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'Never mind twin peaks' — what do the FSA Business Plan, Prudential Risk Outlook and Retail Conduct Risk Outlook mean for the banking sector in 2011/12?

Apr 20 2011 Rosali Pretorius and James Brennan

The Financial Services Authority Business Plan for 2011/2012 is all about consolidation. Gone is the rhetoric of expansionism. Gone are the double-digit budget increases for its ongoing regulatory activities (this year's increase is a relatively paltry seven per cent). Last year, Hector Sants, chief executive of the FSA, declared "if society wants a more proactive approach, it must accept that it will have a larger and more expensive regulator". This year, "we remain mindful of the economic climate and are controlling our costs accordingly."

So what's changed over the last 12 months?

The coalition's decision last June to move to a 'twin peaks' regulatory approach in 2013 has undoubtedly played a major role in change in emphasis. The formal establishment of the Prudential Regulation Authority under the umbrella of the Bank of England and the re-branding of a reduced FSA as the Financial Conduct Authority is at least two years away. Yet the FSA is already beginning its reluctant evolution towards the new structure. Even as it does so, however, there are other pressures bearing down on it.

Increased supranational regulation will radically alter the way the FSA works. The three new European Supervisory Authorities, with their greater capacity to introduce regulation and wide enforcement powers over national authorities, will direct key policy from now on. If the newly-empowered European regulators have reduced the need for the FSA to make new rules, the continued fragility of the financial system has reduced its appetite for it. Underneath the assurance that it has no new discretionary initiatives scheduled for the year ahead is a tacit acceptance that banks operating in the current economic climate are anxious about the cumulative compliance costs of the existing reform agenda. So as the FSA begins the process of internal transition to better reflect the future division of competences, it has started to focus on a manageable set of deliverables.

What does this all mean for the banking sector?

Essentially, more of the same. Both deposit takers and investment banks can continue to expect intensive supervision and a spotlight on consumer protection.

'Prudential banking': capital and liquidity

While the FSA wants to avoid imposing a greater regulatory burden by its own initiatives, it also wants to ensure that international regulatory reform is delivered effectively. This is important for the banking community because of the Basel Committee agenda. The FSA will keep the rigorous interim capital framework introduced in October 2008 to enable UK banks to achieve a smooth transition to the Basel III capital regime. The Prudential Risk Outlook sets out a lengthy, phased transition period from 2013 onwards, allowing banks who need it the chance to strengthen their capital positions further. However, the capital requirements are only one tenet of a preventative risk management policy.

Reshaping the business. As capital positions are consolidated, the FSA encourages banks to continue to take opportunities to shed or unwind non-core, risky assets. This "encouragement" will of course now be overshadowed by the Vickers report on banking, and any rules made to force universal banks to ring-fence deposit taking, commercial lending, payment systems and other crucial business lines.

Stress testing. The FSA hopes to improve and refine its stress testing, again providing an anchor macroeconomic scenario in the Prudential Risk Outlook to supplement banks' internal stress tests. As in 2010, it assumes a worsening in both the UK and global economies, with a substantial decrease in property prices and high unemployment.

Liquidity. FSA will keep its liquidity policy, governed by the overarching principles of self-sufficiency and adequacy of liquid resources, in place until supranational reform is finalised. It will continue to monitor quantitative liquidity data from individual firms and across the market. It will actively take part in the

European Banking Authority's liquidity review, which includes reports on the liquidity position and leverage coverage ratio of EU banks.

Funding. The FSA is keen to ensure that stable customer deposits and long term debt form a larger part of funding and that banks reduce their reliance on short-term wholesale debt. However, it recognises that significant funding challenges still lie ahead and the demand for wholesale debt issuance will probably surpass 2010 levels, even if growth in corporate and household deposits continue to exceed their borrowings.

SIFIs. The FSA is eager to work with the G20's Financial Stability Board to develop an effective international regime for systemically important financial institutions. It wants additional capital requirements to further minimise the likelihood of failure. Meanwhile, it is committed to working with selected firms to develop comprehensive recovery and resolution plans to increase the robustness of the financial system against a future crisis.

'Delivering consumer protection': intensive supervision

The consumer protection strategy started in March 2010 remains a significant priority. The FSA is again looking to provide earlier, more effective supervisory intervention — anticipating consumer harm and stopping it before it occurs.

Product intervention. For banks, this will mean greater testing of internal product design and controls. Linked to this is the continuing review of incentive structures for in-house sales teams to make sure that staff benefit doesn't encourage consumer detriment. Further, following the FSA's Retail Distribution Review and, more recently, the Policy Statement on Professionalism (PS11/1), the FSA will work with firm supervisors to develop an adviser database to identify high risk advisers.

Enforcement. To this will be added greater redress for the consumer. To reinforce the link between misconduct and the consequent penalty, the FSA intends to make full use of its new powers under the Financial Services Act 2010 to suspend individuals or firms and to publish decision notices when it brings enforcement actions.

Complaints. Final proposals on customer complaints procedure will be published in May 2011 following last year's review of the complaints handling of major banking groups. Two banks were referred to the FSA's Enforcement Division in the light of this review, and fined £2.8m in January for multiple failings in the way they handled customers' complaints. Five banks have already agreed to make significant changes.

A steady path over difficult terrain: a chance to catch our breath?

It's set to be a tough year ahead for the regulator as it continues its attempts to restore public confidence in the banking sector. Not only will the move towards the new regulatory structure be watched closely within the industry, but the relentless pace of the supranational agenda and continuing fragility of the financial industry will place heavy demands on the FSA's resources. Yet it also looks set to be a year of few surprises, with the emphasis very much on delivering the essentials as effectively as possible while readying itself for the changes ahead. In the current climate of regulatory fatigue, any other course would have plainly been imprudent.

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- ***Rosali Pretorius*** *is a partner in the Banking and Finance department, specialising in financial regulation and derivatives.* ***James Brennan*** *is a trainee solicitor in the same department.*

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