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Financial Regulation Strategy
HM Treasury
1 Horse Guards Road
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18 October 2010

Dear Sirs

HM Treasury Consultation Paper – 'A new approach to financial regulation: judgement, focus and stability' (the "Consultation Paper")

PricewaterhouseCoopers LLP ("PwC" or "we") welcomes the opportunity to comment on the Consultation Paper. As requested we have responded to the questions that we believe are relevant to our business and experience. The response to the questions has been included in the main body of the report attached.

We have also taken the opportunity to provide some more general observations on certain aspects of the proposals; these are set out in the letter below.

Improving the regulatory framework

We agree that there were certain failures of the regulatory system during the emergence of the recent financial crisis and we support the objective of the Consultation Paper to make improvements in order to avoid similar failures in the future. We have considered all of the proposals against this overall objective and we have commented where we believe that better regulation may not ensue.

When implementing the new regulatory framework, the government and regulators should be particularly rigorous when assessing the cost and benefit implications, all potential consequences that may result and any wider economic consequences of reform, given the importance of the financial sector to the UK. For example, the following issues should be considered:

- The cost of implementing change is necessarily a secondary consideration when working towards a better regulatory model. However, for certain aspects of the proposals we suggest that a detailed cost-benefit analysis be conducted to ensure that regulatory and firm resources are deployed only where the objective of improved regulation can actually be achieved. This will be particularly critical when assessing the operational reality of disaggregating the regulatory architecture;
- There are many examples of regulatory changes having unintended consequences, which have resulted in regulatory arbitrage, market failure and loss of competitiveness for certain jurisdictions. Historically, many of these instances have occurred overseas, allowing us to

grow the financial services sector in the United Kingdom. For example, the introduction of the US Sarbanes-Oxley Act in 2002 benefitted the UK through encouraging capital flows away from the US and into the UK. Careful analysis of these reforms will be required to identify any such unintended consequences.

Moving towards judgement based regulation

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. However, we note the inherent challenges in the design and application of any judgement-based methodology. For example, the methodology must be supported by:

- Creation and maintenance of a principles based culture throughout the organisation(s);
- Active involvement of highly accomplished and experienced individuals in setting principles, supervising and enforcing regulation; and
- Regular training and education of all people.

The regulatory bodies are likely to need to recruit additional skilled resource in order to effect successful culture change and to make a more judgement based model work effectively.

If these challenges are not overcome, there could even be a risk of future regulatory failure, 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.

Our audit practice has significant experience of working successfully within a judgement based framework and we would be delighted to share more detailed experience in this area.

Statutory objectives and principles of good regulation

Under the existing regulatory framework and legislation, the Financial Services and Markets Act 2000 ("FSMA") sets out five statutory objectives that direct the regulatory activities of the FSA. The statutory objectives are supported by a set of principles of good regulation to which the FSA must have regard when discharging its functions under FSMA. The FSA's statutory objectives and principles of good regulation are set out in Appendix A.

The principles of good regulation include considerations such as:

- The international character of financial services and markets and the desirability of maintaining the competitive position of the UK; and
- The desirability of facilitating innovation in connection with regulated activities.

The Consultation Paper proposes that these considerations could be removed from the regulation setting process.

We believe that these factors, together with the other principles of good regulation, are an important part of the development of balanced regulation, although we agree that it is appropriate that they should be subordinate to overall regulatory objectives.

The financial services sector is a key part of the UK economy, contributing some 8% of UK Gross Value Added, employing over 1 million people and enabling and stimulating growth in other

sectors. The development of an effective, respected and balanced regulatory framework is an important element of maintaining the UK's competitive position as a leading financial market. If regulation becomes imbalanced – either overly permissive or overly stringent - we will jeopardise this position, and hence the economic health of the UK.

We recognise that the principle covering innovation will need to be carefully considered. This principle should exist to support socially useful innovation, rather than overt financial engineering that generates little value for the UK economy and the wider public. We have given an example of socially useful innovation in our detailed response to Question 4.

We note that, in practice, there may be some confusion over the status of the principles of good regulation. We therefore recommend that additional guidance be published to clarify the expected actions of regulatory bodies in respect of these principles when developing new regulation.

Disaggregating the regulatory architecture and implementing the new structure

The Consultation Paper proposes that prudential and conduct of business regulation require different approaches and cultures, and thus that the Prudential Regulatory Authority (the "PRA") and the Consumer Protection and Markets Authority (the "CPMA") should be independent regulators with differing objectives. We recognise that there are valid reasons for bringing greater focus to both prudential and conduct regulation.

The FSA currently has annual revenue and costs in excess of £420 million, over 3,300 employees and the responsibility for the regulatory oversight of 29,000 firms and 165,000 individuals. The design and implementation of the current regulatory architecture took over 4 years to complete at some significant expense. The task of disaggregating this architecture will be similarly complicated and costly and we expect it will require time and additional expert resources.

The Consultation Paper also recognises that the PRA and the CPMA will need to work together in many situations, particularly in relation to firms where both authorities have a supervisory interest. It will be necessary, therefore, to create a framework which facilitates coordination and cooperation between the new regulatory bodies. This framework should incorporate a cultural attitude encouraging close liaison and a detailed modus operandi covering the practicalities of working together.

The framework should ensure that duplication is avoided, that there are no gaps in regulatory coverage and that firms have no opportunity for "regulatory arbitrage" through taking advantage of differing regulators' objectives. Functions where we believe joint operation or closely dovetailed working will be appropriate include:

- Risk assessment
- Ongoing supervision
- Enforcement
- Authorisations and permissions
- Levying fees (already contemplated in the Consultation Paper)
- Operational functions such as finance, human resources and IT.

Joint operation will not only reduce the risk of gaps and regulatory arbitrage, but will also reduce the cost of disaggregation we referred to above.

Resolution of conflicting objectives

We expect that there will be instances where the objectives of the new regulatory bodies will conflict, in particular when taking enforcement or corrective actions. The Consultation Paper recognises this possibility and notes that, in extremis, the objectives of the PRA will be deemed superior to those of the CPMA. However, we note that the modus operandi to be established between the new regulatory bodies will need to provide a mechanism for identifying and mediating any such conflicts before defaulting to the philosophical superiority of the PRA's objectives.

The future of the UKLA

The UK Listing Authority (the "UKLA") currently resides within the FSA and is responsible for regulating access to the UK's capital markets and for setting continuing obligations for those companies with listed securities.

The Consultation Paper notes that the Government is considering whether the UKLA should be merged with the Financial Reporting Council (the "FRC"), further suggesting that any such move could be the first step to creating a powerful companies regulator, reporting into the Department of Business, Innovation and Skills ("BIS"). We note that there will be a further consultation in this regard in due course.

The UKLA currently runs a regime which strikes a balance between efficient access to the capital markets and robust reporting and regulation (often involving a degree of "super equivalence"), allowing the UK to become the pre-eminent European location for capital raising. In addition, there have been no major incidents that suggest that the UKLA's approach to regulating primary access to the UK capital markets needs reform. Whilst we acknowledge that there are certain areas where functions of the UKLA could share practice with counterparts at the FRC (for instance with respect to narrative reporting in company accounts and in prospectuses), we do not believe that combining these functions would unlock significant synergies. This backdrop does not support a case for change and therefore we question whether merging these bodies would contribute to the overall objective of improving regulation within the UK.

A move of the UKLA would also separate responsibility for primary access to capital markets from those responsible for market conduct (responsibility for which will lie with the CPMA). We believe that these two aspects of market regulation should be closely linked and that a separation could lead to poorer regulation in practice.

Finally, it is planned for the CPMA to be the UK's representative on the European Securities and Markets Authority ("ESMA"). If the UKLA were to be removed from the CPMA, the degree to which it could influence regulation in the European capital markets would be constrained. This could be particularly disadvantageous for the UK's interests, given that the new European regulatory architecture is planned to become operational from January 2011, and UK influence could be diminished at a critical stage in the development of the new EU institutions.

Maintaining influence on the European and global stage

There is a common consensus that for regulation to be effective in the future we need better communication and coordination between global, regional and national regulators. The FSA is currently regarded by many as Europe's pre-eminent financial services regulator; through the FSA, the UK has a respected voice in European and global discussions.

The FSA is the designated competent authority under the European single market directives for banking, insurance, investment business, payment services, collective investment schemes and other financial services, including insurance intermediation. The FSA is also the competent authority under a host of other EU directives, including the Market Abuse and Prospectus Directives.

The new structure will introduce several UK regulatory authorities that do not align with the new European supervisory structure and it is not yet clear how our seats at the tables of the European regulatory bodies will be allocated, or how the competent authority designations referred to above will be delegated. Whilst this issue can be resolved by the allocation of responsibilities between the new bodies, it will be critical to ensure that splitting representation between the UK bodies, particularly in the transitional period, does not result in a loss of focus or influence in European developments.

It will be essential for HM Treasury ("HMT") and the Bank of England (the "BoE") to monitor closely European and global developments for any indication that UK influence may be diluted because of this lack of structural alignment.

The role of the auditor

The role that auditors (including PwC) should play in the future regulatory framework is already the subject of much debate, and we refer you to our recent response (dated 29 September 2010) to the combined FRC and FSA Discussion Paper DP10/3 "Enhancing the auditor's contribution to prudential regulation". We note that the Consultation Paper does not cover the role of auditors or audit firms although the responsibilities of auditors under FSMA will need to be migrated and/or amended as part of the implementation of the new regulatory framework.

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

Contents

1. The Bank of England and Financial Policy Committee

1. Should the FPC have a single, clear, unconstrained objective relating to financial stability and its macro-prudential role, or should its objective be supplemented with secondary factors?

We believe that the primary objective of the FPC should be to protect financial stability through identification of systemic risk and, where appropriate, addressing imbalances. However, as set out in our covering letter, in particular under the paragraph entitled "Statutory objectives and principles of good regulation" we strongly support the existence of secondary factors, to which all regulatory bodies should have regard when determining actions. These secondary factors will be an important part of the development and implementation of balanced regulation.

We note that, in practice, there may be some confusion over the status of these secondary factors. We therefore recommend that additional guidance be published to clarify the expected actions of regulatory bodies in respect of the secondary factors when developing new regulation. We suggest that particular thought be given to how the secondary factors should be applied to different aspects of the regulatory process: for instance the impact of the secondary factors on the setting of regulatory policy will be entirely differently from their impact on supervisory and enforcement decisions.

2. If you support the idea of secondary factors, what types of factors should be applied to the FPC?

We suggest that, of the principles of good regulation currently enshrined within FSMA, the principles relating to "International character" and "Competition" become secondary factors to which the FPC should have regard when pursuing its primary objective. In addition, we recommend that the FPC should consider the impact of its actions:

- On the other UK regulatory bodies and their statutory objectives, including the PRA, CPMA and MPC;
- With respect to the European and global regulatory landscape so that, where appropriate, regulatory arbitrage is avoided or at least anticipated; and
- On the wider social agenda, for instance, the impact on housing access and availability which could follow from actions to slow the housing market.

In many cases, it may be determined that, notwithstanding any adverse consequences relating to the secondary factors, the FPC's course of action remains appropriate. However, we believe that the timing and proportionality of macro-prudential actions can be better calibrated if these consequences are clearly understood. In addition, the early identification of any such issues should facilitate a more effective response, where one is required.

3. How should these factors be formulated in legislation – for example, as a list of 'have regards' as is currently the case in the Financial Services and Markets Act 2000 (FSMA), or as a set of secondary statutory objectives which the FPC must balance?

As noted in Question 1, there may be some lack of clarity over the status and impact of the secondary factors currently in existence. If the factors are formulated in legislation as a set of secondary statutory objectives, we believe that their status would be more easily understood; we recommend that, in addition, guidance be published to illustrate the actions that the FPC could take in responding to the secondary objectives.

2. Prudential Regulatory Authority

4. The Government welcomes respondents' views on:

- ***whether the PRA should have regard to the primary objectives of the CPMA and FPC;***
- ***whether some or all of the principles for good regulation currently set out in section 2 of FSMA, particularly those relating to good regulatory practice, should be retained for the PRA;***
- ***whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and***
- ***whether there are any additional broader public interest considerations to which the PRA should have regard.***

The primary objectives of the CPMA and FPC

We believe that the PRA should have regard to the primary objectives of the CPMA and FPC. As we have explained in our covering letter, in particular within the paragraphs entitled "Disaggregating the regulatory architecture and implementing the new structure" and "Resolution of conflicting objectives", the success of the new regulatory model will be contingent on close cooperation and coordination between the new regulatory authorities.

The stipulation that the PRA must have regard to the primary objectives of the CPMA and FPC is consistent with the establishment of a culture of working together. Also, there are likely to be situations where prudential and conduct requirements overlap, or indeed conflict, and where a balance will need to be sought.

If the new bodies do not have regard for the objectives of the other bodies, there is unlikely to be an adequate framework for resolving these conflicts. Successful conflict resolution will depend on rapid identification of conflicting objectives; if the PRA is mandated to have regard to the objectives of the other regulatory bodies this should facilitate the early understanding and resolution of such conflicts.

FSMA principles for good regulation

As set out in our covering letter, in particular within the paragraph entitled "Statutory objectives and principles of good regulation", we support the retention of all of the principles for good regulation currently set out in section 2 of FSMA.

We note that the principle requiring the regulator to have regard to the desirability of facilitating innovation in connection with regulated activities could be refined to refer to "socially useful innovation", as previously referred to by Lord Turner, being innovation that supports regulatory objectives and/or provides products and services that create tangible benefits for the UK economy or wider public.

An example of such socially useful innovation was recently seen within the building society sector which developed an innovative core tier 1 instrument – Profit Participating Deferred Shares ("PPDS") to enable the raising of core tier 1 capital externally. This instrument was successfully used for the first time by the West Bromwich in 2009 which strengthened the quality of its capital when its subordinated debt holders agreed to convert their holdings into PPDS.

Systemically important institutions

When designing and implementing the new regulatory framework, the importance of focusing on those firms that are deemed to be systemically important should be emphasised. Protecting against any failure is a part of regulation, however, as has been demonstrated in recent years, failure of these firms has a far greater effect on the UK economy and public finances.

5. Is the model proposed in paragraph 3.16 – with each authority responsible for all decisions within their remit subject to financial stability considerations – appropriate, or would an integrated model (for example, giving one authority responsibility for authorisation and removal of permissions) be preferable?

As noted in our covering letter, in particular within the paragraph entitled "Disaggregating the regulatory architecture and implementing the new structure", when implementing the new regulatory framework it will be important to avoid:

- Duplication of activity between the new regulatory authorities;
- Increasing the regulatory burden on firms without proportional benefit; and
- Any opportunity for regulatory arbitrage between the new regulators, for instance, through lack of clarity over who will be responsible for certain issues or risks.

In order to mitigate these risks and to increase efficiency, we support the development of an integrated model for certain regulatory functions. The degree to which integration will be possible or appropriate will vary depending on the function. For example, we suggest that:

- Authorisations and permissions be carried out by one regulatory authority, probably the CPMA. In making this recommendation, we have considered the fact that the level of prudential authorisation and permission decisions would be only a fraction of those to be performed by the CPMA (we estimate that some 3,000 to 4,000 firms will be regulated by the PRA compared to over 20,000 by the CPMA). Therefore to create a separate authorisations and permissions function within the PRA would seem inefficient;
- A consolidated register of regulated firms and approved persons be maintained by the CPMA;
- If it is not possible for one regulatory body to assume responsibility for these functions then we would encourage the regulators to explore the development of an integrated "front-end" system that would enable firms to initiate a single application process;
- Supervisory activities to be coordinated between the two new authorities, whilst noting that each regulatory authority will have individual responsibility for its own supervisory activity. However, coordination of supervisory visits will enable regulatory and firm resources to be deployed in responding properly to the most critical regulatory needs; and
- In particular, as part of the supervision process, that risk analyses of firms regulated by the PRA be carried out jointly with the CPMA, whilst recognising that the focus of risk analysis within the PRA may differ from that of the CPMA. We believe that a consistent risk analysis will facilitate a dovetailed approach to supervision and assist in appropriate prioritisation of regulatory activity.

We further suggest that cost efficiencies will be optimised if "back office" type functions are shared by the new regulatory authorities. For instance, finance, accounting and human resource functions could be provided by a shared service centre, supporting both the PRA and the CPMA.

6. Is the approach outlined in paragraph 3.17 to 3.23 for transfer of regulatory functions and rule making sufficient to enable the PRA to take a more risk-based, judgement-focussed approach to supervision?

As noted in our opening letter, we support the move to a risk and judgement based approach to regulation. However, we believe that further activity beyond that outlined in the Consultation Paper will be required in order to make this move successful.

Detailed planning will be required in respect of the cultural underpinning required to implement effective judgement based regulation. The cultural shift will need to be effected through deploying resource experienced in working in a risk-based environment (additional senior level resource may need to be recruited), encouraging close coaching, supervision and review of more junior staff, and implementing a learning and development programme which supports working within a principles-based framework.

The FSA's staff currently work with a very detailed and highly prescriptive rule book; the impact of shifting these detailed rules towards sets of guiding principles, should not be underestimated. The exercise to simplify the current rulebook will be substantial. We estimate that the FSA rule book currently runs to thousands of pages and therefore resource demands (both in terms of volume of resource and capability) to simplify these rules will be significant. Finally, we note that removal of detailed rules will create a degree of uncertainty for the firms; we suggest that a careful balance between principles and more substantive guidance will need to be reached.

7. Are safeguards on the PRA's rule-making function required?

We support the maintenance of the existing consultation safeguards set out in FSMA. We believe that they contribute to the development of balanced regulation which is understood and supported by all stakeholders and that they facilitate the identification, and hence avoidance, of unintended consequences of changes in regulation. To eliminate any of the current safeguards, in particular the consultation mechanisms, could result in implementation difficulties with the potential to undermine regulatory objectives.

Recent experience has indicated that, in times of crisis, it may be necessary for the regulatory authorities to act swiftly in pursuit of their financial stability objective. The new regulatory framework should include the provision for such prompt action, whilst setting appropriate safeguards for use in such an emergency situation.

Given that many of the future changes in regulation will be driven by the EU, we believe that it is important that the UK bodies, and other stakeholders, have sufficient influence to allow for these changes to be reviewed and shaped prior to their inclusion in EU Directives through the operation of suitable safeguards at the EU level.

8. If safeguards are required, how should the current FSMA safeguards be streamlined?

As noted above we believe that the current FSMA safeguards are essential to achieving balanced regulation. However, we suggest that the current mechanism for the cost benefit analysis in the consultation process could be simplified to result in a simpler, quicker analysis achieving the same objectives.

9. The Government welcomes views on the measures proposed in paragraphs 3.28 to 3.41, which are designed to ensure that the operation of the PRA is transparent, operationally independent and accountable.

We support the governance and oversight mechanisms proposed, in particular, the cross-membership of boards between the PRA, CPMA, FPC and MPC as this should help reduce the potential for duplication and conflict between the new regulatory bodies.

We agree with the importance of the non-executive role on the board of the PRA and the need to ensure that the non-executives have appropriate experience and background, without conflicts that could impact their objectivity.

We agree that it is appropriate for fees to be levied on firms provided they are calculated in a competitive manner.

As noted in the Consultation Paper, some of the transparency and accountability mechanisms that are included in FSMA have been omitted for the PRA. These have been included in the plans for the CPMA and are summarised in the CPMA section of the Consultation Paper (paragraph 4.36). We feel that all of the items listed in paragraph 4.36 should be replicated for the PRA, including:

- a requirement to produce an annual report to be laid before Parliament by the Treasury;
- a requirement to hold annual public meetings;
- a duty to establish consultative panels where necessary;
- a duty to maintain a complaints mechanism similar to that required of the FSA by schedule 1 of FSMA;
- decisions to be subject to appeals in the Upper Tribunal, where appropriate; and
- reviews and inquiries (along the lines of those provided for currently in sections 12 and 14 of FSMA).

In principle, we support the PRA being subject to audit by the National Audit Office ("NAO") as this will improve public accountability. However, we would like to better understand the cost and consequent benefit that will be obtained from this change and how the NAO would interact with the Internal Audit function that is currently in place.

Overall, to achieve better regulation and accountability we believe that there is a need to ensure that there is more, and not less, transparency and oversight.

3. Consumer Protection and Markets Authority

10. The Government welcomes respondents' views on:

- ***whether the CPMA should have regard to the stability of firms and the financial system as a whole, by reference to the primary objectives of the PRA and FPC;***
- ***whether some or all of the principles for good regulation currently set out in section 2 of FSMA should be retained for the CPMA, and if so, which;***
- ***whether, specifically, the requirement to have regard to potential adverse impacts on innovation or the competitiveness of the UK financial services sector of regulatory action should be retained; and***
- ***whether there are any additional broader public interest considerations to which the CPMA should have regard.***

We believe that the CPMA should have regard to the primary objectives of the PRA and of the FPC and that the principles for good regulation currently set out in section 2 of FSMA should be retained. Our rationale in making these recommendations is set out in our response to Question 4.

11. Are the accountability mechanisms proposed for the CPMA appropriate and sufficient for its role as an independent conduct regulator?

We support the governance and oversight mechanisms proposed, in particular, the cross-membership of boards between the PRA, CPMA, FPC and MPC as this should help reduce the potential for duplication and conflict between the new regulatory bodies.

We agree with the importance of the non-executive role on the board of the CPMA and the need to ensure that the non-executives have appropriate experience and background, without conflicts that could impact their objectivity.

We agree that it is appropriate for fees to be levied on firms provided they are calculated in a competitive manner.

As we note in our response to Question 9, some of the transparency and accountability mechanisms that are included in FSMA are proposed to be retained for the CPMA and are summarised in paragraph 4.36. We support the inclusion of these mechanisms for the CPMA but recommend that similar mechanisms be implemented for the PRA. We suggest that the consultative panels to be established for the CPMA should also act as consultative panels for the PRA, recognising that a subset of the Practitioner Panel would need to be convened to debate issues relevant to the PRA.

In principle, we support the CPMA being subject to audit by the NAO as this will improve public accountability. However, we would like to better understand the cost and consequent benefit that will be obtained from this change and how the NAO would interact with the Internal Audit function that is currently in place.

Overall, to achieve better regulation and accountability we need to ensure that there is more, and not less, transparency and oversight.

12. The Government welcomes views on the role and membership of the three proposed statutory panels for the CPMA.

The Consultation Paper suggests that the CPMA should retain the two current panels required under FSMA, the Consumer Panel and the Practitioner Panel. In addition, it is suggested that the Small Business Practitioner Panel be placed on a statutory footing and retained by the CPMA.

We believe that the members of these panels should be able to demonstrate relevant experience and independence (wherever possible). In relation to the Practitioner Panel, we note the advantages that accrue from members having a degree of influence within the wider marketplace and therefore would recommend that this characteristic be considered in the recruitment process.

As part of the review of the regulatory framework, we would encourage HMT to review the objectives, operations and activities of each of the panels to ensure that they are delivering tangible benefits that are commensurate with the costs and resources incurred.

Other than as noted above, we have no specific views on the role and membership of these panels.

13. The Government welcomes views on the proposed funding arrangements, in particular, the proposal that the CPMA will be the fee- and levy-collecting body for all regulatory authorities and associated bodies.

We support the levy of fees from firms provided fees are calculated in a fair manner.

We agree that the CPMA should be responsible for the collection of fees and levies for all regulatory authorities as this should increase efficiency, reduce costs and improve transparency of the overall regulatory costs.

As we have already noted in this response, this process, along with many others, will require the regulatory authorities to coordinate and cooperate very closely.

We note that there may be a need for the regulatory authorities to monitor the degree of credit risk they face in respect of the CPMA and develop their risk management frameworks accordingly.

14. The Government welcomes views on the proposed alternative options for operating models for the FSCS.

The FSCS provides consumer protection when a firm is in default, and, as explained in the Consultation Paper, its core business is to compensate consumers for the more frequent failures of small firms such as Independent Financial Advisers.

We agree with the proposal that the FSCS should be the responsibility of the CPMA as its core business fits naturally with the scope of the CPMA's activities. However, it will be important for the PRA to work closely with the CPMA and FSCS to ensure that the role of the FSCS in the event of a failure of bank, insurer or investment bank is appropriately determined.

We believe that the main issues currently facing the FSCS are:

- The affordability of the levies for smaller firms;

- The capacity of the scheme to cope with large defaults; and
- The ability of the FSCS to enable the UK to meet its obligations under the various EU Directives which deal with compensation arrangements in different sectors of the market.

In order to overcome these issues, we recommend that the FSCS should remain a single scheme, with a cross-subsidy between different classes of levy payers. The single scheme approach should maximise efficiency and be the most cost-effective solution. In addition, without an implicit or explicit cross-subsidy arrangement, we believe that there could be situations where separate schemes would be insufficiently funded to provide adequate consumer protection. We understand that further consideration may be given to:

- pre-funding in respect of the banking class of the FSCS; and
- Future EU developments on compensation schemes.

We will consider responding to any specific consultations on these areas in due course.

4. Markets and Infrastructure

15. The Government welcomes views on the proposed division of responsibilities for markets and infrastructure regulation.

We understand the principle between the separation of responsibility for regulating exchanges and other trading platform providers (CPMA) from that for regulating CCPs and settlement systems (BoE). However we note the operational difficulty of making this separation and that the regulators will need to work together effectively and efficiently, with coordinated supervision.

16. The Government welcomes views on the possible rationalisation of the FSMA regimes for regulating exchanges, trading platforms and clearing houses.

We note that the current FSMA regimes for regulating exchanges, trading platforms and clearing houses treat exchanges and clearing houses (regulated directly by the FSA) differently from trading platforms owned by regulated firms. This inconsistency presents the risk of regulatory arbitrage.

We suggest that any rationalisation of the current regimes should remove this inconsistency.

17. The Government would welcome views on whether the UKLA should be merged with the FRC, as a first step towards creating a companies regulator under BIS.

As noted in our covering letter, we believe that the UKLA is currently an effective regulator. We do not see obvious synergies between the UKLA and FRC and question whether a merger of those bodies would contribute towards to the development of better regulation. In the absence of compelling benefits to justify a change to the existing arrangement, we recommend that in the new regulatory framework the UKLA be housed within the CPMA organisational structure; this would be consistent with the current position of the UKLA within the FSA organisational structure.

This positioning would ensure that the regulator with responsibility for primary access to the capital markets (the UKLA) would be an integral part of the regulator with responsibility for market conduct (the CPMA). We believe that these two aspects of market regulation should be closely linked and that a separation could lead to dysfunctionality and poorer regulation in practice.

We note also that it is planned for the CPMA to be the UK's representative on the European Securities and Markets Authority ("ESMA"). We believe that it is critical for the UKLA to have adequate representation on ESMA; were the UKLA not to form part of the CPMA, its voice would necessarily be diluted and it would be constrained in the degree to which it could influence the development of regulation within the European capital markets.

It is relevant to consider the inherent differences in scope and approach which exist between the FRC and the UKLA. For example, the FRC regulates a wide spectrum of UK companies, not just listed companies, and therefore has a much broader scope than the UKLA who focus on companies seeking to access the UK capital markets (the majority of whom are based outside of the UK). Additionally, the FRC typically employs a retrospective approach to regulation, with much activity focussed on review, challenge and discipline. The UKLA, in contrast, operates a more immediate approach, working with those companies seeking to access the capital markets to review and, if appropriate, approve their investment circulars, typically within a six to eight week time frame.

There are functions within both organisations that have similar roles, notably the:

- Issuing of guidance on narrative reporting in annual reports (Accounting Standards Board) and in listings documents (UKLA);
- Enforcing narrative reporting in annual reports (Financial Reporting Review Panel) and in listings documents (UKLA);
- Issuing of guidance on the role of auditors in relation to listings documents (Auditing Practices Board); the reports issued by those auditors form part of the UKLA's assessment of suitability for listing; and
- Publication of the UK corporate governance framework (Financial Reporting Council); the UKLA monitors the governance and financial reporting capability of those companies seeking to raise capital in the market.

However, we believe that in each of these areas, the current regulatory bodies take account of each other effectively without undue duplication. We do not believe that combining these functions would unlock significant synergies and in fact, since the objectives of these functions are very different, combination could potentially lead to inefficiencies.

18. The Government would also welcome views on whether there are other aspects of financial market regulation which could be made more effective by being moved into the proposed new companies regulators.

As we note in our response to Question 17, we believe that all aspects of financial market regulation should be housed within the CPMA organisational structure. We note that further discussions and consultations on the future of the UKLA are expected and we will respond to these in due course.

5. Crisis Management

19. Do you have any overall comments on the arrangements for crisis management?

The future regulatory framework for crisis management is already the subject of much debate, and we refer you to our separate response to the HMT consultation paper "Establishing resolution arrangements for investment banks" which sets out our views on this area. Some of our most experienced insolvency practitioners have been in discussions with HMT and other relevant authorities to provide guidance in this area.

Given the ongoing consultation referred to above, and the breadth of this subject, we have responded only briefly to the crisis management consultation questions in this paper. We look forward to a continued dialogue with you as future crisis management arrangements are developed.

We believe that the change in regulatory framework proposed in the Consultation Paper and, in particular, the move of responsibility for prudential regulation under the BoE and the increased focus on macro-prudential risk, should better equip the regulatory authorities to identify and respond to future systemic risk.

The recent crisis demonstrated the need for administrators and insolvency practitioners to have flexibility to respond to unique situations. When reviewing the arrangements for crisis management, HMT should ensure that there is no erosion of this flexibility which could impede the ability of regulators and practitioners to protect financial stability and achieve effective and efficient resolutions.

20. What further powers of heightened supervision should be made available to the PRA and the CPMA, and in particular would there be advantages to mandatory intervention, as described in paragraph 6.17?

We believe that a critical element of a response to any future crisis will be the timing of any mandatory intervention or implementation of recovery and resolution plans. Any trigger points should be clearly defined, and the framework should ensure that there is sufficient frequency and transparency of reporting to allow trigger points to be identified.

We note that whilst there may be circumstances where swift mandatory intervention is necessary, we believe that it should remain the option of last resort.

21. What are your views about changes that may be required to enhance accountability within the SRR, as described in paragraphs 6.21 to 6.24?

We have no specific comments on accountability within the SRR.

6. Impact Assessment

22. Annex B contains a preliminary impact assessment for the Government's proposals. As set out in that document, the Government welcomes comments from respondents on the assumptions made about transitional and ongoing costs for all types of firm. In particular, comments are sought from all types and size of deposit-taking, insurance and investment banking firms (including credit unions and friendly societies), and from groups containing such firms.

We have not provided specific feedback on this question.

Appendix A – FSA's Statutory objectives and principles of good regulation

a) The Financial Services and Markets Act 2000 (FSMA) gives us five statutory objectives:

- **Market confidence** - maintaining confidence in the financial system;
- **Public awareness** - promoting public understanding of the financial system;
- **Financial stability** - contributing to the protection and enhancement of the UK financial system
- **Consumer protection** - securing the appropriate degree of protection for consumers; and
- **The reduction of financial crime** - reducing the extent to which it is possible for a business to be used for a purpose connected with financial crime.

b) In pursuing our functions under FSMA, we are required to have regard to additional matters that we refer to as 'principles of good regulation'. These are:

Efficiency and economy

The need to use our resources in the most efficient and economic way:

The non-executive committee of our Board is required, among other things, to oversee our allocation of resources and to report to the Treasury every year. The Treasury is able to commission value-for-money reviews of our operations. These are important controls over our efficiency and economy.

Role of management

The responsibilities of those who manage the affairs of authorised persons:

A firm's senior management is responsible for its activities and for ensuring that its business complies with regulatory requirements. This principle is designed to secure an adequate but proportionate level of regulatory intervention by holding senior management responsible for risk management and controls within firms. Accordingly, firms must take reasonable care to make it clear who has what responsibility and to ensure that the affairs of the firm can be adequately monitored and controlled.

Proportionality

The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions:

In making judgements in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements. This approach is shown, in particular, in the different regulatory requirements we apply to wholesale and retail markets.

Innovation

The desirability of facilitating innovation in connection with regulated activities:

This involves, for example allowing scope, where appropriate, for different means of compliance so as not to unduly restrict market participants from launching new financial products and services.

International character

The international character of financial services and markets and the desirability of maintaining the competitive position of the UK:

We take into account the international aspects of much financial business and the competitive position of the UK. This involves co-operating with overseas regulators, both to agree international standards and to monitor global firms and markets effectively.

Competition

The need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate:

These two principles cover avoiding unnecessary regulatory barriers to entry or business expansion. Competition and innovation considerations play a key role in our cost-benefit analysis work. Under the Financial Services and Markets Act, the Treasury, the Office of Fair Trading and the Competition Commission all have a role to play in reviewing the impact of our rules and practices on competition.

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