



House of Commons  
Treasury Committee

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**Financial Regulation:  
a preliminary consideration of  
the Government's proposals:  
Government Response to the  
Seventh Report from the  
Committee**

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**Fifth Special Report of Session 2010–12**

*Ordered by the House of Commons  
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## The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury, HM Revenue and Customs and associated public bodies.

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Mr Andrew Tyrie MP (*Conservative, Chichester*) (Chairman)  
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The Reports of the Committee, the formal minutes relating to that report, oral evidence taken and some or all written evidence are available in printed volume(s). Additional written evidence may be published on the internet only.

### Committee staff

The current staff of the Committee are Chris Stanton (Clerk), David Slater (Second Clerk), Adam Wales, Jay Sheth, Peter Stam and Daniel Fairhead (Committee Specialists), Phil Jones (Senior Committee Assistant), Caroline McElwee (Committee Assistant), Steve Price (Committee Support Assistant) and Nicholas Davies (Media Officer).

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## Fifth Special Report

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The Treasury Committee published its Seventh Report of Session 2010–12, *Financial Regulation: a preliminary consideration of the Government's proposals* on 3 February 2011, as House of Commons Paper No. 430. The Government Response to this Report was received on 5 April 2011 and is published as an appendix below.

The response from the Government is in plain text and the Committee's conclusions and recommendations are in bold text.

## Appendix: Government Response

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The Government welcomes the report of the Treasury Select Committee published on 3 February 2011, and thanks the Committee for their work.

The Committee's report is primarily based on the Government's initial consultation on financial regulation reform, *A new approach to financial regulation: judgement, focus and stability*, published on 26 July 2010 (the July consultation).

In November 2010, during the period of the Committee's consideration of the Government's proposals, the Government also published a summary of responses to the July consultation, which also set out its preliminary policy thinking in reaction to a number of themes which emerged from the responses.

The Government included preliminary thinking on the Committee's report in its second consultation, *A new approach to financial regulation: building a stronger system*, published shortly after the Committee's report on 17 February 2011 (the February consultation). This formal response builds upon that initial thinking.

### Recommendations and response

**1. We are concerned that the current proposals for reform say relatively little about some key segments of the UK financial sector. Inappropriate regulation of non-banking sectors could cause serious and unintended damage to companies within those sectors, and to the UK more widely. As the Treasury's consultation evolves, it is important that the Government clarifies the regulatory impact of its proposals on the non-bank sectors. (Paragraph 15)**

Given that the lessons of the financial crisis have been predominantly focused on the micro- and macro-prudential regulation of the banking sector, it is inevitable that Government's presentation of its proposals for improving regulation, in both the July and February consultations, should focus on banking and banking examples. It is, after

all, in banking regulation and supervision that the greatest need for improvement has been identified.

That does not mean, however, that regulation of other sectors does not remain a priority. The Government recognises the importance of effective regulation in all sectors of the financial services industry. The Government agrees that the reforms should not be concerned exclusively with banking. This is reflected in the February consultation which includes greater detail on different sectors, e.g. retail versus wholesale markets.

## **The Government's timetable**

**2. We welcome the establishment of the Independent Commission on Banking. The Government should pay full regard to Vickers before coming to conclusions. Once Vickers has reported it will be equally important to maintain the political will to act on the Commission recommendations, if, after scrutiny, action is needed. This has implications for the timetable for the reforms set out in the current consultation paper. (Paragraph 23)**

The Government welcomes the progress the Independent Commission on Banking (ICB) has made and looks forward to receiving Commission's interim report in April. The ICB is due to issue its final report in September 2011, at which point the Government will be able fully to assess the potential impact of the Commission's recommendations on its regulatory reform programme.

**3. The Government needs to take the time required to get its reform of financial regulation right. We note there was a year between the first publication of draft clauses on the Financial Services and Markets Bill, and the appearance of a further draft. Although the Joint Committee which scrutinised the Bill was given only eight weeks for the task, it subsequently took from 17 June 1999, when the Bill was presented in the Commons, to 14 June 2000 to become law. The Bill was very heavily amended in Committee in response to widespread criticism after its initial publication. It is one of the longest and most complex pieces of legislation on the statute books. The Government's current proposals include a suggestion that FSMA could be revisited in its entirety. We urge the Government to ensure that this is done, and present a new Bill only after full consideration has been given to responses to initial consultation. Drafting the legislation will then be likely to secure a more coherent final product and may eventually be quicker, given the complexities involved in comprehensive amendment of FSMA. (Paragraph 25)**

**4. The legislation to establish the new regulatory structure should be subject to pre-legislative scrutiny, over a reasonable timescale; the eight weeks allowed for the Joint Committee on the Financial Services and Markets Bill was inadequate. Even with proper pre-legislative scrutiny, once introduced, the timetable for the Bill should be generous enough to allow proper parliamentary consideration, using carry-over if necessary. (Paragraph 26)**

**5. However, scrutiny of the legislation will not be possible without fuller discussion of what financial stability might look like and how the democratic responsibilities of government can be combined with the delegation of significant economic policy making powers to an independent body. There also needs to be greater clarity about the wider regulatory framework; the major decisions on the structure of financial regulation should not be taken until there has been time to consider the recommendations of the Independent Commission on Banking. Whether or not it is possible to produce the final legislation within the two year time frame the Government envisages, the aim of introducing the legislation in “mid-2011” appears optimistic and, if pursued too rigidly, runs the risk of compromising its quality. (Paragraph 27)**

The Government believes that its aim to implement the reform programme by the end of 2012 remains an appropriate and achievable target. It is important that stakeholders, including regulated firms, have confidence in the timetable for implementation and are assured that disruption will be kept to a minimum. In its 2011 Economic Survey of the United Kingdom,<sup>1</sup> the OECD has recommended that the new financial architecture should be put in place rapidly.

The Government is committed to getting this legislation right. It has conducted two consultation exercises on its policy proposals and, as part of these consultations, has sought the input of a diverse range of stakeholders. This stakeholder feedback will shape the White Paper, which will include a draft Bill, which the Government intends to publish later this spring.

The Government has also committed to bring the draft Bill forward for pre-legislative scrutiny (PLS). PLS will provide a further opportunity for stakeholders and parliamentarians to engage with the details of the Government’s proposals for financial regulation reform and to improve the quality and coherence of the Bill before it is formally introduced to Parliament.

While the exact format of PLS will be a matter for Parliament, the Government believes that it should last for 12 parliamentary sitting weeks to ensure that there is ample time for thorough scrutiny of the draft legislation, in line with normal procedures.

As explained in the February consultation, the Government has decided that reform of regulation of individual firms will be implemented through primary legislation amending the Financial Services and Markets Act 2000 (FSMA), rather than revisiting FSMA in its entirety. This approach, which will involve modifying, adapting, supplementing, and in some cases replacing the current legislative framework, will allow the Government to implement changes more quickly, while minimising the cost and disruption to firms that would arise from repealing FSMA and starting with an entirely new Bill. The Government aims to publish a “consolidated” version of FSMA,

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<sup>1</sup> Economic Survey of the United Kingdom 2011, OECD, March 2011

incorporating the changes that would be made through the current Bill, to assist the scrutiny process.

The Government will be able to assess the recommendations of the ICB once its interim report is published in April, and its final report in September. Should the Government accept or otherwise respond to the ICB's recommendations in a way which requires changes to the Bill, the timetable will allow this.

**6. The FSA will divide internally, in preparation for the new arrangements. The Bank of England will continue to publish the Financial Stability Report, which is likely to be more influential in the interim period. While the draft legislation is being thought through, clear non-statutory interim arrangements will need to be in place. The Treasury should consider the preparation of a Memorandum of Understanding with the Bank of England and the FSA setting out those arrangements. (Paragraph 29)**

The Treasury, the Bank and the FSA are working closely and effectively to implement the reform programme through the transitional period. The Government does not believe that a formal transitional Memorandum of Understanding between the Bank and the FSA is necessary.

### **A super regulator—the Bank of England**

**7. Until now, such policies have been seen as the responsibility of the elected Government. If the Financial Policy Committee is to be given lead responsibility for securing financial stability there needs to be clarity about what such stability means. The overall stability of the financial system should certainly not mean that no firm will ever fail. However, there is room for debate about how frequent and severe firm failures may be before it is considered that the system is unstable. Moreover, in the short term, there could be trade-offs between some types of stability and growth if, for example, regulation restricts free entry and exit of firms or discourages innovation in other ways; there are trade-offs between the stability of the individual firm and growth. Unlike the MPC, which has a clear inflation target and the well-defined tool of interest rates and now quantitative easing to achieve its target, the remit for the FPC is difficult to define rigorously. Nonetheless, the Government needs to give a view, and a detailed one, of what the financial stability 'target' should be, how it should be assessed, and how any trade-offs that financial stability policy requires are to be managed. (Paragraph 38)**

The Government provided further detail on these points in its February consultation document. As the Committee acknowledges, the Government proposes to build the balance between financial stability and sustainable economic growth into the FPC's objective by ensuring that the FPC cannot take action which it believes likely to have a significant adverse effect on the capacity of the financial sector to contribute to the growth of the UK economy in the medium or long term.

The Government believes it important to give the FPC a clear and permanent objective in primary legislation. Nevertheless, the Government agrees with the Committee that the general concept of a more flexible remit could be usefully applied.

Therefore the Government will legislate to give the Treasury a discretionary power to provide the FPC with guidance in the form of a remit. This will give an opportunity for the Chancellor to write to the FPC to provide greater clarity on the overall approach the FPC should take in pursuit of its objectives. The FPC will be required to respond to the remit, setting how it has taken the Government's views into account. Both the remit and the reply will be published and laid before Parliament, subject to a public interest test.

**8. The independent members of the FPC will play a crucial role, at least as important as that of the equivalent members of the MPC. Given the close links between the internal members, the external members will play an essential role in ensuring that the Committee does not succumb to organisational “groupthink”. They will need adequate support from the Bank. They should be given the right to commission any information and analysis they feel they need. (Paragraph 43)**

The Government agrees that, for both the Monetary Policy Committee (MPC) and FPC, non-Bank members play a vital role in ensuring that a diverse range of experience and views contribute to the committees' decision-making. The Government expects the FPC's external members, like those on the MPC, to have access to Bank resources, including the ability to commission information and analysis.

**9. Whilst the MPC has four external members out of a total of nine, the FPC would have four external members out of eleven. A better balance between internal and external members of the FPC seems desirable. It could be achieved by increasing the number of external members on the FPC, to say six. That would increase the committee's size to thirteen, so that it would become rather unwieldy. The alternative would be to reduce the Bank's representation. The Treasury has given no explanation of the rationale for having Bank executives on markets and financial stability as full members of the FPC, rather than non-voting participants, when their respective bosses are already present, or for including such executives rather than staff of the PRA. (Paragraph 44)**

The Government agrees that it is important to strike the right balance between Bank and non-Bank membership. The proposed membership format for the FPC closely mirrors that of the MPC, whose membership also includes two Executive Directors. On the FPC, alongside the four independent members, there will be an additional non-Bank member: the Chief Executive of the independent Financial Conduct Authority (FCA). This means that the balance currently proposed within the FPC – six Bank members and five members from outside the Bank – is similar to that of the MPC, where the ratio is five to four.

**10. At least some of the external members of the FPC should have a recent senior background in the financial services industry. (Paragraph 47)**

**11. However prestigious a regulator may be, it will always lose many of its best staff to the industry it regulates. This is why the experience and credibility of the external members will be particularly important in ensuring the success of the FPC, and its credibility in the industry. The Committee must contain someone with recent experience of risk management at the highest level from the regulated sector. It would be wrong to require that the FPC contain members with experience in particular industries; the task of the FPC is to look at the financial system as a whole. However there must be no room for accusations that it is overly focused on banking nor that it lacks the expertise to look at important sectors, such as insurance. (Paragraph 49)**

**12. Conflicts of interest will be hard to avoid, even if external members have retired from the industry. They will need to be managed carefully. Some have made a case for those with current experience serving on the FPC, and we do not exclude that possibility. However, if the Government is considering this, it should set out clearly how those conflicts of interest will be dealt with. (Paragraph 50)**

The Government agrees that the external members of the FPC will play a vital role in ensuring that a diverse range of experience and views contribute to the development of macro-prudential policy. It will be essential to ensure that these members have the necessary knowledge, experience and expertise to play this role fully. In particular, it will be important to ensure external members are able to offer insights from direct experience as financial market practitioners—not only in banking, but also other sectors such as insurance and investment banking. This has been reflected in the Chancellor’s appointments of external members to the interim FPC.

The Government agrees with the Committee that it would be inappropriate for external FPC members to be appointed to represent particular sectors or constituencies: the role of the external members is to provide independent viewpoints and relevant expertise and experience in a neutral way.

The Government also agrees that the external members of the FPC should not have any significant conflicts of interest, as this would prevent them from fully participating in the work of the Committee. Therefore, the legislation will set out that when appointing external members of the FPC the Chancellor must consider whether potential candidates have conflicts of interest that would limit their participation in the FPC’s work. In addition, the Bank, with the consent of the Chancellor, may remove an external FPC member if that person’s financial or other interests substantially affect their ability to fulfil their role in the FPC. However, as the Committee recognises, it would be virtually impossible to appoint individuals with the right experience and expertise for the FPC and avoid potential conflicts of interest entirely. The legislation will therefore require FPC members to declare any relevant interest and will allow the FPC to determine to what extent it is appropriate for that member to be involved in discussions or decisions relating to that matter.

**13. The interim FPC is intended to have an important role in carrying out preparatory work and analysis for the permanent FPC. Its work may well result in fine tuning or even substantial amendment of the Government's proposals. It should be engaged in developing proposals for macro-prudential tools, and ways in which they might be adjusted. Given that this body has yet to be established, the current restructuring timetable, where the new regulatory system will be in place by the end of 2012, may be too challenging. We note that the Government has been unable to avoid delay on this, despite its desire for speed and the considerable control it had over this part of the process. (Paragraph 54)**

The interim FPC was created in February 2011 by the Bank's Court of Directors, as a sub-committee of Court. The interim FPC will undertake analysis into potential macro-prudential tools as part of its preparatory work. The composition of the interim FPC's membership resembles closely that of the proposed statutory body. The Bank's Court of Directors has appointed the following members:

- the Governor of the Bank of England, Mervyn King, as Chair;
- the Bank of England's Deputy Governor for Financial Stability, Paul Tucker;
- the Bank of England's Deputy Governor for Monetary Policy, Charlie Bean;
- the Chief Executive of the FSA, Hector Sants (in his capacity as future Deputy Governor for Prudential Regulation of the Bank of England and Chief Executive of the Prudential Regulation Authority (PRA));
- the Chairman of the FSA, Lord Turner;
- the Bank of England's Executive Director for Financial Stability, Andy Haldane; and
- the Bank of England's Executive Director for Markets, Paul Fisher.

Working closely with the Governor of the Bank, the Chancellor has appointed the following four independent members to the interim FPC:

- Alastair Clark, senior adviser to the Treasury for financial stability and former executive director and adviser to the Governor in the Bank of England;
- Michael Cohrs, former co-head of corporate and investment banking and member of the Group Executive Committee at Deutsche Bank;
- Donald Kohn, senior fellow in the Economic Studies Programme at the Brookings Institution and former Vice Chairman of the US Federal Reserve; and
- Sir Richard Lambert, former Director General of the Confederation of British Industry.

The future Chief Executive of the FCA, Martin Wheatley, will sit on the interim FPC once he takes up office on 1 September 2011. These highly experienced independent members will provide vital expertise and challenge to the Committee's deliberations.

**14. While in the long-term effective macro-prudential tools should increase economic welfare overall, particular individuals and companies find their access to**

**credit affected, even though they are confident they could service the debt they seek. Many macro-prudential tools are only now being developed, and their effectiveness will need to be monitored. As the consultation paper notes, quantitative credit controls, which were used until the early 1980s, led to distortions. Moreover, financial innovation can be redirected to get around new regulations. (Paragraph 65)**

As the Committee suggests, and as outlined in the February consultation document, each of the potential macro-prudential instruments under consideration will need to be carefully weighed up to determine their likely impact and effectiveness. The interim FPC will also play a vital role in assessing the risk of unintended consequences, distortions, opportunities for arbitrage, or other regulatory costs. The Government recognises that the majority remain untested, and whatever the final composition of the FPC's toolkit, adjustments will inevitably be needed as more evidence becomes available.

Establishing the toolkit in secondary legislation will allow the Government to adapt the toolkit over time to reflect international developments in macro-prudential policy and to incorporate evidence and lessons learned on the effectiveness of individual tools.

**15. The Government has proposed that the tools available to the FPC should be set out in secondary legislation so that they can be 'fine tuned' if necessary. Given the impact that the use of macro-prudential tools may have, we recommend that secondary legislation used to introduce or alter them require the approval of Parliament. This raises wider scrutiny issues, to which we shall return. Parliament needs to assess the nature of the powers which it is to devolve to the FPC, and the extent to which these can be satisfactorily encapsulated in legislation. This means that the bulk of the secondary legislation should be available before the House begins detailed examination of any Bill. (Paragraph 66)**

The Government notes that, by providing that the FPC's toolkit will be set out in secondary legislation, it has ensured that it will be subject to approval by both Houses of Parliament (via the affirmative procedure) on an ongoing basis.

The timetable for the development of this secondary legislation relies to a large extent on international developments in macro-prudential policy. It will also be important to give the interim FPC time to carry out one of its key tasks, which will be to analyse potential macro-prudential tools and advise the Treasury on this matter. Given these constraints, it will not be possible to make the secondary legislation setting out the FPC's toolkit available before scrutiny of the Bill proper begins. However, the Government will of course aim to maximise the amount of scrutiny available to Parliament of the FPC toolkit.

**16. Once appropriate tools are defined, we understand the rationale for giving the FPC discretion—in 'peacetime'—on when to use such tools, without reference to the Treasury. "To take away the punch bowl just as the party gets going" is easier said than done: it will be far harder if the FPC first has to identify a problem and then get the Chancellor to agree to the use of the tools which might mitigate it. However, only**

**the Government and the House of Commons have the power to authorise the expenditure of public money. As we discuss further below, the accountability issues raised by the Government's proposals are complex, and hard to resolve and are discussed further in Chapter 9. (Paragraph 67)**

The Government is pleased that the Committee endorses its approach to giving the FPC discretion over the use of macro-prudential tools. The Government agrees that Parliament's responsibility for authorising the expenditure of public money, as well as the Government's accountability for its use, are absolute. Therefore, the FPC will not have control over public money, nor will its tools involve the use of public money.

**17. In its consultation document, the Government states that "the objectives of price stability and financial stability should generally be consistent and complementary". However, in acting to achieve their respective objectives, the MPC and the FPC will employ tools that may interact in unexpected ways. These interactions may mean the actions of one committee could affect the achievement of the other committee's objective. (Paragraph 72)**

**18. The Government's proposals divide responsibility, but address coordination by having cross membership between the committees. At least three Bank officials will be members of both committees, giving them immense influence on monetary and macro-prudential policy making. Given this cadre of Bank cross-members, ensuring that adequate resources and support are available to the external members of each committee will be extremely important. (Paragraph 73)**

The Government believes that cross membership between the FPC and the MPC and careful sequencing of meetings will be sufficient to manage the interactions between monetary and financial policy and avoid potential conflicts. Some macro-prudential interventions have a long time horizon and may be adjusted infrequently, whereas the MPC meets (and may adjust interest rates) much more regularly. The Government expects therefore that the MPC will be the 'last mover', adjusting its analysis to take account of the likely impact of the most recent action taken by the FPC.

**19. One of the ways to monitor the influence of the Bank cadre will be through the transparency of the minutes of the two committees. We will expect full disclosure of voting within the FPC on the use of the macro-prudential tools. External members of either committee will always have the ability to write to this Committee with any concerns they may have. Other aspects of accountability are discussed in Chapter 9. (Paragraph 74)**

The Government agrees that the FPC's analysis and actions should be transparent, consistent with public interest constraints. The Government will legislate to require the FPC to publish a record of each meeting within six weeks. These meeting records will describe the FPC's discussions in broad terms, but without identifying the contributions of individual members.

As set out in the February consultation, meeting records will set out the decisions the FPC has taken (including any decision to issue a recommendation or direction, and the contents of these) and an explanation of the balance of arguments behind those decisions. As part of the consultation process, the Government will further consider whether explicit voting disclosure should be adopted for the FPC.

**20. The consultation paper proposes “Meetings of the MPC and the FPC will be carefully sequenced in order to ensure that both committees are able to fully take into account the most recent decisions of the other.” This presumably means that one committee will not meet until the minutes of the other have been published. We support this, as likely to strengthen the position of the independent members. (Paragraph 75)**

The Government welcomes the support of the Committee on this matter.

**21. Cross membership and sequencing of meetings may be sufficient in times of stability. However, in crisis periods the committees may need to work together more closely. Provision for joint MPC/FPC meetings so that policies on financial stability can be coordinated more effectively may be required. (Paragraph 76)**

The objectives of price stability and financial stability are sufficiently distinct that they should be managed separately, with different tools used to pursue the two objectives. It is important to prevent any dilution or confusion of the MPC’s inflation remit; the MPC’s role does not include financial stability, and the Government does not propose giving the MPC any responsibilities in this area. It would therefore be inappropriate for the MPC and FPC to meet together to consider financial stability. Of course, the MPC and FPC cannot exist in a vacuum: the decisions and actions of one will clearly affect the other. The cross-membership of the two committees will ensure that each committee is fully aware of the work of the other and able to take it into account in its analysis.

The Government’s consultation document sets out the Government’s proposed arrangements for crisis management, including legislative mechanisms and a statutory MoU to frame how the Bank group and the Treasury will work together to manage any crisis situation.

**22. Risks to financial stability may evolve, and may change in response to regulation. We welcome the proposal to give the FPC responsibility for monitoring the regulatory boundary. (Paragraph 79)**

**23. The FPC should also have the power and the responsibility to recommend changes to the wider legal and regulatory framework, including arrangements that go across national boundaries, such as those for the resolution of cross-border banks. Any such recommendations should be copied to us. (Paragraph 80)**

The Government welcomes the Committee’s support for the proposal that the FPC should monitor the regulatory perimeter. The FPC will be responsible for advising the

Treasury on any changes to the perimeter of regulation that it believes necessary. The FPC will also be able to recommend any other action it believes necessary, including to international and EU bodies. Any recommendations made by the FPC will be included in its published meeting record (subject to a public interest test).

## Micro-prudential Regulation

### **24. Further consultations should give a fuller explanation of the reasons for making the PRA a subsidiary of the Bank of England. (Paragraph 86)**

As explained in the February consultation document, a strong, integrated and judgement-based approach to macro and micro-prudential regulation is at the heart of the Government's regulatory reform programme. By bringing the PRA within the Bank of England group, the Government aims to improve coordination and harmonised action between the micro-prudential regulator (which will be responsible for addressing firm-specific risks), and the Bank of England (which will have the tools to address system-wide risks). The subsidiary model allows each institution to focus on its specific expertise and responsibility.

### **26. We are also concerned about the suggestion that the PRA's efforts will be focused on what it considers to be medium and high-impact firms. As the case of Northern Rock demonstrated, the failure of a company which was apparently "low-impact" engendered a systemic loss of confidence. The PRA will need to have a strong justification for reducing the supervisory effort for such 'low-impact' firms. (Paragraph 91)**

The PRA will focus with greatest intensity on firms whose failure could cause the greatest risk to the financial sector. But the Government recognises that the failure of smaller firms can also cause disruption to the financial system and cost to regulated firms, customers and taxpayers. For each firm, the PRA will make an assessment of the financial system's exposure to disruption and cost in the event of its failure. More generally, in addition to minimising the cost and disruption of failure, the PRA will also be responsible for promoting the soundness of firms that it regulates.

### **25. While there may be circumstances in which public authorities need to prop up a particular firm to avoid systemic risk, we are concerned by the implicit acceptance that any failure of a high-impact firm should be avoided. (Paragraph 89)**

**27. We agree that regulatory success does not and should not mean that no firm will fail. The Prudential Regulation Authority's aim should be, not to prevent firm failure, but to protect taxpayers and the wider economy from the consequences of such failure. Hector Sants' suggestion that the PRA will have a low tolerance for the failure of high impact firms is a source of concern. The assumption that certain firms cannot be allowed to fail results in market distortion, entrenches the market power of large incumbents and thereby stifles competition. That lack of market discipline may, over the long term, itself engender systemic instability. Although**

**there may be combinations of circumstances in which individual firms require support to limit systemic risk, we reiterate our predecessor Committee's recommendation that no firm should be too important to fail. Competitive markets need both freedom to exit and freedom to enter. (Paragraph 92)**

The Government agrees that no firm should be too important to fail, and is committed to embedding this approach in the legislation. The PRA's objectives have been designed to achieve this. While the regulator will have an important role in promoting the soundness of firms that it regulates, its duty will also be to ensure that the cost and disruption arising from a potential firm failure is minimised. This limb of the PRA's objective makes clear that, to strengthen market discipline and avoid moral hazard, the regulatory system should allow firms to fail. In support of this, the PRA's supervisory approach will have a greater focus on the resolvability of firms, in order to ensure that failures occur in an orderly manner and that systemic impact is minimised.

**28. Judgement-based regulation can cover a number of approaches, from challenging a company about how it would perform under a variety of market conditions, to substitution of the regulator's judgement for that of the company management. The aim should be to ensure that companies can fail without undue adverse impact, rather than to attempt to second guess management approaches. We are also concerned about how the PRA will manage situations in which members of the board of a supervised firm, who have personal legal responsibilities, do not agree with its judgment. (Paragraph 98)**

The Government agrees that judgement-based regulation should not be a substitute for firms' own management and the decisions they take. This will be reflected in the regulatory principle that senior management of regulated firms are responsible for securing compliance with the regulatory framework—a principle to which both authorities must have regard. However, the Government will also ensure that the regulatory authorities have sufficient powers to enforce their decisions, including exercising prior approval of persons taking up functions which exercise significant influence over regulated firms.

**29. We welcome the memorandum of understanding between the FRC and the FSA on audit. The regulator needs to be confident that auditors will share their concerns directly and they should have a duty to do so. The regulator should also be able to obtain any audit information it needs from the auditors. (Paragraph 100)**

The Government welcomes the Committee's support and notes its suggestion. The Government expects both the PRA and the FCA to benefit from close relationships with the audit (and actuarial) professions, taking advantage of their expertise on authorised persons.

The Government will consider further whether there is any need for the regulatory authorities to have additional powers over auditors, and whether their dialogue needs to

be put on a statutory footing, as recommended by the House of Lords Economic Affairs Committee's December 2010 Inquiry *Auditors: market concentration and their role*.

**30. The debate about whether the CPMA should be a consumer champion demonstrates the importance of making sure that definitions are clear. We have no doubt that effective conduct regulation should be in consumers' best interests and will involve a high degree of consumer protection. Nonetheless, branding the CPMA as a consumer champion would be inappropriate, confusing, and potentially dangerous. The job of the regulator is to ensure that regulation is effective and proportionate. That requires a balance between preventing abusive behaviour and ensuring that regulation does not impose excessive costs and restrictions, in order to optimise economic efficiency. Financial markets manage and price risk; they do not remove it. If a regulator is promoted as a consumer champion, consumers may falsely believe that all financial products are risk free, creating moral hazard. It is simply not possible to protect every interest at all times. We strongly urge the Government to drop the title of 'consumer champion' from the CPMA. There are other organisations which campaign for consumers; the regulator's task is to be alert to abuse, and to ensure that consumers are appropriately protected in an open and fair marketplace with the minimum of moral hazard. (Paragraph 110)**

The Government has finalised the title of the consumer protection and markets authority as the Financial Conduct Authority (FCA).

The Government notes the Committee's concerns about the description of the FCA as a 'consumer champion'. The summary of responses published in November last year made clear that the use of the term 'consumer champion' should be viewed in the context of the FCA's role as a focused and proactive conduct regulator that is entirely independent and impartial.

The February consultation further clarifies the FCA's role in a number of respects:

- the Government recognises that, as a regulator, the role of the FCA should not be confused with that of consumer advocate organisations, which themselves have a vital and distinct role to play. The FCA will, of course, be an entirely impartial regulator from whom firms and consumers can expect fair treatment;
- the Government believes that the FCA's regulatory focus on achieving better outcomes for consumers of financial services must be pursued in a way which recognises not only the limitations of regulation, but also the potentially negative effects of excessive regulation on market efficiency and consumer choice;
- proportionality will be crucial; the FCA, as an integrated regulator of retail, wholesale and market conduct will need to take a tailored approach to thinking about the interests of the consumers of products and services in each of these market segments. The interests of retail customers seeking financial advice will be different from those of pension funds purchasing investment management services, or from investment banks dealing in equities on their own account

using hypothecated client assets. The degree and type of regulatory protection afforded to them should be tailored to their needs and expertise. The FCA will take these differences into account in determining what sort of regulatory action to take in each sector, on a case-by-case basis; and

- the concept of the responsibility of consumers for their own choices will also be important. The Government recognises, however, that for retail customers the Consumer Financial Education Body will have an important role to play in educating retail customers so they are empowered to take decisions confidently.

The Government agrees that regulation should be effective and proportionate. To achieve this, both the FCA and the PRA will be required to analyse the costs and benefits of proposed rules, and to have regard to the principle of proportionality – that a burden or restriction imposed on a person or activity should be proportionate to the benefits which are expected to result.

**31. Competition is a highly effective means of protecting consumers' interests. The response given by the Financial Secretary when we pressed him on whether promoting competition should be treated as a primary objective for the new authorities was disappointing. The CPMA should have competition as a primary objective. This will benefit consumers directly and indirectly. Not only will there be a greater choice available for consumers, but the transparency which effective competition brings should reduce the need for heavy-handed regulation. Greater competition should also help prevent firms becoming too big to fail. We do not, however, believe that the regulator should have a remit to facilitate innovation—a properly functioning market will do that. (Paragraph 118)**

The Government agrees that competitive markets are vital to delivering better outcomes for consumers. That is why the FCA will have an operational objective of facilitating efficiency and choice in financial services. This captures two important elements of competitive markets—efficiency in terms of pricing and delivery, and an appropriate degree of choice in products and services.

As set out in the February consultation, and in line with the Committee's recommendation, the Government wants to go further and make clear that, where appropriate, the FCA should take action in pursuit of competition more broadly. The Government therefore proposes to impose a duty on the FCA to ensure that the FCA must, wherever appropriate, discharge its general functions in a manner intended to promote competition. In proposing this model, the Government has concluded that this approach to reflecting competition in the FCA's remit would be more appropriate than a primary competition objective explicitly focused on competition alone. The advantages of the Government's proposed approach are that:

- it focuses on the positive outcomes of greater competition, rather than on competition per se;

- it reflects the Government’s approach of providing each authority with a single strategic objective to ensure clarity of purpose and focus – given this approach, the FCA’s competition mandate needs to be balanced carefully alongside its primary objective. The FCA will not be expected to pursue greater competition in a way that is incompatible with its strategic objective, or indeed any of its operational objectives;
- furthermore, in key regulatory areas potentially impacting on competition, the PRA will have a major role, over which the FCA will have limited or no responsibility or locus – accordingly the proposed approach realistically reflects the way the FCA will be able to promote competition to achieve better outcomes for consumers; and
- it reflects the continuing role in this area of the competition authorities.

The Government considered whether the new regulatory authorities should have regard to broader considerations such as innovation, and, like the Committee, concluded that they should not.

**32. We have already proposed that the CPMA should have a primary objective of promoting competition, and there may be other places where regulators need a spread of objectives. However, we are unconvinced that ‘have regards’ provisions are effective in directing a regulator. The regulator will have to decide what trade-offs to make when desirable objectives compete: secondary statutory objectives are likely to be a more satisfactory way to specify such objectives for all but the most general provisions. (Paragraph 120)**

The Government notes the Committee’s view that secondary objectives will be more effective in directing the regulators than factors to which the authorities must have regard.

However, the Government’s priority is for the authorities to work to a focused set of strategic and operational objectives to ensure that the regulators have a clear mandate and focus. In responses to the July consultation document, there was widespread support for the general concept of ‘have regards’. Therefore, the Government has decided, alongside focused primary objectives, to retain the basic concept, while simplifying its implementation. The Bill will establish a common set of regulatory principles to which both the PRA and FCA must have regard in exercising their general functions.

**33. The CPMA will have a dual remit between consumer protection and markets regulation. The Government believes that a strong consumer division is required to deliver protection for consumers, while the industry believes there is a need for a strong markets division. It has also been suggested that market supervision might fit more naturally within the PRA. We urge the Government to give more detail about its thinking on this subject in the next consultation paper, and, in particular, what**

**structure it proposes to ensure that both market regulation and consumer matters receive the attention they need. (Paragraph 123)**

As described in the February consultation document, the Government believes that retail and wholesale conduct regulation should be combined in the FCA. There are clear synergies from bringing retail and wholesale conduct together – particularly when products sold to retail customers are based upon instruments traded on wholesale markets. Of course, there are also circumstances in which wholesale activities do not have an immediate retail dimension, and the approach to regulation will need to vary accordingly. However, the flexibility of the FCA’s statutory objectives and remit, combined with the regulatory principle of proportionality, will enable the FCA to vary its approach to the regulation of wholesale and market activities appropriately.

**34. We welcome the Government’s decision to put the UK Listing Authority in the CPMA, rather than splitting responsibility for markets regulation between three bodies, as first proposed. However, there are still issues to be resolved, such as the concern about the UK’s corporate governance position within Europe, where the CPMA will represent the UK in the European Securities and Markets Authority, although many corporate governance issues remain with the Financial Reporting Council. The success of the London markets underpins the success of the United Kingdom financial services industry; the markets division within CPMA must be adequately resourced, and may need a wider focus than pure conduct of business. (Paragraph 128)**

The Government welcomes the Committee’s support for locating the UKLA in the FCA.

Where another competent UK authority, such as the Financial Reporting Council, has an interest in matters discussed in an international body such as the European Securities and Markets Authority, the Government expects the PRA or FCA to agree coordination mechanisms on a bilateral basis with that authority.

**35. In principle the consequences of financial crises could pose more threats to consumers than individual cases of detriment. However, if the new arrangements work properly, choices between financial stability and consumer protection should be rare. If the FPC and PRA can produce a system in which companies can fail without financial instability, then CPMA decisions should not pose systemic risk. We welcome the Treasury’s reassurance that the PRA’s veto over the CPMA can only be used as a last resort. To ensure that this is so, cases when the power is exercised should be made public. It may not be possible to do so immediately, without threatening stability. In such circumstances the authorities should write to the Chancellor in confidence to notify him, explaining the reasons that the two authorities differed. We expect almost all such reports to be made public at the earliest opportunity, recognising that there may be exceptional circumstances. In such cases arrangements should be made to inform the Chair of this Committee. (Paragraph 133)**

The Government recognises the importance of transparency around use of the PRA veto. Therefore, the legislation will require that the notification of the veto must be laid before Parliament, subject to considerations of public interest, including considerations of financial stability and confidentiality; and that the PRA must report on the use of the power in its annual report, subject to the same considerations.

**36. It is important that the PRA and CPMA work closely together on both prudential and conduct of business issues; the absence of a Chief Executive designate of the CPMA risks regulatory thinking being developed only by those responsible for the parts of the regulatory structure which are or will be directly related to the Bank of England. We are likely to return to the relationship between the CPMA and the Bank of England in future work. (Paragraph 134)**

It was announced on 2 February 2011 that Martin Wheatley has been named as the Chief Executive-designate of the FCA. He has been appointed by the FSA as managing director responsible for consumer protection and markets, and will take up this post in September, when he will also join the FSA Board, playing a central role in shaping the transition to the FCA. Once the FCA is established, Mr Wheatley will take up his role as the head of the new organisation.

## Cost of regulation

**37. Given the urgency of the Government's reform programme and the resources and time needed to produce a further full study of the costs of regulation, it will be impractical for the FSA to devote resources to such a review at this stage. Once the new architecture has been set up, we recommend that the PRA and the CPMA revisit the whole issue of cost of regulation, in the light of the financial crisis and the changes in regulatory structure. (Paragraph 140)**

The Government notes this recommendation, which is addressed at the PRA and FCA.

**38. Under FSMA, the FSA is required to undertake a cost-benefit analysis of any proposed regulatory changes. However, the full costs—always ultimately borne by consumers—need to be shown. Cost-benefit analysis must be improved within the PRA and the CPMA. New regulatory requirements should only be introduced if a full cost-benefit analysis has been conducted. The authorities also need to be certain and demonstrate that the benefits are justified by any additional costs to consumers that might be caused by restrictions to competition. (Paragraph 141)**

The Government agrees that the new authorities should be bound by the requirements of regulatory good practice, including conducting comprehensive impact assessments.

**39. We are unconvinced by the Financial Secretary's explanation that the £50m transition costs will be borne by the industry alone. His contention that a competitive market means that the industry will not be able to pass on the costs to consumers begs the question as to the degree of competitiveness in the market. We**

**urge the Treasury to give more detail about the assumptions underlying the £50m transition cost. It should also report regularly over the transition period on the level of actual costs being incurred. (Paragraph 144)**

The Government published alongside the February consultation document a revised Impact Assessment which provides more detail on the costs of these reforms. A further impact assessment will be published at the appropriate time.

**40. We appreciate the importance of avoiding the regulatory underlap that we have seen under the Tripartite system. However, removing the underlap should not result in an overlap of responsibilities between the new bodies. Overlap, like underlap, can lead to confusion and paralysis. Careful planning and consideration needs to be given to the remits and boundary of responsibilities, especially between the PRA and CPMA. (Paragraph 147)**

The distinct objectives of the new authorities will reduce the risk of overlap. Coordination between the regulators will also be important. Ensuring that arrangements are in place for each regulator to work closely with the other will enable both regulators to focus on their core remit. For example, the Government has outlined that the PRA and FCA will be obliged to prepare a Memorandum of Understanding. In the February consultation, the Government has outlined high level principles to ensure that coordination between the PRA and FCA supports the regulators in delivering their statutory objectives in an effective and timely manner. The consultation also sets out a number of proposals for coordination between the regulators on specific regulatory processes.

**41. The move to new regulatory arrangements should be accompanied by better analysis of the cost of regulation, both one-off and ongoing, for all kinds of financial firms, by sector and by size. The aim should be to produce a better, more effective and more cost efficient regulatory system. (Paragraph 148)**

As noted in response to recommendation 38, the Government agrees that there should be rigorous analysis of the cost of regulation. Effective cost-benefit analysis should contribute to this.

## **International regulation**

**42. Effective participation in international regulation is both a central part of macro-prudential policy and key to ensuring that micro-prudential policy can be conducted effectively. (Paragraph 150)**

The Government agrees, and will continue to play a leading role in the international debate on strengthening the framework for financial regulation.

**43. Implementing the G20 priorities alone will place a heavy legislative burden on the EU. The lion's share of action will need to be taken at a global level if it is to be**

effective. The economic welfare added by regional action therefore requires particularly careful scrutiny. We are concerned about the scale of the EU agenda, particularly given that the European Supervisory Authorities, which should at least be able to help the Commission prioritise its work, have only just been established. The focus of European effort should be on explicit commitments by the G20 for reform. These should be implemented in close cooperation and after careful consultation with other jurisdictions. (Paragraph 158)

**44. If the European Supervisory Authorities focus on improving coordination between regulators, and drawing up technical standards which are based on a deep understanding of the markets regulators have to deal with, they can add value. However we are concerned at the sheer scale and pace of the reforms taking place at European level. The Commission needs to ensure its reforms are technically sound, and only brought forward after consultation. It also needs to avoid the danger that political pressure may lead to poor regulation. Inappropriate regulation will not only damage the United Kingdom, but the European Union as a whole.**

The Government agrees and is working closely with EU and international partners to implement the global priorities for reform as agreed by the G20. A key Government objective is to ensure consistent application of the reforms, which is essential to minimise the risks of regulatory arbitrage and support strong and stable international financial markets.

As underlined in the February consultation document, the Government agrees that all regulatory proposals must be based on a clear evidence base, following extensive consultation and accompanied by a thorough impact assessment. EU level reforms should implement G20 agreements, reinforce the single market and deliver a level playing field across Member States, which is central to supporting EU competitiveness in global financial markets.

The European Supervisory Authorities (ESAs) have already made good progress since their establishment in January 2011, and the Government places great importance on giving them time to deliver on their current responsibilities. The new European supervisory framework has the potential to deliver higher and consistent standards of supervision across the EU, to implement common and high standards that every institution must adhere to, and most importantly, help create a level playing field across Europe. The ESAs must adopt a proportionate regulatory approach, which will manage risk without stifling the benefits.

The UK regulatory authorities will be well placed to influence and take part in the technical work of the ESAs, for example the development of binding technical standards, and the production of guidance and advice. Alongside this, the FSA (and, in due course, the PRA and FCA) will have a significant formal role in representing the UK's competent authorities in the ESA Boards of Supervisors, and voting in the Board on ESA decisions (for more detail see response to recommendation 45 below).

**45. It is important that the UK, with a particularly large share of the financial services activity of the EU, secures appropriate representation on the EU regulatory bodies. (Paragraph 169)**

The Government agrees. The three ESAs will each have a voting member from the UK, as well as the ability to bring up to three additional non-voting members. As the prudential regulator, the PRA will represent the UK in the new ESAs for banking and insurance, while the FCA will represent the UK in the securities authority. They will ensure that there is a strong and credible voice to promote the interests of the UK in these new institutions.

The PRA and FCA will work closely together to ensure that the other regulator and any other relevant authorities are kept fully informed of any matters due to be discussed in EU bodies that fall into their sphere of responsibility. The February consultation document sets out clear mechanisms to ensure UK cooperation, including bilateral coordination mechanisms and statutory MoUs where appropriate. Where an item of discussion falls within the competence of another national body, the UK member may bring along a non-voting representative of that other national body.

The UK has secured senior UK representation from the FSA in all three ESAs: Thomas Huertas is the Vice Chair of the European Banking Authority; Hector Sants is on the European Insurance and Occupational Pensions Authority's Management Board; Alexander Justham is on the European Securities and Markets Authority's (ESMA) Management Board; and Verena Ross is ESMA's first Executive Director.

**46. The establishment of the ESAs means the Government and the FSA need to treat engagement in European negotiations as a high priority. The United Kingdom's regulatory framework must be designed to ensure that engagement with Europe is effective. (Paragraph 170)**

The Government agrees, and has placed renewed emphasis on EU and international engagement, which will continue to be an ongoing priority. The Government intends to continue the leadership role it currently plays in key international policy bodies such as the International Monetary Fund, the Financial Stability Board and the G20. The Treasury will also maintain its current role engaging extensively with the EU policy development and legislative processes, and will continue to lead negotiations for the UK on EU legislation. The Government is focused on ensuring EU measures are coherent, evidence based, proportionate, and focused on reducing systemic risk, whilst making markets work effectively, contributing to growth.

The Government also expects the UK's regulatory agencies to put significant time and effort into ensuring that the UK's voice is heard at the European level and that the decisions taken by the new authorities are appropriate. The PRA and FCA will work closely together to ensure that both are kept fully informed of any matters due to be discussed in EU bodies that fall into their sphere of responsibility.

The Government is proposing legislation which will put the regulators under a duty to coordinate. It will also require them to agree a memorandum of understanding setting out how the duty to coordinate will be delivered. This will include how the regulators will coordinate their engagement with foreign regulatory bodies.

**47. At national level the Government is proposing to devolve a great deal of power to independent regulators. We do not oppose this, but many of the actions to prevent a recurrence of the crisis depend on actions which must be negotiated at an international level. Both the regulators and the Government may be involved in such negotiations. There are two potential dangers. The first is that international regulation becomes the preserve of technocrats, and Governments may become dangerously disengaged. The second is that political pressure results in bad regulation. The Government should provide greater clarity about the way in which negotiations will be handled and co-ordinated, what role the Government will play, and how it proposes to minimise these risks. (Paragraph 172)**

The Government agrees that in order for the UK to continue to play a lead role in the ongoing development and implementation of internationally-agreed changes to financial regulation, the UK authorities will need to maintain a single, coherent and consistent overall strategy. This will be vital in ensuring that the UK's interests are protected, and that individual proposals are consistent, based on sound evidence and fit for purpose. In order to support this, the Government intends to legislate to require the establishment of a statutory memorandum of understanding between the Treasury, the Bank of England, the PRA and the FCA on overall international coordination within the UK's system for financial regulation. Among other things, the MoU will set out the process for discussing and agreeing strategic objectives to inform a single UK approach to significant changes in financial regulation and how the authorities will coordinate their engagement in international bodies.

### **Responsibilities in times of crisis?**

**48. We have some doubts about a system in which one authority decides whether or not to put an institution into resolution, another related institution decides what form that such a resolution arrangement should take and a third is responsible for the decision to use public funds. We also note that the decision to allow an individual firm to fail might contribute to a systemic loss in confidence. (Paragraph 179)**

**49. We accept that the Governor will keep the Chancellor up-to-date with developments in the markets which may have an impact on financial stability. However, if a systemic crisis occurs which the Bank considers public money is required to resolve, it is hard to see how the Government could assess such a request while remaining at arm's length from the process. As we have seen recently, rescuing the financial system may have significant effects on public finances. Only a democratically elected Government should make such decisions. It will bear the responsibility for any errors; it must have the information and freedom it needs to**

**choose its position. In times of crisis, it has to be the Government that is in charge. Once it appears likely that intervention beyond a single firm is necessary, and where public funds are put at risk the authorities should take decisions together, led by Treasury Ministers, and where appropriate, the Chancellor, chairing any crisis management meetings. (Paragraph 181)**

**50. The boundary between ‘emerging risks’ and ‘crisis mode’ is often unclear. As we saw in the banking crisis, major financial institutions, such as RBS and HBOS, had to be rescued over a short time frame, such as a weekend. There has to be some mechanism that will allow the Government to intervene if, in its view, a crisis is developing, and other authorities are unwilling to act. (Paragraph 183)**

As the Committee notes, the PRA (which will be part of the Bank of England group) will ‘pull the trigger’ to put a failing firm into the Special Resolution Regime (SRR). Key PRA decisions involving major firms or other high risk issues will be taken by an executive committee of the board, comprising the Chairman, the Deputy Governor, Financial Regulation, other PRA executives and the Deputy Governor, Financial Stability. This will mean that in the period leading up to a resolution, PRA and the rest of the Bank group will share a common analysis of the risks, including a shared understanding about the likelihood of failure, and the most appropriate response. They will also be better equipped to deliver a coordinated and harmonised response.

However, it is right that the final decision to put a failing firm into the SRR will lie with the PRA executive (rather than with the Bank), and that the PRA will be operationally independent in its decision. This is because the decision to trigger the SRR is a regulatory decision, based on the regulator’s judgement that the firm is no longer meeting the conditions to continue as an authorised entity, and that it is not likely that action will be taken that would enable it to meet its threshold conditions. The fact that the PRA is a separate legal entity from the Bank means that it can be held accountable for this decision.

The Government notes the Committee’s point that the failure of an individual firm could contribute to a systemic loss in confidence. This is why it is important that when failures do happen, they are managed in an orderly way that protects depositors and maintains financial stability. The SRR is one set of tools for managing firm failure.

Since 2007 the Committee has often pointed out that one of the weaknesses of the tripartite system was that it was unclear who was in charge in a crisis. One of the key aims of the Government’s reforms is to unambiguously delineate responsibilities between the authorities, so it is clear who is responsible for taking decisions to take action and who is ultimately accountable for effectiveness of those actions. This is why in the new regulatory structure the Bank group will be fully responsible for financial stability, including designing and executing most elements of the regulatory and resolution response to an emerging financial crisis.

However, given Parliament’s responsibility for authorising the expenditure of public money and the Government’s accountability for its use the Treasury will remain in control of any decision involving the use of public funds. As the Committee rightly points out, performing these discrete, but complementary, roles effectively will require close cooperation between the Treasury and the Bank group when managing a specific risk to stability. The Government will put in place two specific legislative mechanisms to frame and support this close cooperation: a regular twice annual update from the Governor to the Chancellor on developments in financial stability and prudential regulation; and a statutory duty on the Governor to notify the Chancellor as soon as it becomes clear that there is a potential risk to public funds.

The Governor’s duty to inform the Treasury of a risk to public funds will be framed in terms of a ‘possibility’ of public funds being needed at some stage in the future. This ensures that the Bank must inform the Treasury in the very first stages of contingency planning—as soon as a risk becomes apparent. This will mean that the Treasury will be made aware of any potential risk to public funds - such as the example cited by the Committee: a risk to a large, systemic firm – well in advance of any decision needing to be taken in order to allow the Chancellor to consider and discuss a range of options.

In addition, in order to establish clear procedures for how this process will be managed, the Government will legislate to require the establishment of a statutory Memorandum of Understanding (MoU) on crisis management. This MoU will principally be between:

- the Treasury, responsible for public funds and accountability to Parliament; and
- the Bank group, comprising the Bank itself, as resolution authority and central bank and the PRA, as prudential regulator and responsible for triggering firms into the SRR.

This MoU will set out how the authorities will work together to identify and manage specific threats to stability. In particular, it will supplement the duty on the Governor to notify the Chancellor of risks to public funds by setting out what happens after the notification is made. For example, it will establish how the Bank group will keep the Chancellor updated about a specific threat, what information will be shared with which authorities and which different resolution options would be considered.

**51. Despite granting the Bank of England independence in monetary policy, the Treasury retains an emergency power to give the Bank directions in setting monetary policies, when it considers it is in the public interest to do so and under extreme economic circumstances. A similar ‘reserve power’ should be given in the new legislation. It is important that the Government retains the power to take control over actions for which it will ultimately be held responsible whilst recognising that the use of such draconian powers would be an extreme step and would prejudice the perceived independence of the regulatory institutions. (Paragraph 184)**

The Government believes that in order to preserve the ability of the Bank of England to operate at arm’s length from Government, it is important to ensure that the work of the

independent central bank is as far as possible free from political interference. The Government retains the ability, under section 4 of the Bank of England Act 1946, to give directions to the Bank if it believes it necessary in the public interest. Monetary policy is excluded from this power, but all other work of the Bank is included. While the Government has, to date, never used this power to direct the Bank of England, it would be able to do so in relation to financial stability.

### **Transparency and accountability of the new bodies**

**52. The Monetary Policy Committee and the Bank of England have repeatedly demonstrated their commitment to transparency. They have seen their engagement with the Treasury Committee as a means of securing accountability. That has been a key reason for the system's success and we warmly welcome it. (Paragraph 189)**

**53. The performance of the inflation targeting regime in the UK is measurable, with explicit and well-defined roles for the Treasury and the Monetary Policy Committee of the Bank of England as to overall policy remit, decision taking and implementation. Deviations from the target are obvious, to both the participants, and the wider public. By a one person, one vote system on the MPC, alongside vote publication in the minutes, decision making is transparent. The Treasury Committee takes an active part in this process, pursuing both transparency and accountability, using our hearings to draw out MPC members' thinking on key topics, and appointment hearings to assess their competence and independence. We can also question the Chancellor as to the remit set by the Treasury for the MPC. Independence is maintained by the strict separation between remit setting at the Treasury, and decision making over interest rates at the MPC. (Paragraph 196)**

The Government agrees with the Committee that the transparency and accountability arrangements for the MPC have worked well. This is why the Government has aimed to reproduce these arrangements for the FPC as far as appropriate and practical.

**54. The Treasury and the FPC must provide far more detailed criteria against which the achievements of the new regime can be assessed. Without this accountability will be considerably weakened. (Paragraph 197)**

**55. The MPC is given its target in a regular, published remit letter from the Treasury. We recommend that this be the case for the FPC. We would not be surprised if the remit changed as more information and further research becomes available about the operation of the macro-prudential tools, and about how financial stability can usefully be defined. Such remit letters provide the political authority for the operation of such independent bodies. Their publication allows for scrutiny by this Committee, as well as other interested parties. We will take a close interest in the Financial Policy Committee, and its relations with government, and we will hold regular hearings. (Paragraph 199)**

The Government warmly welcomes the Committee's intention to take a close interest in the work of the FPC and to hold regular hearings. The Government believes that accountability to the Committee will prove crucial in scrutinising the FPC's decision-making and achievement of its objectives.

As the Committee acknowledges, financial stability is difficult to define quantitatively or precisely, and is subject to complex trade-offs. As set out in response to question 7, while believing it important to give the FPC a clear and permanent objective in primary legislation, the Government agrees that the general concept of a remit could usefully be applied. Therefore the Treasury will be able to provide the FPC with guidance in the form of a remit, alongside its statutory objectives, to help shape its pursuit of financial stability.

**56. The Committee will give further consideration to the accountability of the new regulatory structure in the light of the Government's second consultation document, due to be published shortly. Meaningful proposals on accountability cannot be made without more detail. (Paragraph 201)**

The Government is committed to having in place strong accountability mechanisms for each of the new bodies, and looks forward to hearing the Committee's thoughts on the detailed proposals provided in the Government's February consultation document.