The Industry and Regulators Committee Inquiry into UK regulators

Submission by The Financial Inclusion Centre

About The Financial Inclusion Centre

The Financial Inclusion Centre (FIC) 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. We focus on households who are excluded from, face discrimination in, or are underserved by financial markets and services.

For further information please contact:

Mick McAteer
Co-Director
Financial Inclusion Centre
mick.mcateer@inclusioncentre.org.uk, or mickmcateer92@gmail.com

We are pleased to make a submission to the Committee's Inquiry. Please note that, while we make a number of general comments on regulation, we focus on the financial regulators given the areas in which we work.

1) Are UK regulators being given a clear job to do?

1. Unfortunately, we do not have the resources to analyse the objectives and duties provided to each of the main regulators. So, any remarks we make must be fairly high level. However, we do provide some detailed comments on the Financial Conduct Authority (FCA)[1], to illustrate our response.
2. The job of regulators is determined by the statutory objectives and duties given to them by Parliament. These objectives and duties are intended to ensure that the overall purpose or aim of a regulator is understood. Objectives and duties determine which activities and who (firms and individuals) are to be regulated, and what regulation is intended to achieve. Regulatory objectives and duties tend to be quite general and high level and, therefore, can be open to interpretation.
3. The primary role of some regulators is to act as the economic regulator of critical sectors. For other regulators, the primary roles are to address market failure, promote effective competition, or protect consumers from harm.
4. We think the overall intention of the existing objectives and duties given to regulators is reasonably clear. Of course, greater clarity on Parliament's intentions could be created by defining statutory objectives with more precision. But, this would require Parliament agreeing and setting specific outcomes intended to interpret those objectives.
5. In our view, expecting Parliament to determine specific outcomes would run the risk of politicians becoming too closely engaged in the operations of regulators. Moreover, on a practical level, determining more specific regulatory outcomes through the legislative process is likely to be very difficult. Agreeing the high-level objectives and duties through the legislative process is challenging enough as it is. Defining specific outcomes through the legislative process would significantly slow down the development of legislation.
6. We would say that the most appropriate balance of responsibilities is for Parliament and Government to determine the high-level objectives and duties for regulators, and for the boards of the regulators to determine specific outcomes using a transparent process of engagement and consultation. Keeping the statutory objectives and duties at this fairly high level allows for a difficult balance to be struck between: providing regulators with a clear, understandable purpose; enabling regulators to be as operationally effective as possible; ensuring proper governance and accountability mechanisms are in place to allow Parliament to hold regulators to account and give them direction; and maintaining regulatory independence.
7. By way of illustration, the Financial Conduct Authority has a high-level strategic objective to make sure relevant markets function well. This is supported by three key operational objectives to: protect consumers from bad conduct; protect the integrity of the UK financial system; and promote effective competition in the interests of consumers. The intention of those high-level objectives seems reasonably clear – even if we think these are limited given

[1] The author of this submission is a former board member of the FCA.

the importance of the financial system to the real economy, environment, and society (see below).

8. Those FCA objectives could well be clarified further but it would require Parliament defining more clearly what a functioning market looks like and addressing questions such as:
   - Whose perspective is used to assess whether the market is functioning well? Markets are amoral and allocate value according to economic power not rights. A market that operates to market principles will focus on serving consumers who are profitable and economically viable, not those consumers who are poor and who cannot afford to buy commercially provided products and services. Should the FCA be judged on how well it influences markets to serve excluded consumers?
   - What should consumers be protected from, where does the boundary of responsibility lie between regulators, markets, and consumers?
   - Which particular financial activities damage the integrity of the UK financial system?
   - What happens if we factor in externalities when assessing whether markets are functioning well? UK financial markets were lauded for their innovation and efficiency pre 2008 financial crisis. The UK financial sector congratulates itself on the contribution it makes to the UK economy including the amount of tax revenue generated. A very different picture emerges if the externality costs imposed on the environment, real economy, and society by financial markets are factored in.[2]
   - What does effective competition mean? What outcomes should effective competition produce – lower prices, better value, fairer treatment, and higher levels of inclusion? Effective competition is often taken to mean consumers having plenty of choice or providers and products in a market, a high level of new product and service innovation, and a market having low barriers to entry and exit. But, this is not the same as ensuring markets produce the right outcomes for consumers.
9. Whether regulators have the right objectives is a separate matter. For example, it is acknowledged that we face a climate crisis. The financial sector continues to finance climate damaging activities at scale.[3] Parliament has, rightly, mandated the FCA to prevent misselling, money laundering, insider dealing, and the financing of terrorism as these have wider impacts on the UK's national interest. Yet, despite the role finance plays in the climate crisis, Parliament has not given the FCA a mandate to protect the environment from finance.[4]
10. Nor has Parliament made the promotion of financial inclusion one of the FCA's primary (or even secondary) objectives even though we have serious and chronic financial exclusion in the UK.[5]
11. There will also be different opinions on what success looks like, and what outcome measures and indicators should be used to judge success against those objectives – see our response to Q9 and Q10. Similarly, whether the FCA interprets and fulfils its existing objectives in the most effective way is also open to debate. We would argue that the FCA (and other sectoral regulators) should adopt a much more interventionist, precautionary approach to control the behaviour of providers and protect consumers. This is all the more important as AI/

[2] See An Economic and Social Audit of the City | The Financial Inclusion Centre and Time for Action – Greening the Financial System | The Financial Inclusion Centre
[3] https://inclusioncentre.co.uk/wp-content/uploads/2020/03/Time-for-Action-Greening-the-Financial-System-FIC-FPF-Report.pdf
[4] The Devil is the policy detail – will financial regulation support a move to a net zero financial system? | The Financial Inclusion Centre
[5] The Financial Inclusion Centre | Financial markets that work for society

tech/ data plays an increasingly important role in financial markets and the provision of financial services.[6]

12. So, while we think there are certainly issues about the FCA's actual objectives, how the FCA regulates, and the outcomes measures and metrics used to assess performance, we would conclude that the overall role intended for the FCA is reasonably clear, albeit limited.
13. However, we do think there is an issue relating to public and commentator understanding of the limits of the FCA's role and responsibilities. The FCA must wait until financial activities are included within the regulatory perimeter. This can hinder the ability of the FCA to respond to 'innovations' which cause harm. The growth in buy now, pay later (BNPL) credit is a case in point. We are still waiting for HM Treasury to include BNPL within the FCA's remit. The FCA can get blamed for not dealing with emerging detriment even though they may not have the powers to do so.
14. Certain financial products and services can be very complex with some aspects of marketing and promotion falling within the FCA's remit, while other aspects remain outside. This can make it difficult for the regulator to prioritise such activities. It covers a huge number of firms, products, and activities. It has to prioritise those risks which fall fully within its remit. This can leave consumers of partially regulated products and services exposed to harm, and the FCA subjected to sometimes unfair criticism.

2) Is the right balance being struck between the responsibilities of regulators and those of the Government, particularly where there are political or distributional trade-offs that need to be resolved?

15. Previously, decisions made by EU institutions influenced the direction and shape of much of the UK's regulatory policy. We now need 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). It is right that Parliament should determine the overall policy purpose and direction of the regulators of critical economic sectors.
16. The issue of trade-offs can be a very complex one. It can involve taking a political or moral standpoint, not just addressing technical economic or regulatory policy issues. Again, the answer to whether the right balance is being struck between Government and regulators will very much depend on which regulated sector is being assessed and the harm or national policy goal that is being addressed. So, we can only provide a fairly high-level response to this question.
17. An issue may arise when there may be tension or conflict between objectives. For example, like many civil society organisations, we are very concerned that the growth and competitiveness objectives given to the financial regulators (and now other regulators) could undermine the primary objective of protecting consumers. This new objective risks making regulators agents of government national economic policy, which can conflict with the need to protect consumers.

[6] See: AI in Financial Services: How to avoid the big risks - Finance Innovation Lab, and Fintech – beware of 'geeks' bearing gifts? | The Financial Inclusion Centre

18. With regards to distributional trade-offs, there are a number of issues to consider. Trade-offs can require prioritising *competing* interests, which is particularly difficult when there are finite goods and services available, or when markets are a zero-sum game. In blunt terms, in a sector organised according to market principles, one set of interests gains at the expense of another set of interests unless regulators are mandated to address the inherent disadvantages faced by certain groups of consumers.
19. In addition, distributional trade-offs may have to be considered between consumers and shareholders, not just between different groups of consumers. The wider societal interest also has to be considered (sometimes referred to as externality costs).
20. There may be distributional trade-offs required *within* specific markets. Consideration of distributional trade-offs is particularly important in relation to services we consider to be essential to a decent quality of life that are primarily provided by the market. These include water, energy, banking, insurance and so on.[7]
21. Any system organised according to market principles will default to rewarding consumers who are more profitable or represent a lower risk and penalising those who are less profitable/ cost more to serve or represent a higher risk (the risk being set by the market, not society).
22. Distributional trade-offs may need to be assessed at different levels. For example, is there a high-level trade-off needed between protecting the environment and promoting economic growth? Is there a conflict and trade-off between protecting consumers and maintaining financial stability, and promoting growth of the financial services industry?
23. If we are to achieve net zero, the transition will have to be just and fair to receive the support of citizens-consumers. This will require difficult trade-offs on how to share the costs of the transition in a just and fair way. Distributional trade-offs must be considered *within* current generations of consumers (intra-generational), and *across* different generations (inter-generational).
24. This leads us to the critical questions of *who* decides whether a distributional trade-off is needed, and *how* that trade-off should be implemented through regulatory policy. We would argue that it is for Parliament and Government to decide whether a trade-off is appropriate and set down the objectives of any trade-off (eg. subsidising low-income consumers).
25. This leaves the question of how that trade-off should be implemented. There are two main options – either Parliament mandates regulators to ensure trade-offs happen in a market or Government provides alternatives for those the market cannot serve.
26. Trade-offs require social policy interventions to constrain or control the usual dynamics of a market. These are different to regulatory interventions. Social policy interventions can include measures such as universal service obligations and requiring market operators to provide services to low-income consumers at below market rate. These interventions can be mandated by Parliament through legislation or by regulators setting price conditions to protect low-income consumers.

[7] Note that we do not consider distributional trade-offs with regards to all essential goods and services. Access to and the cost of food is the prime example. There is a good reason for this. While there may be a case for maximum prices for certain priority food stuffs, the sheer complexity of the food sector means it would be difficult to re-configure to achieve distributional trade-offs.

27. There are some specific universal obligations in consumer markets - for example, in postal services, and some telecoms services. Price caps are used by energy regulators in an attempt to protect financially vulnerable consumers in the energy market.
28. In financial services, certain banks must offer payment accounts with basic feature,[8] and Government has recently introduced measures to preserve access to cash for communities. But, generally speaking, in financial services firms do not have an *obligation* to provide products and services to excluded consumers, or at a certain price. Consumers do not have *rights* to products and services. It is mostly left to market forces to determine who is and is not able to obtain products and services.
29. The FCA talks about fair treatment and fair risk pricing meaning consumers are not *unduly* excluded. It also talks about how in a market-based economy, consumers do not have an automatic right to receive products and services. The FCA does not tackle systemic exclusion. The FCA would say that, in the current set up, addressing systemic exclusion is a matter for Parliament and Government and not the regulator's job to require financial firms to serve consumers who are not viable for markets, or to determine the terms on which, say, poorer consumers are served.
30. The alternative to social policy interventions is for government to support or enable alternatives to market-based provision. Examples of this include the creation of the NEST pension scheme or Flood Re in the insurance sector.
31. The key is having the right strategic policy framework to identify the most effective approach – social policy interventions or alternative provision - for meeting the needs of consumers excluded from or disadvantaged by markets.
32. The choice of intervention will depend on the sector and the nature and scale of the harm caused to consumers. For example, Government is unlikely to ever set up a state energy company to serve consumers who commercial energy companies do not want to serve. Similarly, given that banking is provided by established market providers, Government is unlikely to create a state bank to serve excluded consumers.[9] So, in these cases, it has concluded that it is best to require market operators to provide services at below market rates. In other areas, such as pension provision, it has made sense to established alternative provision.
33. In our view, we do not have an effective strategic policy framework to allow us to determine the appropriate interventions and distributional trade-offs.

3) Are regulators appropriately independent of government? Is the right balance being struck between strategic and political input from government and preserving the operational independence of the regulators?

34. It is welcome that the Committee differentiates between strategic and political input, and operational independence. This is an important distinction. It is right that Parliament and Government should determine the overall policy direction of regulators of the most important sectors of the UK economy and the high-level legislative framework that enables the intentions of Parliament to be implemented. With Parliament responsible for

[8] This is as a result of EU legislation, not UK Government intervention.
[9] Although we would argue that a structural solution such as using central bank digital currencies (CBDCs) and the Post Office network would be an effective way to promote financial and economic inclusion.

determining overall direction and strategy, government overseeing the establishment of the high-level framework, this should allow the sectoral regulators the space and operational freedom to design and implement the regulatory standards that apply to firms and markets.

35. The boundary is not always clear. As with the issue of trade-offs considered in Q2, we do not think we have a clear, effective framework in place to effectively delineate 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).
36. Until recently, we were comfortable with the balance between Parliament, Government, and regulators. Operational regulatory independence has been a key strength of the UK regulatory system. But, we are very concerned at the imposition of secondary growth and competitiveness objectives on key regulators such as the FCA and PRA. In the Autumn statement, government announced its intention to extend the role in promoting growth and competitiveness to Ofgem, Ofwat, and Ofcom.
37. We are concerned that this will compromise the operational independence of regulators. This competitiveness and growth objective allows well resourced, influential industry lobbies yet another lever to undermine necessary regulation – the disingenuous argument is often deployed that regulation is a burden and stifles innovation and growth.
38. It is important to protect the operational independence of regulators. Of course, this needs to be complemented by robust Parliamentary scrutiny and regulatory accountability mechanisms.
39. Of course, independence does not just mean independence from political interference. It means independence from undue influence of vested interests. Industry lobbies[10] are very well resourced and influential. This influence needs to be countered by robust governance, accountability, public interest representation, and transparency mechanisms.

4) Does the Government provide too much or too little guidance to regulators in making decisions, particularly in deciding between different objectives and priorities?

40. It is difficult to say without analysing specific case studies. But, as mentioned above, we think the current approach based on Parliament and Government setting the high-level framework and objectives, leaving it to the regulators to determine how to regulate, is the best model. Regulatory operational independence is critical to regulatory effectiveness.
41. This is why we are so concerned that recently Government is beginning to exercise undue influence over regulatory policy. We are particularly concerned about the regulation of financial markets where there is a risk that the efforts to promote the growth and competitiveness of the economy (and the financial sector itself) could undermine the FCA/ PRA's primary objectives to protect consumers and ensure financial institutions are soundly managed.

[10] Lobbies for industries that are regulated and those who want to remain unregulated.

5) Are the roles and remits of different regulators sufficiently discrete, or is there overlap and duplication?

42. Again, to give a proper answer, this would have to be addressed on a case-by-case basis. We do have a system in which, by and large, the sectoral regulators map fairly closely on to vertical economic sectors such as financial services, energy, water, telecoms and so on. This is sensible in our view. Of course, some of the strategic challenges and causes of consumer detriment are common across the different vertical sectors. But, these are manifest sufficiently differently in each sector to warrant specific vertical regulators.
43. Vertical regulators are complemented by horizontal regulators covering issues common to each sector and best addressed using common standards and enforcement - for example, the Competition and Markets Authority (CMA) and Information Commissioners Office (ICO).
44. However, in our view the main issue is regulatory 'underlap' rather than overlap, creating gaps in the regulatory architecture. For example, the rapid emergence of big tech/ big data/ artificial intelligence (AI) requires a rethink on regulation. This sector is not regulated to any meaningful standard.[11] This is a big gap in UK regulation.
45. There are major issues at the 'intersection' of vertical sectors and the tech/ data sectors. For example, we have seen the rapid emergence of digital 'embedded finance' where consumer credit products such as buy now, pay later (BNPL) are integrated into online sales and marketing of non-financial products and services. This promotes the overconsumption of both goods and services and the credit which facilitates that overconsumption.
46. Of course, each vertical regulator considers to varying degrees the impact of AI/ tech/ data on the behaviours of firms within their remit. But, the potential harm caused by AI/ tech/ data is so great that we call for a dedicated Digital Conduct Authority to set conduct standards for tech/ data firms, or at least a Digital Standards Agency to set standards for vertical regulators to apply to relevant markets.

6) How effectively do regulators co-operate with one another, and how could this be improved?

47. In our experience, the main regulators we engage with do seem to co-operate and collaborate effectively. The relationships between the vertical sectoral regulators and the cross-cutting authorities such as the CMA and ICO seem to be clear. Moreover, organisations such as the UK Regulators Network[12] enable the main regulators to collaborate on cross sectoral issues such as consumer vulnerability, protecting consumers during the cost-of-living crisis, and the use of data in regulation.
48. There is always scope for improvement and the relationships should be continually monitored. This should include close monitoring of the use of important Memoranda of Understanding (MoUs) between regulators to ensure they remain fit-for-purpose and are being followed by the relevant regulators.
49. For example, during the recent Liability Driven Investment (LDI) crisis in the defined benefit pensions sector, there was certainly room for improvement in the way the relevant regulators – FCA, PRA, and The Pensions Regulator (TPR) – had monitored the market and shared data prior to the crisis emerging. However, even that crisis was more to do with the

[11] The Digital Markets Unit (DMU) within the CMA is adopting a competition approach to this market. It is not deploying the type of robust *conduct of business* interventions that have been so effective at improving behaviours in financial services.
[12] The author of this submission is a member of the UKRN Expert Panel

present regulatory architecture which meant that responsibility for overseeing that part of the market was, and remains, fragmented.

50. As mentioned above, we do have specific concerns about the approach to regulating the intersection between big tech/ big data sector and vertical sectors such as financial services.

7) Do the UK's regulators have the necessary skills, capabilities and expertise internally to perform the roles they have been given? If they do not, how could this be improved?

51. Again, we can only provide a general response to this as we do not have the resources to analyse the human resource capabilities of each of the main regulators. Nor are we aware of any comprehensive cross sectoral research having been undertaken on this subject.
52. The level of skills and expertise required will depend to a degree on the sector activities being regulated. In areas such as financial services, certain financial activities and products can be very complex (often unnecessarily so). Understanding the risks associated with these products and activities does require regulators having enough staff with the appropriate levels of expertise, or the ability to call on external and independent expertise.
53. For the most part, we think the FCA has done a good job regulating complex products and activities. There are exceptions to this. But, we would argue that where issues have fallen through the gaps, or the FCA has not performed well, this has been more to do with the sheer number of priorities the regulator has to deal with and the regulator's approach, not the lack of technical skills and expertise.
54. It must be acknowledged that regulators will find it hard to compete to attract people with the very highest skills who are influenced by the level of remuneration they can obtain in the market. The financial and digital sectors are a particular problem. But, more important than the skills of regulators' staff is the approach adopted by regulators. Adopting outcomes-based regulation and a precautionary approach can mitigate the risk that complex products and activities might harm consumers or the economy.

8) Who should hold the regulators accountable for their performance against their objectives? What is the appropriate role of Parliament in performing this scrutiny role?

55. The boards of regulators, particularly the non-executive directors, should have the direct and immediate responsibility for holding regulators to account for performance against the objectives determined by Parliament.
56. But, ultimately, Parliament has the key role in holding regulators to account for their performance against the statutory objectives set down in legislation. As outlined above, there is a difficult balance to be struck between effective accountability, regulatory effectiveness, and independence.

9) How should the Government and the regulators themselves facilitate appropriate scrutiny and accountability of regulators? Are regulators sufficiently transparent about their own performance?

10) What mechanisms and metrics could be used to hold regulators accountable on a regular and ongoing basis and to judge whether a regulator is performing well?

57. We answer Q9 and Q10 together. The selection and use of appropriate outcomes and performance metrics is critical to effective regulatory governance, assessment of the performance of the regulators, and to allow for reporting to Parliament and the public.
58. Regulators should be judged on how well they make the industries they regulate serve the interests of the real economy, environment, and society not on how well they serve the interests of regulated industries. Therefore, it is important that any metrics chosen allow for an objective assessment of how well those regulated industries are serving the interests of consumers/ households, the real economy, and the environment.
59. As it stands, it is actually very difficult to know how well the regulators are performing against their statutory objectives. This is because the performance framework and metrics are not sufficiently outcomes-based, and the protections given to commercial interests in legislation prevent meaningful scrutiny of firms and regulators.
60. We have noticed recently that Government is placing greater emphasis on how well regulators support the industries they are meant to independently regulate. The decision to give growth and competitiveness objectives to the main regulators could compromise their independence and undermine consumer protection objectives.
61. Specifically, in financial services regulation, HM Treasury has consulted on how to measure the success of the financial regulators. We are concerned that Government will adopt a set of measures and metrics that focus on the operational efficiency of the regulators from the perspective of regulated firms, rather than choose metrics which measure how well regulators are serving the wider public interest.[13]
62. In Annex A of our response to HM Treasury's consultation, we have set out a reporting framework and set of metrics that would allow for a more meaningful assessment of whether the financial sector is serving the interests of the real economy, environment, and society. A similar approach could be used for the other main sectoral regulators.

11) Do any of the UK's international comparators address the above questions particularly well? What lessons, if any, can the UK learn from other jurisdictions on these matters?

63. There is limited research on how international regulators perform on the issues raised by the Committee. What research there is suggests that, counter to the views that the UK is overregulated, the UK actually has low levels of regulation compared to rivals in the OECD.[14] But, this 'light touch' regulation has not contributed to producing better outcomes for consumers. Indeed, the 'heavier touch' approach adopted by other countries can contribute to more robust business practices and better risk management.[15]

This marks the end of our submission.

December 2023

[13] HM Treasury Financial Services Regulation: Measuring Success, Call for Proposals | The Financial Inclusion Centre
[14] A Short Guide to Regulation (nao.org.uk) p14 https://www.oecd.org/trade/topics/services-trade/documents/oecd-stri-country-note-gbr.pdf
[15] https://assets.publishing.service.gov.uk/media/5bea9751ed915d6a1e83911f/CAoRR_final_report1.pdf