HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

The Lord Livermore
The Lord Sharkey
House of Lords
London
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15 May 2024

Dear Spencer and John,

THE FINANCIAL SERVICES AND MARKETS ACT 2000 (DISAPPLICATION OR MODIFICATION OF FINANCIAL REGULATOR RULES IN INDIVIDUAL CASES) REGULATIONS 2024

Thank you for your contributions to the debate on the Financial Services and Markets Act 2000 (Disapplication or Modification of Financial Regulator Rules in Individual Cases) Regulations 2024 ("the regulations"), which took place on 26 March 2024. I said I would write to give additional detail on some of the points raised during the debate. I apologise for the delay in my response.

The ability of a financial services regulator to flex the application of its rules for individual firms is a useful regulatory tool which can enable a regulator to take account of a firm's specific circumstances to ensure that rules are applied in ways which achieve the most appropriate regulatory outcome. This flexibility has long been a feature of the UK's regulatory regime, and is supported by our regulators and the financial services industry. Since it was introduced over 20 years ago, the Financial Services and Markets Act 2000 ("FSMA") has included such a tool.

The existing tool to disapply or modify regulator rules is set out in section 138A of FSMA. Section 138A provides that the Prudential Regulation Authority ("PRA") and the Financial Conduct Authority ("FCA") can disapply or modify certain rules made under FSMA if a firm has requested it, or if the regulator has the consent of the firm. Section 138A contains a test which must be met before a regulator can permit a firm to disapply or modify rules: the regulator must be satisfied that the application of unmodified rules to the particular firm would be "unduly burdensome", or "would not achieve the purpose for which the rules were made". Given these criteria, section 138A does not always allow for rules to be flexed, even where appropriate disapplication or modification of rules would provide a better regulatory outcome. As part of the government's work to adapt our regulatory regime for the UK's new position outside of the EU, section 138A was reviewed and it was concluded that, while useful, the tool is not as effective as it could be.

An example of how section 138A can be overly restrictive is to consider how it would apply to the capital requirement rules for insurers. Under the UK's prudential regime for insurers, an insurer must hold capital to withstand the shock of a 1 in 200 year event over one year. To calculate this, insurers are required to use a set of standardised requirements known as the "standard formula" (which is currently set out in assimilated law, but which in future will be provided for in PRA rules). However, legislation allows the PRA to permit an insurer to instead use its own approach to calculate its capital requirements, known as an "internal model", which may be more appropriate for the firm's particular business model and the risks it is exposed to. The benefits of using an internal model would not necessarily meet the test for disapplying or modifying rules under section 138A. Arguably, the application of standard formula requirements, which are designed to work for any insurance firm, is not "unduly burdensome". And as standard formula requirements are designed to function for any firm, it would be difficult to see them as not achieving the purpose for which they have been designed.

The government decided to address the restriction in section 138A by introducing a new statutory provision to enable the regulators to disapply or modify FSMA rules in individual cases. This was legislated for through the Financial Services and Markets Act 2023 ("FSMA 2023"), and is now set out in section 138BA of FSMA. Under section 138BA, the Treasury may specify regulator rules which the relevant regulator can then permit a firm to disapply or modify. The government is using the regulations to specify all PRA rules, with the exception of the rules referred to in section 138BA(3)(a) and (b) that apply to conduct and threshold conditions.

As section 138BA does not include the test which is required by section 138A, it was asked during the debate how the PRA would make its decisions to allow a firm to disapply or modify rules using the new tool. An important part of the government's work to adapt the regulatory regime to the UK's position outside of the EU has been to ensure the overall statutory framework within which the regulators operate is fit for purpose. Through FSMA 2023, Parliament approved an updated statutory framework for the regulators. In particular, the FSMA framework for the PRA now sets the following objectives:

i. A general objective to promote the safety and soundness of PRA-authorised firms;

ii. An insurance objective, to contribute to the securing of an appropriate degree of protection for those who are, or may become, insurance policyholders;

iii. A secondary objective to facilitate effective competition in the markets for services provided by PRA-authorised firms; and

iv. A secondary objective to facilitate, subject to aligning with relevant international standards, the medium-to-long term growth and international competitiveness of the UK economy.

It is for the PRA, acting in accordance with the statutory framework set by Parliament, to set out its policy on the disapplication or modification of rules under section 138BA, consistent with how the PRA determines its general policy and principles for discharging its functions under FSMA. The PRA is currently consulting on its general approach to the use of section 138BA[1] and will consult on its approach for granting specific permissions under section 138BA, as it has done for the Matching Adjustment.

During the debate, questions were asked about the impact of the regulations. A 'De Minimis' impact assessment was published, explaining why the government estimates the impact of these regulations to be under £5million per annum. The reason for this is that the power granted to the PRA in the regulations largely replicates the existing powers available to the PRA, whether powers to grant permissions under section 138A or those set out in assimilated law. A firm will still need to apply to the PRA for permission to disapply or modify rules, or the firm will need to give its consent. The obligations on the PRA to issue and publish decision notices also follow the established approach. The process to request and be granted permission to disapply PRA rules will therefore be familiar to the PRA and its regulated firms. Over the last two years, the PRA has dealt with an average of 55 applications per month from firms wishing to disapply or modify rules under section 138A or for the PRA to grant a permission under assimilated law.

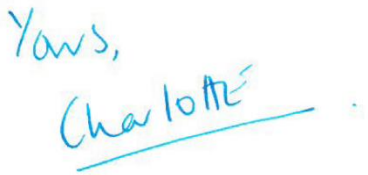
Where a firm is aggrieved by a PRA decision taken under section 138BA, the regulations provide that the firm may refer the decision to the Upper Tribunal, a part of the Courts and Tribunals Service responsible for hearing appeals against decisions made by various public sector bodies, including the PRA. The regulations are not expected to have a material impact on the work or resources of the Upper Tribunal and there is no existing Tribunal case law on the disapplication or modification of FSMA rules.

During the debate, I gave an example of how the regulations would be used by referring to the Matching Adjustment, which is an important feature of the prudential regime for insurers that encourages life insurance firms to match certain long-term liabilities with suitable long-term assets. Once the relevant PRA rules come into force, an eligible firm wishing to use the Matching Adjustment will need to apply to the PRA for permission under section 138BA. The regulations made under section 138BA do not deal with the design of the Matching Adjustment, they simply provide the mechanism by which firms can apply to the PRA for permission to use it. In December last year, the government legislated to reform the Matching Adjustment by expanding the range of potential assets eligible, to encourage insurance firms to invest in UK productive assets such as green technology, housing and infrastructure. The PRA has now consulted on how it will permit firms to use the Matching Adjustment using section 138BA and the reformed Matching Adjustment will be available for eligible firms to use from 30 June.

[1] CP3/24 – The Prudential Regulation Authority's approach to rule permissions and waivers | Bank of England

I hope this letter is helpful in providing more background on the purpose of section 138BA FSMA and how the regulations will enable the PRA to disapply or modify rules in individual cases.

Thank you again for your contributions during the debate. A copy of this letter will be deposited in the Library of the House.



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