the PRA?

Further to our comments in the covering letter, we highlight two specific areas for consideration with regards to the proposed objectives for the PRA.

- **International and domestic competition**

The financial services sector is unquestionably a key component of the UK economy. The development of an effective, respected and balanced regulatory framework is a key element of maintaining the UK's competitive position as a leading financial market on the global stage.

In our response to the previous HM Treasury Consultation Paper we recommended that the new regulators should be required to "have regard to" the competitiveness of the UK on the international stage; we continue to believe that this recommendation is appropriate.

In line with the desire to maintain a competitive UK financial services market internationally, we believe that competition within the UK market is positive for consumers and the economy. Whilst we do not believe that financial stability should be compromised solely for the objective of competition, we encourage an approach that allows for growth, flexibility and the evolution of the UK market. We support the comments of the Independent Banking Commission (“IBC”) in their Interim Report published this week, which cites the FCA as a “vital spur to competition in banking.” We agree with the IBC that the FCA should have a clear primary duty to promote competition.

The Consultation Paper proposes that the FCA “must, so far as is compatible with its strategic and operational objectives, discharge its general functions in a way which promotes competition”. We believe that a regulatory body needs to be mindful of evolving market demands and be flexible in allowing markets, products and services to develop, allowing the UK financial services market to maintain a high level of choice for consumers. Therefore we would encourage HM Treasury to include a similar objective for the PRA, ensuring that this regulatory body has regard to its influence on the UK and international markets.

- **Interaction with the European and global regulators**

In the future, financial services regulation within Europe and on the global stage will have an increasing impact on the UK. Market participants generally agree that effective regulation requires communication and coordination between global, regional and national regulators.

The Consultation Paper recognises the importance of international coordination. We agree with this acknowledgement and encourage further cooperation within the regulatory framework to ensure that the UK’s influence at the European and global level is maximised. The PRA’s role in future European regulatory developments should be included in their objectives to ensure that they are able to participate effectively in shaping any potential changes in the EU and global regulatory frameworks.

7. What are your views on the mechanisms proposed to make the regulator judgement-led, particularly regarding: rule-making; authorisation; approved persons; and enforcement (including hearing appeals against some decisions on a more limited grounds for appeal)?

As detailed in the covering letter and our previous response, we support a move towards judgement based regulation, and away from a “check box” approach. We believe that a judgement based regime, properly applied, will result in better regulatory outcomes. Given the inherent challenges in the design and application of such a methodology, we note that it must be supported by:

- Creation and maintenance of a principles based culture throughout the organisation(s);
- Active involvement of well trained and experienced individuals in setting principles, supervising and enforcing regulation; and
- Regular training and education of all people and the ongoing review of additional skilled resource required.



If these challenges are not overcome, future regulatory failure could result through the poor application of judgement based regulation, resulting in a worse outcome than would have been achieved through a more regimented, but less thoughtful, “check box” approach. Nonetheless, we support the move towards judgment based regulation, providing that it is supported by the cultural and organisational developments that are required to implement the strategy effectively.

8. What are your views on the proposed governance framework for the PRA and its relationship with the Bank of England.

Please refer to our response to Question 3.

9. What are your views on the accountability mechanisms proposed for the PRA?

The Consultation Paper proposes a full audit of the PRA and FCA with accountability to the Public Accounts Committee (“PAC”). We welcome this proposal. In addition, we recommend that it would also be prudent for the National Audit Office to review the working relationship and coordination between the PRA and the FCA two years after implementation of the new framework to assess effectiveness and efficiency and to make recommendations for improvement.

10. What are your views on the Government’s proposed mechanisms for the PRA’s engagement with industry and the wider public?

As highlighted in our covering letter, we believe that good governance is fundamental for a regulator and the financial industry as a whole. The Practitioner Panel and Consumer Panel provide the FSA with an important perspective of the market and, at the very least, are a sounding board with industry. We strongly feel that the PRA would benefit from access to these Panels so that the objectives, strategy and activities of the PRA can be made transparent and challenged, where appropriate. In addition, we believe that it would be prudent for the PRA to engage with the industry and the wider public through holding an annual public meeting.

3. Financial Conduct Authority

11. What are your views on the (i) strategic and operational objectives and (ii) the regulatory principles proposed for the FCA?

Further to our comments in the covering letter, we would like to highlight the following specific area for consideration with regards to the proposed objectives for the FCA.



- **Interaction with the European and global regulators**

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The Consultation Paper recognises the importance of international coordination. We agree with this acknowledgement and encourage further cooperation within the regulatory framework to ensure to maximise the UK's influence at the European and global levels. The FCA's role in future European regulatory developments should be included in their objectives to ensure that they are able to participate effectively in shaping any potential changes in the EU and global regulatory frameworks.

12. What are your views on the Government's proposed arrangements for governance and accountability of the FCA?

Please refer to our response to Question 9.

14. The Government would welcome specific comments on:

- **The proposed approach to the FCA using transparency and disclosure as a regulatory tool;**
- **The proposed new power in relation to financial promotions; and**
- **The proposed new power in relation to warning notices.**

We welcome the Consultation Paper's proposals on transparency and believe that it is a key consideration to building a stronger regulatory system. We recommend, however, that further thought be given to the risk of any implication that a firm is already "guilty" when a warning notice is published, as publication could then lead to an implicit market penalty for a firm that may not be guilty of a regulatory breach. Any such publication should be subject to an appropriate and rigorous governance framework.

4. Regulatory Processes and Coordination

17. What are your views on the mechanisms and processes proposed to support effective coordination between the PRA and FCA?

As we discussed in our covering letter and previous response, the proposed regulatory framework should ensure that duplication is avoided, that no gaps in regulatory coverage exist and that firms have no opportunity for "regulatory arbitrage" through taking advantage of differing regulators' objectives. In developing our response to this Consultation Paper, we have also considered the coordination between the new regulatory bodies from the perspective of a dual-regulated firm. These firms will



need confidence that the approaches of the new bodies are consistent, co-ordinated effectively and do not create unnecessary inefficiencies.

We understand that a Memorandum of Understanding between the PRA and the FPC will be developed to facilitate coordination between the regulatory bodies. We recommend that this memorandum takes account of those areas of regulation likely to fall into an overlap in the scope of the new regulators; for instance, sections of the current FSA handbook such as SYSC, PRIN and APER are relevant to both prudential and conduct regulation. For overlapping areas, it will be particularly important to be clear how rules and regulation in these areas will be developed, implemented and supervised in the new framework.

In addition, we also refer to our comments regarding the role of the NAO in Question 9.

18. What are your views on the Government's proposal that the PRA should be able to veto an FCA taking actions that would be likely to lead to the disorderly failure of a firm or wider financial instability?

We note that the Consultation Paper proposes that the PRA will hold a power of veto over the FCA in order to ensure that disagreements between the two regulatory bodies can be resolved. Granting this veto power implies that the PRA will be the "lead regulator" in the new framework. Given that both the PRA and the FCA are essential parts of the new regulatory framework, we are mindful of the need to retain equivalence of power between the bodies except in very unusual situations. We recommend therefore that the detailed rules surrounding operation of the veto power emphasise that it should only be used in extreme circumstances. We believe that in most circumstances, disagreements between the PRA and the FCA should be resolved through appropriate mediation processes.

We welcome the Consultation Paper's proposals on transparency, including the requirement to lay the circumstances in which the veto is used before Parliament, subject to considerations of public interest. If the disagreement giving rise to the exercise of the veto is in respect of a policy matter, it will usually be appropriate to disclose the surrounding circumstances. However, we anticipate that in most scenarios involving individual firms, the circumstances in which the veto is used will not be made public prior to the veto being exercised. This lack of transparency makes having a clear governance framework surrounding use of the veto is even more critical.

5. European and International Issues

32. What are your views on the proposed arrangements for international coordination?

In the future, financial services regulation within Europe and on the global stage will have an increasing impact on the UK. Market participants generally agree that effective regulation requires communication and coordination between global, regional and national regulators.

The Consultation Paper recognises the importance of international coordination. We agree with this acknowledgement and encourage further cooperation within the regulatory framework to ensure that



the UK's influence at the European and global level is maximised. The PRA and FCA's role in future European regulatory developments should be included in the regulators' objectives to ensure that they are required to participate effectively in shaping any potential changes in the EU and global regulatory frameworks.

We note also that part of European Securities and Markets Authority's remit will cover company and auditor regulation which, in the UK, will remain within the scope of the Financial Reporting Council ("FRC"). It will be important, therefore, to ensure that there is an appropriate Memorandum of Understanding between the FCA and the FRC to ensure that the FRC's perspective on relevant matters is reflected at a European level.