HMT Financial Services Future Regulatory Framework Review Phase II Consultation

Submission by The Financial Inclusion Centre

The Financial Inclusion Centre is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change
Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met
Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform.

Financial Inclusion Centre, AreaWorks, Second Floor, 57a Hatton Garden, Holborn, London EC1N 8JG, 0207 241 2864
info@inclusioncentre.org.uk, www.inclusioncentre.org.uk
Non-profit organisation, Company no: 06272007, Vat no: 144925501

INTRODUCTION

We are pleased to submit our response to this important consultation. We take the view that, in recent years, the current regulatory model has functioned fairly well given the sheer scale and complexity of the UK's financial markets and services. In the post 2008 financial crisis period, we have seen considerable improvements in the conduct of business standards in UK financial markets driven by a more robust approach by the regulators.

But there is considerable room and need for improvement. The effectiveness of regulation depends on: the regulatory architecture; the legislative framework; the objectives and powers given to regulators; regulatory governance and acountability; and the regulatory culture, philosophy, and approach.

We do have concerns about the regulatory culture, philosophy, and approach adopted by UK financial regulators who follow a permissive approach to regulation rather the precautionary approach needed for complex, high risk, system critical markets like financial services. They sometimes show a reluctance to intervene to *make* markets work. However, this consultation relates more to the regulatory model and structures than the culture, philosophy, and approach. Therefore, the main emphasis of our submission is on what we see as the four main structural flaws in the current model of UK financial regulation:

- the legislative framework which determines the relationship between lawmakers and regulators;
- the objectives and powers given to the regulators;
- governance, accountability, and public interest representation mechanisms; and
- the lack of transparency relating to the regulators' supervision of financial firms.

For further information on this submission, please contact:
Mick McAteer, Co-Director, Financial Inclusion Centre
mick.mcateer@inclusioncentre.org.uk or mickmcateer92@gmail.com

BACKDROP TO REGULATORY REFORM

Now that the UK has left the EU, the future of financial regulation will be a key issue for government, financial regulators, civil society organisations and, of course, the financial services industry. This is taking place against a very challenging backdrop.

When deciding on the future of financial regulation, policymakers and civil society must factor in the:

- Post-Brexit environment which could lead to a more fragmented, complex regulatory system and risks a reduction in regulatory and consumer protection standards
- Role of the financial sector in dealing with the economic crisis caused by Covid-19 and the need to support economic recovery
- Failure of the financial system to meet the needs of real economy firms and households fairly and efficiently (what we call economic and social utility)
- Failure of financial markets, despite the hype, to provide significant support to the greening of the economy and promote responsible corporate behaviours
- Continuation of the low interest rate, low bond yield era, which is distorting the behaviours of financial markets, institutions, and households
- Litany of misselling and other financial scandals which have left a legacy of mistrust in financial services and damaged confidence in regulators
- Impact of digitisation, fintech, and big data
- Need for regulation to be agile, responsive, and effective in increasingly complex, fast moving financial markets and services

We think that the strategic objectives for regulatory reform should be to:

- reform the financial sector so it works better for the real economy, the environment, and households;
- stamp out damaging activities and restore confidence and trust in the sector; and
- position the UK financial sector so it can be a world leader in economically and socially useful finance such as green finance and responsible finance.

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RESPONSES TO SPECIFIC QUESTIONS

1 How do you view the operation of the FSMA model over the last 20 years? Do you agree that the model works well and provides a reliable approach which can be adapted to the UK's position outside of the EU?

The FSMA model has, by and large, been reasonably successful as a model for regulating the UK's huge and complex financial markets and services. It is sometimes not appreciated by critics of the regime just how large and complex the UK's markets are, and how difficult it is to regulate these markets effectively. There have been significant improvements in the conduct of business in the UK's financial sector due to more robust regulatory interventions. We must consolidate those gains, not risk losing them through deregulation.

But, those gains must be built on. And to do that, we must address the clear failings in the model. We have four main criticisms of the current model:

- the legislative framework which determines the relationship between lawmakers and regulators;
- the objectives and powers given to the regulators;
- governance and accountability mechanisms; and
- the lack of transparency relating to the regulators' supervision of financial firms.

Note that we have other criticisms of the *culture* of and *approach* adopted by UK regulators. The current regulatory framework and structure is not fit-for-purpose. But, it has to be said that even within this limited framework, the regulators could have done better on certain aspects. Regulators could have interpreted their limited objectives and used their limited powers more effectively.

However, this consultation focuses on the framework, structure, and objectives. We now have a once-in-a-generation opportunity to develop a financial regulatory regime that promotes financial markets that work for society and the real economy.

The legislative framework

Firstly, given the fast moving pace of 'innovation' in financial services, new risks and threats emerge frequently. Due to current legislative framework, these innovations can fall outside the regulator's remit – the perimeter issue. The regulators must wait until new products, services, and activities are brought within their remit by Parliament. This slows down the regulator's response.

Moreover, regulators will need to be able to respond to increasing digitisation and **intersection** of markets. Digitisation exists at the intersection between financial services and 'real economy' consumer goods and services. The internet/ social media/ big data analytics is increasingly used to create demand for and to distribute consumer goods and services. Financial services, also increasingly digitised, facilitates the satisfaction of those demands – through consumer credit or insurance. It could be argued that this has always been the case in the sense that advertising has always created demand for products and lenders have provided the means. But digitisation has

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given this a rocket boost. Digital technology and big data analytics are influencing consumer behaviours as never before. This intersection between markets is weakly regulated.

If anything, regulators need to be given more discretionary powers to rapidly bring new providers, products, services, and activities within its remit so that these are subject to regulator's supervision. The question is: how do we square the circle of allowing regulators more flexibility to respond, and ensuring public accountability?

It is possible to square this circle with a system of purpose-based regulation, providing the regulators with more discretion, combined with more formal reviews of the use of those powers by parliament, and enhanced governance and accountability mechanisms for the regulator.

Purpose based regulation means defining financial activities in law according to broad general purposes. For example, this could include: provision of payment services; deposit taking/ savings; creation and provision of credit; insurance and risk management; primary and secondary market activities; and asset management. This would then be underpinned by two supporting categories: provision of financial advice and information; and provision of behavioural information and services.

The fact that financial activities may be managed and distributed via physical branches or tech based is irrelevant. The method of distribution does not change the primary purpose of a financial activity.

Any new financial activity should be presumed to fall within one of these purposes The FCA should be allowed to determine which purpose a new financial activity falls under using a fast track consultation process. Parliament should monitor and review the FCA's use of these powers. Legislation would define these broad purposes, the supervision and enforcement powers available to the FCA, and provide the FCA with the necessary powers to ensure financial services fall within the perimeter. FCA should adopt a precautionary approach to financial innovation and be given tougher product regulation powers.

This purpose based approach to regulation would allow the FCA to deal with risks created by 'innovations' such as buy now, pay later (BNPL) credit or high risk investment products without having to wait for primary legislation to determine activities are within its remit.

The need for new statutory objectives

The second major flaw in the current set up relates to the statutory objectives provided to the regulators by Parliament. These are not sufficient to deal with the extent and nature of market failure in financial services or recognise the role of the financial sector in supporting the real economy, impact on the environment, or financial inclusion.

We argue that the regulators be given new objectives in relation to:

- serving the interests of the real economy
- sustainable and responsible financial behaviours and practices
- access, financial exclusion, and discrimination

These are explained below in our response to Q4.

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Governance and accountability mechanisms

Over the years, public interest representation on the boards of financial regulators has improved. But, even now the financial services industry is over-represented at the highest level. The FCA has seven independent non-executive members (excluding a representative from the PRA). Four have industry backgrounds. Only one has a dedicated consumer background, one has a public interest/ civil society background, and one is competition academic. The majority of FCA's Regulatory Decisions Committee (RDC) members have industry backgrounds.

The majority of the external members of the Prudential Regulation Committee have financial services industry backgrounds. Three out of six Financial Reporting Council board members have financial services backgrounds – three have public interest backgrounds.

None of the members of the regulatory boards appear to have direct experience of environmental issues which, given the increasing importance of the environment in discussions about financial regulation, seems strange.

Therefore, we would suggest that Government should amend legislation to ensure regulators have an appropriate and representative balance of interests on their boards and high level decision making bodies eg. for the FCA this would include the RDC.

There is a case for more fundamental reform of the governance of regulators. We suggest that the assessment of the overall strategy, approach, and effectiveness of the regulators should be scrutinised an independent body consisting of public interest representatives, separate to the non-executive boards of regulators and complementary to existing panels such as the Financial Services Consumer Panel. We call this the Regulatory Oversight Committee. This committee should report to a relevant Parliamentary committee.

There is merit in considering alternatives such as having Supervisory Boards for the FCA and PRA which would oversee the overall strategy and approach of the regulators with separate operational boards to oversee the running of the organisations.

There are a number of other measures which could enhance the governance and accountability of the regulators including:

- **Public meetings.** The FCA and PRA should be required to hold part of their board meetings in public along the lines of the Food Standards Agency. This would ensure that board members are given proper exposure to external views from civil society and consumer advocates.
- **Public hearings.** On key matters, the FCA and PRA should be required to hold formal public hearings (in addition to annual public meetings).
- **Transparency regarding industry lobbying.** The Chairs, CEO, and senior managers should be required to maintain a public register with details of meetings held with external parties.
- **Strengthening whistleblowing measures.** As part of systems and control measures, the FCA now requires firms to have a senior manager or non-executive director to act as a 'whistleblower's champion'. The intention is that whistleblowing is the responsibility of the board.[1] The FCA also has a dedicated team and process for handling whistleblowing

[1] SYSC 18.4 The whistleblowers' champion - FCA Handbook

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complaints from employees in the financial services industry.[2] But, the process for handling external whistleblowing complaints is not overseen by the FCA board – although the adequacy, effectiveness and security of the FCA's internal whistleblowing arrangements is overseen by the FCA's Audit Committee. We propose therefore that the FCA/ PRA be required to ensure there is board level oversight of the external whistleblowing arrangements.

Lack of transparency about the behaviour of individual firms

It is encouraging that Government intends to improve the levels of transparency and accountability on the performance of regulators. We fully support this overall intention.

But, there are serious flaws in the regulatory system with regards to transparency on the behaviour and practices of individual firms. The current overprotection given to commercial confidentiality and sensitivity protects the interests of firms at the expense of consumers and wider regulatory accountability.

The Financial Services Act 2012 made several changes to FSMA 2000 that introduced some improvements on transparency and disclosure. But there are still significant legal constraints on what information the FCA can, and is required to, disclose.

The restrictions in section 348 of FSMA on the FSA's ability to disclose 'confidential information' continue to apply to the FCA. In short, the FCA cannot disclose information that relates to the business or affairs of any person, and information that it receives for the purposes of its functions under FSMA, unless:

- the information is already lawfully publicly available
- the FCA has the consent of the person who provided the information and, if different, the person to whom it relates
- the information is published in such a way that it is not attributable to a particular person (for example, if it is anonymised or aggregated)

This defaulting to the withholding of information is not tenable. The presumption should be for disclosure. It is only in limited cases where constraints on disclosure are justified – for example, to protect the interests of small traders who may suffer reputational damage by unreasonable disclosure.

We have seen some improvements to transparency on FCA enforcement actions. However, the FCA's policy on keeping investigations private until the Warning Notice stage is reached is retained. There is some merit in this on the basis of natural justice – particularly for small traders and individuals. But, the FCA should publish an annual digest of supervisory investigations instigated and completed, decisions on whether or not to take supervisory actions, which form of supervisory action taken against larger firms including an explanation of why investigations have not resulted in public enforcement action.

Transparency on financial promotions which breach rules is a particular issue. The FCA can issue an authorised person with a direction to withdraw, or refrain from making, a financial promotion,

[2] Whistleblowing: How to make a report | FCA

Financial Inclusion Centre, AreaWorks, Second Floor, 57a Hatton Garden, Holborn, London EC1N 8JG, 0207 241 2864
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where it considers that there has been, or is likely to be, a contravention of financial promotion rules in respect of the promotion. In terms of transparency, the FCA may require the authorised person to publish details of the direction, and the FCA itself may publish such information about the direction, as it considers appropriate.

This is not tenable. The FCA should be required to publish details of any direction.

The FCA justifies its current approach on the grounds that: 'clear confidentiality restrictions encourage the free flow of information' and that 'if there was uncertainty about information becoming public, our sources could be less willing to give it to us.' It is not appropriate that a financial regulator should rely on the willingness of entities to supply it with information.

FSMA should be amended to:

- require firms and individuals to supply information to the FCA in a manner that supports the regulator's activities
- provide the FCA with the power to demand relevant information in support of its objectives and activities
- specify that there should be a presumption of disclosure and transparency with the exception of a limited number of specific circumstances

The FCA's compliance with these requirements should be evaluated by the Regulatory Oversight Committee described above.

2 What is your view of the proposed post-EU framework blueprint for adapting the FSMA model? In particular:

• What are your views on the proposed division of responsibilities between Parliament, HM Treasury and the financial services regulators?

• What is your view of the proposal for high-level policy framework legislation for government and Parliament to set the overall policy approach in key areas of regulation?

We support the overall intent of the proposed division of responsibilities between Parliament, HM Treasury, and financial services regulators. It is right that Parliament should determine the overall policy direction of regulators of one of the most important sectors of the UK economy. The effectiveness of regulatory policy in making financial markets and services work for society is integral to the delivery of government's public policy objectives.

As the consultation document rightly highlights, important decisions on issues such as regulatory equivalence with EU regimes could have a significant influence on the future of the UK financial services industry.

It will also be important for Government and Parliament to take a holistic view on the future regulatory framework. There is a very clear risk that the UK's detachment from the EU regulatory system will result in even more fragmentation and complexity, not less.

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We could see a 'trifurcation' of regulation with the development of:

- regulatory standards aimed at allowing the UK to compete on the global stage
- EU aligned regulation – whatever happens the EU will remain an important market for much of the UK financial services industry and protecting this access will require alignment with EU standards
- domestic focused regulation

If this is not managed properly this could result in greater costs and less clarity for industry and confusion for financial users.

The financial services industry is not just important in its own right as a significant contributor to the UK economy. How well the financial services industry performs its functions and activities can determine the success or failure of the real economy – specifically, how well it allocates resources to real economy firms, helps those firms transact, and manage risk.

The products and services provided are an essential part of consumers' lives allowing them to get paid, transact, borrow to buy a home or consumer goods, save and invest for the future, insure themselves (and their families) against risk of losing incomes, health, lives, and possessions. How well the financial services performs in terms of financial inclusion, treating customers fairly, providing value for money is critical to the welfare of citizen-consumers.

We cannot achieve the necessary green transformation of the real economy unless we green the financial system too. The financial sector (investors, lenders, and consumers) can play a major role in determining whether corporations act responsibly towards employees, communities, and supply chains.

These are all matters of public policy not just consumer or regulatory policy. It is appropriate that government and Parliament set the policy framework for delivering those public policy objectives.

But, care must be taken not to compromise the independence of the regulators or to create a policy framework that favours one set of stakeholders over another. For example, the idea of giving financial regulators a *competitiveness* objective would be misguided. This would allow influential industry lobbies to put pressure on regulators to reduce consumer protection and wider regulatory standards in order to give UK financial firms a flawed and illusory competitive advantage.

We support the view that the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) should be responsible for designing and implementing the regulatory standards that apply to financial services firms and markets.

However, we argue for enhancements to the regulators' rule making powers. As explained above, the existing system has been criticised for being too slow to respond to financial innovation and emerging risks. This is in part due to a cultural failure on the part of the regulators. That is, in some cases the regulators ought to have responded more effectively with the powers already at its disposal. But, it must be said that the regulators' ability to respond is constrained by the legislative framework and the process for determining if, how, and when financial activities fall within the regulatory perimeter.

Financial Inclusion Centre, AreaWorks, Second Floor, 57a Hatton Garden, Holborn, London EC1N 8JG, 0207 241 2864
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Recent examples highlight the limitations of the current model. Products such as buy now, pay later products are not classified as consumer credit products - even though they clearly are credit products as they advance money to consumers to purchase goods and services. Certain high yielding 'investments' are not regulated even though they fit a reasonable person's common sense definition of investment – the promoters gather investors' money and claim to offer a return on that money.

Financial activities such as this are not regulated – and therefore consumers are left vulnerable – because these have not been defined as falling within the regulators' remit, the regulatory perimeter. It does not have to be this way. We can move to a purpose based regulatory system where activities are regulated according to broad definitions.

As described above, purpose based regulation would address this problem. Any new financial activity should be presumed to fall within a general purpose The FCA should be given the power to determine which purpose a new financial activity falls under using a fast track consultation process. Parliament and the Regulatory Oversight Committee should monitor and review the FCA's use of these powers.

• Do you have views on how the regulators should be obliged to explain how they have had regard to activity-specific regulatory principles when making policy or rule proposals?

This is an interesting question. The issue isn't just one of how the regulators should be obliged to explain how they have had regard to principles. There are well established mechanisms and formats for doing so. For example, regulators can be required to publish accountability reports, respond to reports from representative and advisory panels, and answer to Parliamentary Committees.

It is important to consider also:

- Which principles are appropriate for a regulator to have regard to?
- The models that are used to evaluate how effectively the regulators have had regard to those principles.

By way of illustration, the consultation document suggests that the PRA might be required to have regard to principles relating to:

- The role of insurance business in facilitating sustainable growth in the UK economy and providing sustainable finance and a supply of long-term investment to support UK economic growth, including the supply of finance for infrastructure projects
- The socially important role that a viable and sustainable life insurance sector plays in retirement provision for UK citizens
- The desirability of innovation in insurance, reinsurance and alternative insurance risk transfer services in order improve the management of risk for individuals and businesses, and to help maintain the UK's leading position as a centre for excellence in insurance, reinsurance and alternative risk transfer activities

These would seem to be very appropriate principles for a regulator to have regard to. Indeed, as we explain above it is surprising that financial regulators are not obliged to evaluate how well the financial sector meets the needs of the 'real economy'. Similarly, as we explain above, financial regulators are not obliged to formally evaluate how well the financial services industry contributes to public and social policy goals.

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But, it would be very important for Government and Parliament not to allow these principles to be Trojan Horses for deregulation and reductions in consumer protection.

It is all too easy to see how these principles could be used by industry lobbies to argue that 'red tape', regulatory 'burdens' are holding back financing of infrastructure or preventing the insurance industry from providing insurance to underserved or excluded households.

Deregulating to allow the industry to close the insurance gap would not be a socially useful outcome. This would just swap misselling or discriminatory practices for exclusion. So, it would be very important to use the right models to evaluate how well the industry is meeting the needs of consumers.

Similarly, including a regulatory principle on innovation or maintaining the UK's position as a leading centre for insurance seems like a back door way to introduce a 'competitiveness' objective for regulators. This would not be welcome as it could compromise the independence of the regulators.

If these principles were to be used to judge the regulators, it would be important to ensure any evaluation is undertaken by Parliament and the Regulatory Oversight Committee.So, in theory it may be possible to use have regards to good effect. But, it would be more effective for the regulators to have positive statutory objectives on these matters – see above.

3 Do you have views on whether and how the existing general regulatory principles in FSMA should be updated?

It is not so much a question of updating the principles as how these are interpreted and evaluated. As with the question above, these need to be evaluated by an independent, objective body made up of public interest representatives.

We have specific comments on a number of the principles.

Proportionate regulation
The current articulation in FSMA on proportionate regulation refers to the principle that:

'a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction'

It would be more accurate for that particular principle relating to be amended to read:

'the principle that a *requirement relating to standards of behaviour* expected of a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from that *requirement*'.

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Desirability of sustainable growth in the economy

We would also propose removing the principle:

(c)the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term;

We do not see how this adds anything. And in the current climate – with the regulator expected to come under pressure from industry lobbies to 'support' recovery through deregulation - it risks being a back door way of introducing promoting 'competitiveness' into the operations of the regulator.

It is, of course, important that the operations of financial markets and services support the real economy. One of the primary roles of financial markets is to allocate resources to the real economy. Yet, no part of the regulatory system is required to assess and report on how well financial markets perform that role.

Therefore, rather than a 'have regard' to a principle, we propose that the Bank of England, Prudential Regulation Authority, and FCA be given a new statutory obligation to assess and report on how efficiently financial markets are financing the real economy. This assessment and reporting should be overseen by the Regulatory Oversight Committee.

Consumer responsibility

We support the retaining of the 'consumer responsibility' principle - the general principle that consumers should take responsibility for their decisions. But, there are limits to this.

There have been too many examples of consumers investing in products claiming to offer very high, clearly unrealistic rates of return at a time when deposit rates and bond yields are historically low. They should not expect to be fully protected against the adverse consequences of making such decisions in every case.

Of course, it is important to take into consideration whether the potential investor was properly informed about the potential risks and rewards.

In other product areas, there are also limits to the responsibility principle. We have seen how potential insurance customers or payday loan borrowers have been misled about or misunderstood the implications of complex terms and conditions.

The current articulation refers to:

the general principle that consumers should take responsibility for their decisions;

This should be amended to read: '*having regard to the effectiveness of the consumer protection measures provided and the compliance of persons providing services with relevant regulations in the circumstances'*

Transparency and disclosure

As we explain above, there are serious flaws in the regulatory system with regards to transparency on the behaviour and practices of individual firms. The current overprotection given to commercial confidentiality and sensitivity protects the interests of firms at the expense of consumers and wider regulatory accountability.

The following principle should be removed:

(g)the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives;

This should be replaced by a principle stating that:

'there should be a presumption of disclosure and transparency with the exception of a limited number of specific circumstances defined and reviewed by an appropriate independent body'

Accessible rulebooks

The government has specifically mentioned the idea of a regulatory principle which requires the regulators to have regard to the importance of accessible, easy to navigate rulebooks, which take advantage of practices and innovations that minimise the compliance burden on firms, such as 'machine-readable' rules.

We would support the idea of making the rulebook more accessible. This would benefit the industry and ultimately end-users of financial services.

But, we would request that HMT and Government generally stop describing regulation as a 'burden'. This may seem like a minor point. But, it is not. This feeds into the myth that regulation hinders markets from working, that it is imposed unnecessarily.

Regulation, in fact, codifies the terms of the social contract between markets and citizens. Another way to think of it is that regulation specifies the terms of the licence to operate for market operators.

Over the years, the body of rules has accreted because the financial services industry has been shown not to be able to interpret that social contract or licence without the terms of that contract/ licence being set down in increasingly precise detail in the regulator's handbook. The industry has shown itself not to be able to work with *principles based* regulation. Indeed, industry itself has often demanded more detail.

Note that we are not in favour of regulation for the sake of it. We propose that Government and regulators set up an independent committee to review whether specific rules can be removed safely.

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This committee should be made up of independent public interest representatives advised by suitable experts. The basis of this review should be: does a specific regulation, rule, or standard

- require anything over and above that would be expected of a well-run business that operates with integrity and with the interests of customers embedded in the culture of the business; or
- duplicate the effect of an existing requirement?

4 Do you have views on whether the existing statutory objectives for the regulators should be changed or added to? What do you see as the benefits and risks of changing the existing objectives? How would changing the objectives compare with the proposal for new activity-specific regulatory principles?

Yes. As we explain above, while regulatory interventions have led to significant improvements in conduct of business standards in financial markets and services, the structure including the statutory objectives are not fit for purpose and need to be modernised to take account of the challenges facing the economy and society.

Activity-specific regulatory principles are unlikely to ensure that the activities, and priorities of the regulators are fully directed towards the great environmental, economic, and social challenges facing us today.

We argue for three new statutory objectives relating to:

- Serving the interests of the real economy
- Sustainable and responsible financial activities
- Access, exclusion, and discrimination

Serving the interests of the real economy

The sheer scale of misselling and other consumer-related market failures in UK financial services has already been well documented and accepted. It is why regulators have statutory consumer protection objectives.

But, less well understood is the failure of the financial sector to undertake one of its primary roles of efficiently allocating resources to the real economy (this is taking on even greater significance given the recognition of the role of 'green finance' in greening the economy). This failure to allocate resources effectively is documented in our report An Economic and Social Audit of the City.[3]

Yet, no part of the regulatory system is required to systematically and objectively assess and report on how well financial markets serve the interests of the real economy.

Therefore, we propose that the Bank of England, Prudential Regulation Authority, and FCA be given a new statutory obligation to assess and report on how efficiently and effectively financial markets

[3] An Economic and Social Audit of the City | The Financial Inclusion Centre

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allocate resources to the real economy. This assessment and reporting should be overseen by the Regulatory Oversight Committee and a relevant Parliamentary Committee.

Sustainable and responsible financial activities

Similarly, no part of the regulatory system is required to assess how well financial markets support or detract from efforts to green the economy, or promote responsible corporate behaviours.[4]

As we highlight in our report, Time for Action, the fact that regulators do not have statutory objectives with regards to sustainable finance or markets are not provided with clear regulatory direction is a major barrier to greening the financial sector - and therefore greening the economy.[5]

Therefore, we propose that the Bank of England should be given a new statutory objective to promote financial market behaviours that contribute to economic and environmental sustainability. The FCA and Prudential Regulation Authority (PRA) should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objective.

The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies disclose compliance with sustainable, responsible, and social impact (SRI) criteria. Reporting on SRI compliance should be made a statutory requirement rather than voluntary, with appropriate sanctions for non-compliance with reporting standards.

Government and Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate related risks – the Bank of England, PRA, FCA, and The Pensions Regulator (TPR).

The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

Access, exclusion, and discrimination

Moreover, there is a strong intersection between regulatory and social policy. For example, social policy decisions such as setting levels of universal credit can determine whether vulnerable households need to turn to borrowing to make ends meet. Similarly, the primary causes of financial exclusion are poverty and the use of risk based pricing by commercial financial services providers.

In the UK, financial services firms have few statutory obligations in relation to financial inclusion. There is almost no transparency on how well financial services providers are performing in relation to financial inclusion or the extent to which financial practices can result in outright discrimination against vulnerable groups.

This is contrast to the obligations faced by US financial institutions under the Community Reinvestment Act (CRA)[6] and Home Mortgage Disclosure Act (HMDA).[7]

[4] For example, responsible practices in corporate supply chains
[5] Time for Action – Greening the Financial System | The Financial Inclusion Centre
[6] Community Reinvestment Act (CRA) | OCC
[7] The Home Mortgage Disclosure Act | Consumer Financial Protection Bureau (consumerfinance.gov)

Financial Inclusion Centre, AreaWorks, Second Floor, 57a Hatton Garden, Holborn, London EC1N 8JG, 0207 241 2864
info@inclusioncentre.org.uk, www.inclusioncentre.org.uk
Non-profit organisation, Company no: 06272007, Vat no: 144925501

Therefore, we propose that the FCA should be given a new statutory objective to promote ***fair access*** to financial services. The emphasis on ***fair*** is deliberate. It would be easy for the financial services industry to provide access to financial services if consumer protection measures were relaxed and it faced no restrictions on charging practices. But, that would not be appropriate. The question is: can commercial providers provide access to fair and affordable financial services? If it cannot, we should be objective and transparent about this. This may require government and regulators intervening through the use of universal service obligations (USOs) or government making available alternative provision of services for households the market cannot serve on acceptable terms.

These issues are set out in more detail in our paper Financial Vulnerability and Rights.[8]

As part of this objective:

- the FCA should be required to produce regular financial inclusion audits assessing the performance of the industry (and sectors) against financial inclusion metrics with a special focus on households with protected characteristics);
- the FCA should be required to report to Parliament and Government on the extent to which commercial financial services is able to meet the needs of vulnerable and excluded groups (especially those with protected characteristics);
- the FCA should be required to report to Parliament and the Government on the impact of policy decisions on financial inclusion – for example, changes to the Universal Credit system; and
- individual firms should be required to produce financial inclusion audits similar to the US CRA and HMDA.

5 Do you think there are alternative models that the government should consider? Are there international examples of alternative models that should be examined?

It is not a question of alternative models, per se. Rather, we now have the opportunity to identify best practice from around the world to create the best regulatory framework and model possible.

For example, the US has a much more developed approach when it comes to access and inclusion through the use of the influential CRA and HMDA – see above.

Similarly, the EU has a much more advanced social justice approach to financial regulation. It is more willing to mandate that commercial markets comply with social policy obligations determined by society rather than let markets determine the terms of access for citizens. Examples of this include giving consumers a legal right to a basic bank account and gender neutrality on insurance pricing decisions.

In Australia, the Australian Securities and Investment Commission (ASIC) can issue legislative instruments on its own initiative – subject to parliamentary scrutiny.[9] We would argue that a similar approach could be amended for UK use. The combination of purpose based regulation with more

[8] Financial vulnerability and rights | The Financial Inclusion Centre
[9] Legislative instruments | ASIC - Australian Securities and Investments Commission

Financial Inclusion Centre, AreaWorks, Second Floor, 57a Hatton Garden, Holborn, London EC1N 8JG, 0207 241 2864
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discretion for the FCA (subject to Parliamentary oversight) could allow the FCA to become more responsive to emerging threats and risks – see above.

6 Do you think the focus for review and adaptation of key accountability, scrutiny and public engagement mechanisms for the regulators, as set out in the consultation, is the right one? Are there other issues that should be reviewed?

We think HMT makes a good point when it says that the post-EU regulatory landscape warrants an adaptation of accountability, scrutiny, and public engagement mechanisms. Decisions made by EU institutions did indeed shape much of regulatory policy in the UK.[10]

HMT now wants to ensure there are clear arrangements in place for dealing with the distinction between higher level strategic or public policy decisions (which might have an impact on wider economic and social issues in the UK) and regulatory policy and operational decisions (which in theory are there to interpret and support wider public policy goals).

The idea is that Government and Parliament should be able to play a much more important role on strategic or public policy direction while leaving the regulators with independence on the regulatory and operational decisions.

We support the idea that the public interest (through Parliament and other mechanisms) should be better represented in determining the strategic direction of regulation.

But, it all depends on how this is done. Moreover, it is very important that additional accountability mechanisms do not inhibit the ability of the regulators to respond quickly to emerging threats and risks.

As we explain above, dealing with emerging threats and risks in such a fast moving market as financial services with constant innovation warrants giving the regulators more discretion and flexibility, not less. It is possible, however, to square this circle by giving Parliament more powers to review regulators' interpretation and implementation of strategic direction and embedding more public interest representation at the important levels of the regulatory structures.

7 How do you think the role of Parliament in scrutinising financial services policy and regulation might be adapted?

In our view, the real issue here is how to balance the demands for greater Parliamentary scrutiny and regulatory accountability, with demands for greater regulatory efficiency and responsiveness.

We cannot see how the regulators – particularly the FCA – can meet public expectations with regards to responding to emerging threats and risks (particularly in an age of digitisation) unless they are given ***more*** discretion on how and when to intervene in markets.

[10] Although it is worth saying that the direct influence of EU institutions on UK public policy should not be overstated

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It is self-evident that giving Parliament more *ex-ante* or even concurrent opportunities to scrutinise the operations of the main regulators will inhibit the ability of regulators to respond to those emerging threats and risks.

However, it must be stressed that giving the regulators more discretion does not necessarily limit public accountability. The way to strike this balance is to give Parliament and public interest representatives more direct opportunities to ***review*** the way regulators perform and execute greater discretion and responsibilities, and hold the regulators to account.

There is a more general issue relating to the governance of the regulators which we set out elsewhere. As explain elsewhere, we also argue for an independent Regulatory Oversight Committee made up of public interest representatives to assess the effectiveness of the regulators interventions. This would report to Parliament.

8 What are your views on how the policy work of HM Treasury and the regulators should be coordinated, particularly in the early stages of policy making?

As the consultation document points out, there already is a significant amount of liaison between HMT and various regulators on policy making. It is a question of how to enhance these relationships. A criticism we have of the current approach is that, although HMT and the regulators (FCA in particular) consult widely on regulatory policy, the general direction of a policy initiative has already been more or less settled by the time external public interest stakeholders are engaged.

The financial services industry, with its well-resourced lobbies and regular high level contacts with Government and regulators, has many more opportunities than civil society (public interest representatives/ consumer advocates) to influence policy. Civil society is at a significant disadvantage when it comes to influencing policy. This is further exacerbated by the lack of resources available to civil society during the formal consultation process.

One way of addressing this disparity in influence would be for HMT to establish an independent expert group consisting of public interest representatives (consisting of civil society, representatives of business, and academics) to advise on early stage policy development.

This could be similar to the system operated by the European Commission with the Financial Services User Group (FSUG).[11] The FSUG provides high level, early stage advice to relevant Commission departments on financial services policy and complements the work of panels and expert groups attached to the European Supervisory Authorities (ESAs). A UK FSUG could play a similar role by advising HMT (and where relevant DWP and BEIS) on financial services policy matters at the early/ development stage. This FSUG could complement the work of the Regulatory Oversight

[11] Financial Services User Group (FSUG) | European Commission (europa.eu)

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Committee we have proposed and the Financial Services Consumer Panel which operates at the regulatory level.

9 Do you think there are ways of further improving the regulators' policy-making processes, and in particular, ensuring that stakeholders are sufficiently involved in those processes?

Processes do not have a life of their own. They emerge from governance structures and are influenced by mindsets and dominant cultures. So, improving the policymaking process requires enhancements to governance structures and sufficient opportunities to provide challenge to dominant ideologies and cultures.

If we are to improve the regulators' policy making processes and ensure that stakeholders are sufficiently involved, then changes are needed at each level of decision making and at each stage of the policymaking process. Imbalances exist at each level and stage which are exacerbated by the constant exchange of personnel between regulators and regulated. The consumer and wider public interest has to be deliberately embedded into the thinking and decision making processes of regulators. The inherent advantages available to the industry must be checked and balanced at each level and stage.

Over the years, public interest representation on the boards of financial regulators has improved. But, even now the financial services industry is over-represented at the highest level. The FCA has seven independent non-executive members (excluding a representative from the PRA). Four have industry backgrounds. Only one has a dedicated consumer background, one has a public interest/ civil society background, and one is competition academic. The majority of FCA's Regulatory Decisions Committee (RDC) members have industry backgrounds.

The majority of the external members of the Prudential Regulation Committee have financial services industry backgrounds. Three out of six Financial Reporting Council board members have financial services backgrounds – three have public interest backgrounds.

None of the members of the regulatory boards appear to have direct experience of environmental issues which, given the increasing importance of the environment in discussions about financial regulation, seems strange.

Therefore, we would suggest that Government should amend legislation to ensure regulators have an appropriate and representative balance of interests on their boards and high level decision making bodies eg. for the FCA this would include the RDC.

As mentioned in the response to the previous question, we propose that Government set up a Financial Services User Group (FSUG) to advise on early stage policy development. This could be further enhanced by improvements to the way the regulators consult on and develop more detailed policy.

For example, although it is fair to say that the FCA consults widely on issues, even the most cursory analysis of the responses to consultations shows that industry responses significantly outnumber those from civil society. This is not because civil society is not interested in those issues. The primary reasons are the limited number of civil society organisations with the necessary technical skills and the lack of resources to respond to consultations which can be time consuming and laborious.

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This could be partially redressed by the independent Regulatory Oversight Committee we propose. The primary role of the Oversight Committee would be to provide independent assessment of the effectiveness of the FCA's approach to regulation. But, as part of the Oversight Committee's remit the Committee could have as it disposal FCA staff whose role would be to proactively engage with civil society representatives. So, instead of relying on civil society representatives to respond in writing to consultation papers, FCA staff should go out and interview civil society representatives.

Moreover, we also propose that the FCA should hold part of its board meetings in public along the lines of The Food Standards Agency. During the public sessions, the FCA should hold hearings to obtain views from civil society organisations on policy proposals in development and more generally on topics such as FCA's approach to regulation or financial inclusion. Those parts of the board meetings requiring decisions on sensitive or confidential issues could still be held in closed session.

Similarly, it would improve the effectiveness of the Regulatory Decisions Committee (and ultimately the FCA) if the RDC was required to hold public hearings on key decisions so as to take into account the impact of market abuse and regulatory breaches on victims.

We must also take into account the interests of consumers in the different nations and regions of the UK. For example, the Bank of England makes use of regional agents to inform its policymaking. This is not a practice adopted by the FCA. This has particular implications for Northern Irish consumers. The Northern Irish financial services market is in several ways very different to the GB market. For example, in banking, the even the largest NI banks would not feature prominently in the FCA/ PRA risk registers because of their comparatively small size in national terms. Yet, they represent a significant risk for the NI economy and consumers.

It would be welcome if the FCA/ PRA were required to have regard to the interests of all consumers including at regional level when developing policy, and supervising markets.

Moreover, as we explain above, we argue the FCA should be given a new *access* objective. The supporting measures we advocate including public inclusion audits would require the FCA to consider more formally the interests of consumers with protected characteristics.

This marks the end of the submission by the Financial Inclusion Centre

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