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Response to the Treasury Committee Inquiry into the Accountability of the Bank of England

Executive Summary

1. The Financial Services Consumer Panel (“the Panel”) is a statutory body established under s.10 of the Financial Services and Markets Act 2000 (FSMA). The Panel advises the FSA on the interests and concerns of consumers, and reports on the FSA’s performance in meeting its objectives in the regulation of financial services. It also looks at the impact on consumers of activities outside, but related to, the FSA’s remit.
2. The Panel’s interest in this issue arises from the proposals for regulatory reform in splitting off the regulator’s current prudential function to a Prudential Regulation Authority (PRA) located within the Bank of England, and in the formation of the new Financial Policy Committee (FPC), also situated within the Bank of England’s governance structure. Our submission to the inquiry will focus on the need for greater accountability and broader representation in the FPC and PRA.
3. Stable financial markets are vital for consumers, but they also have a strong interest in retail markets which are transparent, which deliver good value and which treat consumers fairly. In the proposals for a new regulatory system there is a danger that the link between prudential issues and systemic risk on the one hand, and conduct issues and maintaining confidence in the market on the other, will be weakened. The Panel believes that to strengthen the links between macro-prudential, micro-prudential and business conduct regulation and to ensure that the broader issues and trade offs that impact on financial stability are taken into account, there is a need for broader accountability of the new bodies within the Bank of England structure than allowed for in the current proposals.

To whom should the Bank be accountable? *Are different accountability mechanisms needed for different functions?*

4. The regulatory system should be accountable to citizens and consumers, government and industry for the decisions it makes, the actions it takes and the impact these have.
5. Accountability can be provided through a number of means:
 - In being held to account ex post facto by, for example, reports to the Parliament and to the public such as business plans and annual reports,

minutes of meetings and reasons for decisions, and through complaints mechanisms.

- By securing good, evidence-based inputs from key stakeholders, through dedicated research, analysis and monitoring, and being responsive to the external environment so as to make better informed decisions.
 - By improving the quality of decision-making, ensuring that institutions have an appropriate mix of skills and experience amongst executive management and non-executive members on their boards.
6. The current proposals lack operational detail, but the Panel is concerned that the boards of both the FPC and the PRA have an overly strong Bank of England basis and we would like to see a more diverse and representative structure. We would not want to see the supervision of business conduct downgraded and a failure to adequately consider the possible negative impact on citizens as a result of the structural changes.

The Financial Policy Committee

7. The FPC will use its macro-prudential tools to contribute to the achievement by the Bank of its financial stability objective. It will be required to take account of the effect of its actions on the growth of the UK economy, but there is no requirement, either in taking account of growth issues or in a broader sense, to consider the impact of its actions on consumers' welfare. For example, instruments, such as loan-to-value caps or increasing the cost of capital to manage an emerging asset bubble in the housing market may be effective in stabilising the financial system but could impact consumer confidence and therefore have adverse consequences for the growth of the economy. It is not clear that the constitution of the FPC will provide adequate breadth of experience and independence to provide effective governance for an activity which will have a much broader remit than the MPC.
8. The FPC will be a sub-committee of the Court of the Bank, chaired by the Governor of the Bank. In addition, a majority of the members and the Chairman will be drawn from the executive management of the Bank. The Board of the PRA will also be chaired by the Governor and have majority Bank membership. In our view this does not provide the necessary checks on the decisions taken by the Bank's executive management. We would like a majority of members to be from outside the Bank. These non-Bank executives should be appointed in a transparent way, properly supported and resourced to guard against the phenomenon of "group think". In normal circumstances this will provide the necessary independence to review actions proposed by the Bank, the PRA and the FCA and decide on the best course. In the case of a crisis we think it is extremely unlikely that the independent members will overrule the advice of the bank's executive. In that respect experience, once the recent crisis crystallised, has been reassuring.

9. The Monetary Policy Committee (MPC) provides an example of greater transparency and accountability of operations within the Bank of England and, allowing for the different functions, could be a model for the FPC.
10. The MPC goes to great lengths to explain its thinking and decisions. In addition to the publication of the minutes of meetings and the discussion leading to decisions it also records the votes of the individual members of the Committee. The Committee has to explain its actions regularly to parliamentary committees, particularly the Treasury Committee. MPC members also speak to audiences throughout the country, explaining the MPC's policy decisions and thinking. This is a two-way dialogue. Regional visits also give members of the MPC a chance to gather first-hand intelligence about the economic situation from businesses and other organisations. We would encourage the FPC to adopt a similarly transparent and accountable approach in its engagement with stakeholders.
11. The FSA Panels have traditionally had a worthwhile dialogue with the FSA Board, providing information and particular perspectives, and we propose that this ongoing dialogue should continue with the FPC. We believe that the relationship proposed between the Panels and the FCA would be a useful addition to the governance arrangements of the FPC and PRA. This could be achieved as part of the MoU between the FCA and the FPC and PRA.

The Prudential Regulation Authority

12. The decisions of the PRA and its supervisory work have the potential to impact significantly on consumers, because of the interactions between conduct and financial stability (eg the decisions taken to deal with an asset bubble), the potential for anti-competitive practices to be endorsed in the name of financial stability (eg in a PPI type situation where the business model is common to all) and the power of veto over conduct regulation. It is vital that consumer interests are represented in its discussions. The presence of the chief executive of the FCA on the Board is not sufficient in our opinion.
13. We would like to see the Panels having a relationship with the PRA Board, as now with the FSA, which would enable us to be aware of forthcoming items on their agenda and the ability to submit observations and comments on issues which are being discussed where the experience of the people on the Panel may be relevant. This has been achieved through the requirements in s10 & 11 of the FSMA for the FSA to establish and consult Panels of consumers and practitioners and, for the panels to be able to raise issues formally with the Board and require them to respond. This process has never had to be used formally but, through the MoU under which the Panels operate, it has been possible to discuss issues and provide advice which has improved the debate on the Board.
14. Regulatory intervention undertaken by the PRA may also have a damaging impact on competition. Concentration or a preference for larger, possibly sounder, institutions raises concerns about barriers to entry and the spectre of too big to fail. It is no doubt easier for a regulator to regulate a small number

of firms with a similar operating model. If the PRA only focuses on financial stability it may lose sight of long term impacts on the market.

15. The elevation of competition to a primary PRA objective could lead to muddle and industry gaming of the regulatory rules. We believe that a competition check is required on the PRA's activities. The existence of the FCA provides a primary check, but the power balance between the two organisations as proposed would not produce satisfactory consumer outcomes. Therefore, as one of a number of measures necessary to produce a more balanced power relationship between the PRA and FCA, the Panel urges that the PRA's functions be subject to the former general duty to have regard to:

“the need to minimise the adverse effects on competition that may arise from anything done in the discharge of those functions”.

The PRA's Power of veto

16. The availability of a PRA veto could constitute a restraint on FCA exercising its consumer protection functions and may result in significant detriment to consumers. Financial firms may use the existence of the veto to game the system, seeking regulatory forbearance on exaggerated grounds of instability risks. We are not convinced that the proposed Parliamentary scrutiny would avert these potential deficiencies.
17. The PRA is able to intervene where it considers FCA actions are likely to lead to disorderly failure of a firm or firms, or wider financial instability. We accept the need for a veto in certain limited and well-defined circumstances; it is not in consumers' interest that the disorderly closure of firms disrupts the supply of vital financial services or threaten financial contagion. But we question whether the PRA should be permitted to exercise its veto on grounds of “wider financial instability”, a macro-prudential consideration for the FPC to decide, and remain concerned that the industry will have a large incentive to game the rules even in cases where the risk of instability is limited.
18. The Panel proposes that if there is a role for a veto in circumstances where actions proposed by the FCA create a risk of wider financial instability, the decision to deploy the veto should be with the FPC rather than the PRA. The FPC have no direct relationship with the firms involved and, if the composition and issues under consideration by the FPC are more broadly based, should be able to better balance competing issues. The FPC already has a role in providing advice and expertise to the regulators and in advising on disputes where matters could have material financial stability effects.
19. Ultimately if the PRA has to use its veto it is a strong indication that it has failed in supervision and the required interventions have not been made earlier. The veto should be seen as a last resort.

Co-ordination and communication

20. The proposed split of supervision and conduct functions between the PRA and FCA should be supported by strengthened communication and a commitment to consistency. This will be a challenge between two bodies with completely different objectives. The duty to co-ordinate must result in co-ordination and therefore there is a need for oversight and regular monitoring.¹ The Panel proposes that some of the necessary scrutiny of co-ordination and communication could be provided both through regular internal audit and also through the Special Supervisory Unit, an independent unit within the current FSA which reviews how supervisors are dealing with relationship managed institutions.
21. In addition, we propose the following mechanisms to achieve a more even balance between the PRA and FCA:
- Annual reporting by the Treasury Committee on how the FCA and PRA are co-ordinated.
 - Bi-annual reports by the FCA to BIS and HMT, comparable to the bi-annual stability reports by the Governor of Bank of England.
 - A relationship for the FCA Panels with the PRA and FPC, similar to that in s10&11 of the FSMA to strengthen the governance of both organisations.
22. The exchange of information from PRA to FCA will be paramount to FCA properly performing its functions. There is some concern that because of the commitment to financial stability that prudential supervision will lose its focus on conduct issues and unfairness and that even if information is passed on to FCA, the information will not be adequate. Incentive structures are required to encourage sharing of information rather than just requiring information exchange.

Role of the Panels

23. The role of current FSA Panels has been recognised as a critical and effective component of governance and accountability and an important part of the FCA going forward. The Consumer Panel currently plays a role within the regulator in relation to both prudential and conduct of business issues and also provides advice on matters applicable to both such as consumer and stakeholder engagement. The Panel advises and challenges the FSA from the earliest stages of its policy development to ensure the FSA takes the consumer interest into account. Members of the Panel encompass a broad range of relevant expertise and experience. Formal recognition of the Consumer Panel and its representations, through an MOU with the PRA and FPC, would enable early input and identification of possible consumer impacts of prudential regulation.

¹ The Australian twin peaks model has separate prudential and conduct regulators in addition to the Central Bank who all have representation, along with the Treasury on an overarching Council of Financial Regulators.