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Treasury Committee

Future of financial services regulation: responses to the Committee's First Report

Second Special Report of Session 2022–23

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The Treasury Committee

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Second Special Report

The Treasury Committee published its First Report of Session 2022–23, *Future of financial services regulation* (HC 141), on 16 June 2022. Responses have been received from HM Treasury on 12 August, the Prudential Regulation Authority on 26 August and the Financial Conduct Authority on 30 August. Those responses are appended to this Report.

Appendix 1: Response from HM Treasury

[The Committee's recommendations appear in **bold** type. The Government response to each recommendation appears in plain type.]

The government's response to the Committee's recommendations

The Treasury should respect the principle of regulatory independence, and must not pressure the regulators to weaken or water down regulatory standards, or to accept changes to the regulatory framework which could impede the regulators' ability to achieve their primary objectives. The regulators have been made operationally independent for a reason. If regulatory standards were to be changed or substantially weakened so as to increase the risks to financial stability, UK consumers and taxpayers could be harmed. Simplifying financial regulation and tailoring it appropriately to the UK market must be approached with care, and without compromising regulatory independence.

The government notes this recommendation. Regulatory independence has been at the heart of the UK's domestic model of financial services regulation for over two decades, as set out in Financial Services and Markets Act 2000 (FSMA), and this remains central to the government's approach.

The FSMA model delegates the setting of detailed regulatory standards to regulators, that work within an overall policy framework set by government and Parliament but which are operationally independent. The FRF Review proposed establishing a comprehensive FSMA model of regulation by repealing retained EU law relating to financial services, so that the regulators are able to make the direct regulatory requirements which apply to firms in their rulebooks, in accordance with this framework.

However, more responsibility for the regulators must be balanced with effective policy input and effective oversight from Parliament and government. Parliament and government will continue to play an important strategic role in setting the policy framework within which the regulators operate and holding them to account for their actions to advance their statutory objectives.

The November 2021 FRF Review proposed measures to achieve this. These measures were broadly welcomed by over 100 respondents. Indeed, some respondents to the consultation felt that there should be further measures on accountability, though there was no consensus on exactly what these further measures should be, or whether this accountability should be to stakeholders, Parliament, or the Treasury.

The recently introduced Financial Services and Markets (FSM) Bill includes a package of measures which seek to increase the accountability of the PRA, the FCA, the PSR, and the Bank of England[1] to Parliament, to strengthen their relationship to the Treasury, and to enhance their engagement with stakeholders, reflecting their increased responsibilities now that the UK has left the EU.

There is a clear view from the financial services sector that co-operation between regulators is more significant than trade deals for ensuring reciprocal market access for financial services. While trade deals can open up new markets for financial services, the Government should strive to make progress on mutual recognition as an element in any free trade agreement.

The government notes this recommendation. The UK has a range of tools to pursue new market access opportunities and closer regulatory cooperation in financial services with key international partners. The government works closely with the regulators to achieve progress. The government also operates a range of equivalence regimes and uses this as part of its range of tools to support the openness of the UK's international financial services and facilitate cross border market access. The UK is also pursuing provisions in Free Trade Agreements (FTAs) to support its objectives to deepen longer term regulatory cooperation with key trading partners – for example, the UK's FTAs with Australia and Japan include annexes on financial services regulatory cooperation. In addition, the UK is negotiating an ambitious financial services mutual recognition agreement with Switzerland.

We recommend that there should be a secondary objective for both the Financial Conduct Authority and the Prudential Regulation Authority to promote long-term economic growth. The wording will be crucial: pursuing international competitiveness in the short term is unlikely to lead to economic growth or international competitiveness in the long term if it is achieved by weakening the UK's strong regulatory standards. Weakening standards could reduce the financial resilience of the UK's financial system and undermine international confidence in that system and the firms within it.

In designing the new secondary objective, there should also be some consideration for the ways in which financial services serve the 'real economy'. The financial services industry can help deliver economic growth not simply by growing itself but also by facilitating economic growth by providing capital, credit, insurance and other services to firms in the 'real economy'.

The Treasury should continue to reject any calls for a growth and/or competitiveness objective to become a primary objective. This would increase any pressure on regulators to trade off competitiveness against resilience, and would undermine the regulators' ability to deliver on their core functions. There is a danger that as memories of the financial crisis fade, its lessons are forgotten.

The government notes this recommendation. Following close consultation with the PRA and the FCA, Clause 24 of the FSM Bill implements new secondary objectives for the FCA and the PRA to provide greater focus on the medium to long-term growth and competitiveness of the UK economy.

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1 In its regulation of central counterparties (CCPs) and central securities depositories (CSDs).

The secondary objectives for the FCA and the PRA introduce a new focus within the regulatory framework on these important issues, while still maintaining the regulators' focus on their existing objectives of ensuring that UK firms remain safe and sound, that the UK's markets function well, that there is effective competition in the interests of consumers, and that consumers and users of financial services receive an appropriate degree of protection.

The government is committed to maintaining high regulatory standards in the UK, so these new objectives are subject to regulators aligning with relevant international standards. The Bill also only enables the FCA and the PRA to act in a way which facilitates growth and international competitiveness in the medium to long-term.

Resilient and efficient markets, underpinned by effective regulation and competition, are essential prerequisites for fostering an internationally competitive financial services sector that in turn facilitates long-term growth and international competitiveness of the UK economy.

We recommend that the Treasury should require the FCA to have regard for financial inclusion in its rule-making, but not to make changes relating to financial inclusion to the FCA's objectives.

We welcome the clearer acknowledgement that the FCA is working to support financial inclusion, and we would urge the FCA to continue to do so. The FCA should provide an annual report to Parliament on the state of financial inclusion in the UK and the Treasury should consider putting this report on a statutory basis. This report should also include a summary of areas where the FCA's work has supported financial inclusion or future work which could impact on financial inclusion; and any recommended additional measures lying within its area of competence and which could be taken by Government and other public bodies to promote financial inclusion.

The government notes this recommendation. As I set out in my letter of 25 July, the government's position is that the FCA's existing objectives and regulatory principles are already well-aligned with the government's objectives on financial inclusion. The government does not consider that a separate 'have regards' to financial inclusion for the FCA would lead to a different approach or tangible improvements over the current arrangements.

Many financial inclusion issues are complex and require several organisations to work together to come to a solution. There are numerous examples where this has been done successfully through close collaboration between the government, regulators, industry and the third sector, including through the government's Financial Inclusion Policy Forum which was launched in 2018.

The government already publishes an annual report on financial inclusion, including the work it takes forward jointly with the FCA. The government's last annual report was published on 6 December 2021 and can be found on gov.uk. The FCA already publishes a number of documents, including its annual report and its 2022–25 corporate strategy document published in April which reference its work on financial inclusion and set out several consumer outcomes it is trying to achieve. These outcomes include for consumers to receive fair prices and quality, to be sold suitable products and services and receive good treatment, as well as for consumers to have strong confidence and levels of participation in the markets. The government believes that these reports, in combination with the FCA's supervisory data and research, such as its comprehensive Financial Lives survey, already provide relevant reporting on indicators of levels of financial inclusion in the UK.

The Treasury and regulators should publish a forward-looking schedule of approximately when they expect each EU financial regulatory file to move across to the regulatory rulebooks, including timelines for consultation, and when they expect the overall project to conclude. This should give industry a better opportunity to plan for the changes they may need to make, and give the various stakeholders (including industry, consumer groups, academics, and other experts) more time to plan their engagement in the process.

The government notes this recommendation. The process of moving from retained EU law to a comprehensive FSMA model of regulation will be a significant undertaking (for the Treasury, regulators, industry and other stakeholders) which will take several years. A large-scale programme of secondary legislation, similar to the exercise conducted at the end of the transition period, will be required to give effect to the changes.

The Treasury is already working with the regulators on the potential prioritisation for the repeal of retained EU law.

The government recognises that it will be important to set out further information on the programme. This will ensure stakeholders have an opportunity to engage with the programme of work. The government expects to set out further information in due course.

Regulatory independence is critical for the competitiveness and effectiveness of UK financial services regulation. The host of new accountability mechanisms proposed by the Treasury must be carefully reviewed in this light, to ensure that regulatory independence is not compromised. These mechanisms largely seem reasonable as individual changes, but there is a risk that the collective impact could be excessive in its impact on regulators' resourcing, as well as their ability to make decisions quickly where needed.

The government notes this recommendation. Throughout the development of the FRF Review, the government has considered the collective impact of the additional measures on regulators' operations and independence. The government is confident that the final package strikes the right balance between democratic accountability, regulatory agility, and regulatory independence.

The regulators will be responsible for operationalising the new accountability requirements set out in the Bill and so the overall impact will, to a large extent, depend on how the regulators choose to carry out these functions. In line with the approach taken already in existing, similar provisions in FSMA, the legislation establishing the enhanced accountability mechanisms is relatively high level and provides the regulators with flexibility on how to carry out the new requirements in an appropriate manner. For example, the Bill sets out requirements for the regulators to publish statements of policy for reviewing their rules and conducting cost-benefit analysis (CBA). The legislation includes high-level requirements on what must be covered as part of these statements, but the detail of the regulators' approach to reviewing rules and CBA is for the operationally independent regulators to set out. Similarly, the legislation requires the regulators to each establish a CBA panel and consult the panel as part of their policy development, but provides flexibility for the regulators in appointing and working with the panel. This reflects the approach taken in FSMA to the existing statutory panels. The regulators are also required to consider the efficiency of their use of resources as part of the existing regulatory principles.

The Treasury should be sparing in its use of the proposed power to require regulators to review their rules, and should not use it to implicitly require the regulators to consider a general 'public interest' requirement for rulemaking. Each use of this power is a potential weakening of the independence of the regulators. Regulators should not be expected to reverse or adjust regulation where such regulation is deemed to remain appropriate to carry out the regulators' statutory objectives. That being said, the regulators should not impose costs without being able to show benefits.

The Treasury has not set out the expected impact of this new power on regulatory resources. In order to avoid imposing a significant burden on regulatory resources to conduct these reviews, and to safeguard regulatory independence, the Treasury should fund these reviews itself, whether they are conducted by regulators themselves or independent persons. Reviews of regulatory rules which have been imposed by the Treasury should not crowd out the budgets over which regulators have discretion for fulfilling their objectives. The imposition of such costs on the Treasury would also further help it consider whether all such reviews were necessary.

The government notes this recommendation. Clause 27 of the FSM Bill (which will insert new sections 3RC and 3RD into FSMA) introduces a power for the Treasury to require a regulator to review its rules. This power is designed to be used only in exceptional circumstances where the Treasury considers that it is in the public interest to direct the regulators to review their rules, for example, where there has been a significant change in market conditions, or other evidence suggests that the relevant rules are no longer acting as intended.

The rule review power also responds to concerns from stakeholders who considered that there were few avenues available to challenge regulators' rules. Any reviews initiated under the power will be conducted by the regulators or, where appropriate, an independent person. The regulator will be responsible for taking any action it deems appropriate in response to any recommendations arising from the review.

The government considers that the rule review power offers an important avenue for scrutiny of the regulators' rulemaking where required, while still maintaining the operational independence of the regulators to set detailed regulatory standards that apply to firms.

The government notes the committee's recommendation that the Treasury funds reviews conducted under this power. The FSM Bill includes a requirement for the Treasury to 'have regard' to the desirability of minimising the impact of a direction on the regulator's other functions before directing the regulator to undertake a review.

We expect the regulators to prioritise changes where the cost for consumers is lowest in comparison to the benefit. Regulators' approaches to assessing the marginal impact of new policies is already well-developed. We therefore believe that the creation of a new statutory panel to advise regulators on cost-benefit analysis—in addition to the panels that regulators already maintain for consulting industry and other stakeholders—

would add only marginal, if any, value and could pose some risk to regulatory independence. If such a panel is established, however, it should provide comments on rules changes post-publication, to avoid causing delays to the policymaking process.

The government notes this recommendation. The regulators have regular meetings and discussions with their existing stakeholder panels, in which most major policy and regulatory proposals are presented for comment at an early stage. As part of this, the existing panels can and sometimes are asked for early, qualitative comment on cost-benefit analysis.

However, industry respondents to the October 2020 FRF Review consultation expressed concerns that the regulators' analysis focuses overly on the expected benefits of intervention and underplays the costs to individual firms and the wider market. Some consumer groups, on the other hand, felt that CBA was overly concerned with the cost to firms, and disregarded quantifying benefits. There were also concerns expressed regarding the rigour and scope of the regulators' CBAs. The government recognises the significant concerns around CBA expressed by respondents and proposed establishing CBA panels in the November 2021 FRF Review consultation to address these concerns.

Given the technical nature of CBA, the government considers that a new, specialised CBA Panel can play an important role in improving the production of regulators' CBA. The government also considers that it can increase stakeholders' confidence that there is regular, independent input into the regulators' CBA.

Consultation respondents expressed overwhelming support for enhanced external challenge as a way to improve the quality of the regulators' CBA. They considered that, under either of the options set out in the consultation, a CBA panel would help to improve regulators' CBA.

The government notes the Committee's recommendation on when the panel should provide comment. There was a clear preference amongst respondents to the consultation for a CBA panel which provides comment pre-publication to ensure that rules are brought forward for consultation with robust CBA. However, a number of respondents argued that the panels should have the opportunity to comment on CBA both pre- and post-publication, as post-publication comment would allow for a more holistic review of CBA methodology.

Having considered these views, the Bill will enable the CBA panels to provide comment both pre-publication of individual consultations on rules, subject to a materiality threshold, and post-implementation of a rule change. The government recognises there may be instances where it would be disproportionate for a regulator to consult with the CBA Panel before it publishes a consultation. Clause 40 of the FSM Bill, which requires the regulators to set up and consult the CBA panels, includes provision for the relevant regulator to set criteria determining when consulting with the CBA panel pre-publication would be disproportionate. To manage the resource burden, the regulators will be required to publish a CBA framework, which will specify, amongst other things, when the CBA Panel does not need to be consulted before publication of an individual consultation.

The government does not agree that the proposed CBA panels would impact the independence of the regulators. As with the existing panels, the final decision on whether to address comments from a CBA panel will be for the relevant regulator, and subject to the regulator's usual internal decision-making processes.

In their review of Solvency II, the Treasury and Prudential Regulation Authority (PRA) should aim to secure a robust insurance regulatory regime that adequately captures risk and incentivises investment in infrastructure and business, but one that is also appropriately tailored to the UK market.

The government notes this recommendation. The reform of Solvency II aims to ensure deliver a robust insurance regulatory regime that is tailored to the needs of the UK insurance sector and will be guided by the government's objectives to:

- spur a vibrant, innovative, and internationally competitive insurance sector;
- protect policyholders and ensure the safety and soundness of firms; and
- support insurance firms to provide long-term capital to support growth, including investment in infrastructure, venture capital and growth equity, and other long-term productive assets, as well as investment consistent with the government's climate change objectives.

On 21 February 2022, the government announced major reforms to Solvency II. These include:

- a substantial reduction in the risk margin of around 60–70% for long-term life insurers;
- a reassessment of the fundamental spread used in the calculation of the matching adjustment;
- the introduction of a significant increase in flexibility to allow more investment in long-term assets; and
- a major reduction in the EU-derived regulations which make up the current reporting and administrative burden.

The government's consultation on proposed reforms to Solvency II closed on 21 July 2022. The government is reviewing the responses and will respond in due course, consistent with its objectives.

There is a range of innovations taking place in payments systems and with alternative means of exchange, including crypto-assets, stablecoins, and central bank digital currencies. These innovations could provide opportunities to address weaknesses in international payments systems and potentially to serve consumer needs, and in the case of central bank digital currency to safeguard monetary sovereignty. There are challenges associated with innovations in payments, including consumer protection, preventing crime and financial stability. We will be conducting further work on how these challenges are managed.

The government notes the committee's assessment that there is both opportunity and risk that comes with innovation. With respect to stablecoins, the government set out its intention in April 2022 to bring stablecoins, where used as a means of payment, into the UK regulatory perimeter. The government is taking steps to put in place this regulatory structure for stablecoin used for payment through the clauses 21 and 22, and Schedule 6, of the FSM Bill, which create a framework for the regulation of digital settlement assets. Additionally, it is the government's intention to consult later this year on regulating a wider set of cryptoasset activities, in view of their continued growth and uptake worldwide. The government has already taken action to respond to pressing risks in the sector, including through the introduction of an AML/CTF regime for cryptoasset firms, and has confirmed its intention to legislate to regulate cryptoasset financial promotions.

In addition, the government is currently consulting on the adequacy of the regulatory perimeter for payments.[2] This explores in particular the extent to which the Bank of England should be given more responsibility to supervise systemically important firms across the whole payment chain (where today the Bank of England is responsible only for the systemic supervision of payment systems and associated service providers thereto). The government has indicated that the increasing use of digital payments and innovation in payment chains, which have resulted in payments activities no longer being conducted primarily by banks and payment systems, mean it is the government's view that other firms have the potential to become systemically important firms in payment chains and may warrant Bank of England supervision.

The Treasury is also working closely with the Bank of England, via the central bank digital currency (CBDC) Taskforce, to assess the potential opportunities and risks that could arise from a CBDC. The government has committed to issue a public consultation on a potential UK CBDC jointly with the Bank of England during 2022.

More widely, there are other steps that the government is taking with respect to protecting consumers through the FSM Bill. This includes provisions to ensure that the UK has a legislative framework to protect access to cash (see section 47 and Schedule 8), which will become a new responsibility of the Financial Conduct Authority. Clause 62 of the FSM Bill will require the Payment Systems Regulator to take action in relation to authorised push payment fraud, in order to provide for more consistent and comprehensive reimbursement to victims of these scams. Clause 20 of the Bill requires authorised firms to be assessed by the FCA before they can approve financial promotions for unauthorised firms. This will reduce the risk of consumer harm that can arise from poor quality financial promotions.

2 https://www.gov.uk/government/consultations/payments-regulation-and-the-systemic-perimeter-consultation-and-call-for-evidence

Appendix 2: Response from the Prudential Regulation Authority

Response from the Deputy Governor, and CEO of the Prudential Regulation Authority

I am writing in response to the recent Treasury Select Committee (TSC) report on the future framework for the regulation of financial services, published on 16 June. We strongly support the Committee's report and agree with its recommendations, and set out below our response to some of the key points made by the Committee. We are keen to continue our engagement with the Committee and stand ready to provide additional evidence on any aspects of the report, as well as the Financial Services and Markets Bill as it is debated in Parliament.

Accountability

Given the increase in regulators' responsibilities to set requirements on firms, we support further strengthening our accountability, particularly with respect to Parliament. We therefore welcome the creation of the new sub-committee of the TSC focused on scrutiny of financial services regulations, which should augment the valuable role the Committee already plays in holding regulators to account.

To further our accountability, and as noted in the Governor's letter to the TSC Chair on 27 July, the PRA expects to publish a Discussion Paper (DP) in September setting out our proposed approach to policy-making under the Future Regulatory Framework (FRF). This DP, which touches on many of the issues considered by the Committee in its report, will present our stakeholders with an opportunity to examine our intended approach to policy-making under the new framework. We look forward to sharing this DP with the Committee, and stand ready to discuss it in due course.

The PRA agrees with the recommendation made by the Committee that the collective impact of accountability mechanisms proposed by the Treasury should not be excessively burdensome on our resourcing or hinder our agility in responding to risks and opportunities. Additionally, we agree with the Committee's assessment that the Treasury should use the rule-review power sparingly, given the potential it might otherwise have to weaken regulatory independence. As required by the FRF measure in the Financial Services and Markets (FSM) Bill, we intend to publish our approach to reviewing our rules. The PRA is committed to working with Treasury and our fellow regulators to manage any risks to our agility and resourcing, and also to implementing the FRF measures in a way that ensures we preserve high standards and sufficient dynamism in our approach.

Operational independence

We support the Committee's views on the importance of regulatory independence. In particular, we agree with the Committee's view that operational independence is vital to maintaining the effectiveness of UK financial regulation, and that regulators should not come under undue pressure to weaken regulatory standards or accept changes that could impede our ability to achieve our primary objectives. As the Governor stated during the 11 July TSC hearing and in his letter to the TSC Chair dated 27 July, this is important not only for the pursuit of safety and soundness and financial stability, but also because the independence of the regulators is an important foundation of our international standing and therefore part of the UK's ability to remain at the forefront as an international financial centre. The International Monetary Fund (IMF) recognised the importance of independence in supporting our effectiveness as regulators in its most recent Financial Sector Assessment Programme (FSAP), published in February this year.[3] Independence is also crucial for our credibility in international fora, such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB).

New secondary objective

Regarding the Committee's recommendation that there should be a secondary objective for the FCA and the PRA to promote long-term economic growth, we agree with the Committee's assessment that pursuing international competitiveness in the short term by lowering the UK's strong standards would not result in sustainable economic growth. Reducing prudential standards might appear to be an attractive tool to increase competitiveness in the short run, but could undermine financial stability, and therefore growth, over the long run. It would also hurt the UK's reputation internationally and our ability to influence and shape global standards. In our view, the formulation for the new secondary objective, where the pursuit of competitiveness and growth is subject to alignment with international standards, strikes the right balance.

The PRA already takes international standards, competitiveness and long-term growth into account as matters to which we must 'have regard'. As a secondary objective, they will carry greater weight in decision-making. We will take a proactive approach to advancing the new secondary objective, in line with the approach taken towards our existing secondary objective, and it will have a material impact on policy outcomes. We will outline our thinking in more detail in the Discussion Paper mentioned above.

Schedule of Rule Transfer

The PRA agrees that a fast and efficient transfer of all relevant retained EU law would allow us to address the complex policy framework in a comprehensive and efficient manner. We are committed to working with Treasury and other regulators to agree on a process for this transfer, and to providing as much clarity as possible to stakeholders on our forward plans.

Once requirements are set out in PRA rules rather than retained EU legislation, we will be able to review all rules relevant to a policy area holistically, providing us with greater flexibility to tailor our response and make policy in a more responsive and dynamic manner. It will also facilitate reform of the PRA Rulebook to make it more accessible and easier for firms to navigate. We are already making progress on this long-term project—for example, in July we published a Prudential and Resolution Policy Index[4], which divides

3 "Going forward, preserving the primacy of the U.K. regulators' general objectives in principle and practice will be paramount. Delegating responsibility to the regulators for setting requirements that are often technical and complex is beneficial, but the United Kingdom must avoid a proliferation of wider financial services policy priorities that could divert focus from financial stability. Enhanced accountability and transparency mechanisms should also operate in a way that preserves the independence of regulators and should not reduce operational and regulatory effectiveness." United Kingdom Financial Sector Assessment Program Financial System Stability Assessment 2022

4 Prudential and Resolution Policy Index

policies into sectors and topic areas, allowing stakeholders to identify and browse our policies more efficiently, and this is already enjoying considerable use by practitioners in the industry.

Cost of Regulation

We agree with the Committee's recommendation that "regulators should make every effort to limit the costs of compliance with the rules… [but] should not let short-term costs or the views of market participants… limit the scale of their ambition when finding opportunities to genuinely simplify the regulatory framework without sacrificing resilience" (Paragraph 30).

The FRF proposes a form of regulation in which most technical rules are made by regulators rather than set out in law. This approach is less prescriptive than the approach adopted at the EU level, and it will enable us to tailor our approach and account more effectively for UK circumstances when we make policy. Our work to simplify the prudential regime for non-systemic domestic banks and building societies through our "Strong & Simple" initiative, in which the Committee is already taking a close interest, is a relevant example of our approach in this respect. Our vision is for the simplified framework to be less complex and costly for these firms to operationalise, but to achieve the same overall level of resilience. We are also simplifying and streamlining the unnecessarily burdensome reporting for the insurance industry under the on-shored EU regulations – we have completed Phase 1 of the simplifications, largely focused on smaller firms, and intend to consult on Phase 2 in autumn.[5]

We also note that the Committee's report raises important considerations around the costs of compliance with rules and with changes to rules. We already conduct cost-benefit analysis (CBA) of proposed rules to determine the expected costs and benefits of our proposals. In addition, as part of the FRF we will enhance our approach to CBA including through the establishment of a statutory CBA panel. We will set out our approach to CBA publicly, as required by the FRF measures in the FSM Bill, and will aim to work efficiently with the new panel to ensure the policy-making process is delivered effectively.

Next steps

We believe there is a high degree of consistency between the Committee's findings and our vision for the PRA to be a strong, accountable, responsive and accessible regulator with enhanced accountability to Parliament. As set out above, we will soon publish, and share with the Committee, a Discussion Paper to set out our intended approach in more detail.

In the meantime, we stand ready to engage with Parliament, and in particular with the Committee, as the FSM Bill is debated.

Sam Woods

Deputy Governor, and CEO, Prudential Regulation Authority

26 August 2022

5 Review of Solvency II : Reporting (Phase 1)

Appendix 3: Response from the Financial Conduct Authority

[The Committee's recommendations appear in **bold** type. The FCA's response to each recommendation appears in plain type.]

Response from the Chief Executive of the Financial Conduct Authority

We welcome the Committee's recent report following this timely inquiry. As Parliament begins its consideration of the Financial Services and Markets (FSM) Bill, which aims to build on the opportunities arising from the EU withdrawal, and the country faces cost of living pressures, we look forward to continuing to support the Government and Parliament as you take legislative decisions about the right regulatory framework for the future. The pandemic and Russian invasion of Ukraine have also shown the importance of being able to work collaboratively at pace.

We believe that, given the scale of the challenge facing us with the transfer of EU files and the critical importance of getting this right, to fully embrace this opportunity, the new framework must be one which allows for expert regulators to move quickly and assertively, based on evidence. At the same time, we recognise the need to strengthen our accountability to and oversight by Parliament, given the regulators' new responsibilities for making rules in areas that are currently covered by retained EU law.

With this balance in mind, we support the Committee's recommendations on regulatory independence and the need to be mindful of the impact of new processes on resourcing, as well as the suggestions for ways to boost transparency. We very much look forward to engaging with the Committee and its new sub-committee to ensure that we participate fully in its scrutiny of our work, including on our future work related to the transfer of onshored legislation to our Handbook and our wider policy consultations.

We support the Government's ambition under the Future Regulatory Framework (FRF) Review to ensure that the design of the UK's legislative and regulatory framework maintains a coherent, agile and internationally respected approach to financial services regulation. We believe you can strengthen accountability without undermining agility.

We recognise that financial services regulators have an important role to play in the continued future success of the UK's financial services markets - this includes, supporting long-term economic growth, with safe, stable and open markets. As such, the proposal for a secondary competitiveness objective strikes an appropriate balance, enabling us to continue and further facilitate long-term growth without detracting from our existing primary objectives.

In line with usual practice, we will be proactively engaging on work flowing from the Future Regulatory Framework (FRF) Review over the coming months, including the roll out of a digital channel to keep external stakeholders informed on our policy making process and other developments, which will complement the existing Regulatory Initiatives Grid.

Below is our response to the recommendations set out in the report which are directed towards the FCA.

Changes to regulations post-Brexit

Deregulation or simplification will in themselves impose costs on industry in the short term. Regulators should make every effort to limit the costs of compliance with the rules, for example by communicating planned changes in advance, grouping sets of changes together, and minimising the frequency of changes to those where a compelling need and a significant cost benefit has been articulated. That said, regulators should not let short-term costs, or the views of market participants who have already adapted to existing arrangements, limit the scale of their ambition when finding opportunities to genuinely simplify the regulatory framework without sacrificing resilience.

We are mindful that our interventions impose costs on the firms that we regulate. We seek to balance these costs with delivering a strong system of regulation that offers long-term certainty to markets and consumers. This is vital to the UK's reputation as a stable and attractive place to do business. Consumer protection, market integrity and business growth can be aligned. This is why we prioritise our work based on evidence of consumer harm or risks to market integrity, while making use of cost benefit analysis and post-implementation reviews to ensure the burdens of the rules we impose in the pursuit of our objectives are proportionate to the benefits.

Well-regulated and functioning markets allow for businesses to raise finance and add growth and jobs, which is why we have also been taking forward ambitious reforms of the UK's financial markets through the Primary Markets Effectiveness Review and supporting the Government's Prospectus Regime Review, which aim to encourage businesses raise capital in the UK. The FSM Bill will enable us to deliver a number of reforms to the MiFID framework for secondary markets, in particular to the transparency regime for bonds and derivatives, the commodity position limits regime and the consolidation of market data.

The Regulatory Initiatives Grid serves to ensure that, where we can, we provide notice of interventions in advance. Where it makes sense to consult on proposed changes together at the same time, we do so. A significant amount of coordination with the Bank of England, Prudential Regulation Authority (PRA) and HM Treasury goes into the Grid, alongside other regulators that play a key role in financial services; we are always open to suggestions from industry as to how it can be improved.

We agree with the Committee that short-term costs should not be the main consideration when planning an intervention. However, as reflected in the report, the costs of regulation are ultimately passed on to consumers. Our recent three-year strategy set out several of the ways we are shifting our focus to prioritise outcomes over box ticking and processes, which will lead to an emphasis on the end result for consumers while reducing costs for firms over time. For example, our new Consumer Duty (now finalised in line with the timetable set by Parliament) will require firms to consider the impact of a product or service on the consumer, giving them flexibility as to how to achieve the best result. We will focus more on testing, and requiring firms to test, outcomes for consumers which should reduce the number of rule changes required, benefitting firms as well as consumers. We appreciate the Committee's support for our work on the new Consumer Duty and expect that the Committee will continue to hold us to account on this as part of its ongoing scrutiny of our work and Transformation programme.

The Treasury and regulators should publish a forward-looking schedule of approximately when they expect each EU financial regulatory file to move across to the regulatory rulebooks, including timelines for consultation, and when they expect the overall project to conclude. This should give industry a better opportunity to plan for the changes they may need to make, and give the various stakeholders (including industry, consumer groups, academics, and other experts) more time to plan their engagement in the process.

While decisions on the timing of the movement of EU files across to the regulators is a matter for Government, with technical input from the regulators, we know that we need to be as transparent as we can with all stakeholders, whether they need to plan their response to changes or scrutinise the work that we are doing.

With this in mind, and following the Committee's recommendation, in the autumn we will publish a dedicated space on our website tracking our work in response to the FRF and associated consultations. This is something we will regularly update. In time, and once we have considered jointly with HMT, the Bank and PRA, we intend to use this space to outline the likely timetables for the FRF file transfer. We will also consider how we can use the Regulatory Initiatives Grid to do this as well. We also recognise the importance of engaging more widely, including with industry and consumer representatives, on this prioritisation.

We already publish extensive information about how we make policy. But we will use the website space to provide clarity by setting out information on, for example, our planned approach to embedding the new secondary growth and competitiveness objective.

This will ensure that our stakeholders know how and when to engage with work stemming from the FRF.

Consumers and financial inclusion

The FCA should make every effort to ensure that it is not designing or implementing regulation in a way which could unreasonably limit the provision of financial services to consumers who might benefit from them. When placing new requirements on firms, the FCA should consider not only the impact on consumers and businesses, but also the impact on those who might be prevented from accessing financial services as a result of those new requirements, or who might find themselves accessing services on inferior terms. We recommend that the Treasury should require the FCA to have regard for financial inclusion in its rule-making, but not to make changes relating to financial inclusion to the FCA's objectives.

In the context of the cost-of-living challenges, and the upheaval the pandemic created in the lives of millions of consumers in the UK, the FCA has sought to urgently act in a number of areas in the pursuit of consumer protection, as seen in our activities during the peak of the pandemic and most recently with our letter to 3500 lenders[6] reminding them of their obligations to consumers in payment difficulties and the most vulnerable.

6 https://www.fca.org.uk/news/press-releases/fca-tells-lenders-support-consumers-struggling-cost-living

In our new FCA Strategy[7] published earlier in the year we have set out high level consumer outcomes which drive our work: Access, Fair Value, Suitability and Treatment, and Confidence. These outcomes go to the heart of financial inclusion.

We already work to boost inclusion, where this makes sense in the pursuit of our objectives and consider the impact our interventions could have on access; for example, our work setting out guidance on vulnerability, looking at pricing in the General Insurance sector, or improving access in the travel insurance sector for customers with pre-existing medical conditions. We also explicitly consider the possible impact of our interventions on access and inclusion, having most recently done so when developing the new Consumer Duty.

In addition, where necessary Government can act to help us boost inclusion where potential problems have been identified. We are pleased that Government has recognised that cash continues to be essential for many people, including consumers in vulnerable circumstances as well as small businesses. We welcome Government's intent for us to have new powers to help protect consumers access to cash and expect to use our new powers to ensure that the provision of cash access facilities continues to provide appropriate coverage across the UK for those who need it.

We do not think a have regard on inclusion would add to our existing ability to act within our remit in line with our objectives; and it might risk increasing expectations that the FCA should step in to fix problems that it does not have the power to solve, perhaps contributing to further confusion rather than addressing the root causes of exclusion.

The FCA does not have any levers to make firms offer services to consumers (the decisions to set public service obligations appropriately sit with Parliament and Government—as is the case on forthcoming access to cash legislation), or to change underlying factors which might mean that consumers are considered higher risk by firms. We have not yet seen any convincing arguments that a have regard would strengthen the power we have to investigate and solve exclusionary practices on the part of firms. In addition, it is sometimes necessary to intervene in ways which restrict access to financial products where there is risk of consumer harm. Affordability and appropriate pricing for risk are important tenets of the provision of financial services.

We welcome the clearer acknowledgement that the FCA is working to support financial inclusion, and we would urge the FCA to continue to do so. The FCA should provide an annual report to Parliament on the state of financial inclusion in the UK and the Treasury should consider putting this report on a statutory basis. This report should also include a summary of areas where the FCA's work has supported financial inclusion or future work which could impact on financial inclusion; and any recommended additional measures lying within its area of competence and which could be taken by Government and other public bodies to promote financial inclusion.

In light of our role and given the scope of our powers, we do not believe that it would be appropriate or feasible for us to advise Parliament or other public bodies on the overall state of financial inclusion, or to make recommendations outside of our remit.

7 https://www.fca.org.uk/publication/corporate/our-strategy-2022–25.pdf

Our Financial Lives survey is recognised as one of the most extensive and comprehensive insights into the finances, financial product-holding and financial services experiences of UK consumers. It helps to highlight emerging trends which could lead to consumer harm for us and other stakeholders to consider, including on access and financial inclusion.

The survey provides measurement and tracking on several relevant topics, including low financial resilience/ over-indebtedness, debt levels, use of credit products (mainstream and HCC), use of debt advice, access to cash and difficulty in getting to a bank, Post Office or cashpoint. It tells us about who does not have financial products (not least the 'unbanked') and who has been refused a product and consumer views as to why they believe this happened.

Our most recent survey recently closed, and we will provide the Committee with the report in due course.

In light of the Committee's recommendation, as well as publishing as normal, we will ensure that the results of the next survey are sent to all Members of Parliament, and to HM Treasury in order to support its annual report on Financial Inclusion.

We sympathise with the powerful case made by witnesses to the Committee that this is an issue which appears to fall between various authorities. This is because the causes of exclusion are complex and multifaceted and do not sit neatly in one sector. We think any more detailed analysis of inclusion especially one seeking to make recommendations across organisations - would need to look beyond the firm and product level data available to the FCA, looking at factors like entitlement to Government support, credit scores, financial literacy and other elements which affect consumers' financial circumstances.

We contribute to HM Treasury's yearly report on financial inclusion and support the Government's leadership on this issue, along with a range of stakeholders. We look forward to discussing with the Government how any additional duty to report on our part could avoid duplication and provide benefit to those who need support the most.

The FCA should consider how to improve its engagement with the poorest consumers, including seeking opportunities to improve the availability of data about people who are on the lowest incomes. The FCA must seek data on the issues vulnerable consumers experience directly. Civil society groups and other researchers can provide a valuable input, but they are more constrained than industry in terms of access to funding.

An understanding of the experience of consumers is critical to us achieving our consumer protection objective. We have expanded our presence outside of London with the recent establishment of our Leeds office and expansion in Edinburgh this year; we are a regulator for consumers across the whole of the UK, no matter their circumstances, not just the City of London.

We are improving our use of data so that we can make more effective and faster decisions. As mentioned above, our Financial Lives Survey provides data on consumer levels of indebtedness, low financial resilience and vulnerability. This is a comprehensive survey about the financial circumstances of the nation, which builds on other data we gather and process from our Supervision Hub, firm reporting and through our policy and supervision work, to help us set our priorities for the year ahead. We publish all the data we can in a dedicated section of our website. On top of this, the Consumer Panel plays a vital structural role in the work that we do.

These are not our only channels of engagement with consumers, including those on low incomes. Our Consumer Network provides us with invaluable insights from organisations on the front line of civil society, many of which provide direct support services to those facing some of the toughest circumstances imaginable. Some of these same consumers will of course go directly to our Supervision Hub, or the Money and Pensions Advice Service (MaPS), who are on the Consumer Network but who are also part of regulatory family. MaPS has a consumer facing role, and we work very closely with them to understand the issues consumers are facing in different sectors. The Consumer Network furnishes us with challenge and insights based on their depth of experience, and that makes us a better regulator for the public that we serve.

We also place a great emphasis on ensuring that our Executive team prioritise visiting communities across the country, to meet consumers and the organisations who are working to make a difference to their lives. Recent visits have taken our Executive team to Bradford, Essex and Leeds, and have prioritised meeting consumer groups to understand the impact of the cost-of-living crisis on communities in these areas.

Innovation

The FCA should investigate whether there are more opportunities to enable larger firms to undertake controlled, supervised experiments with innovative products. For example, it may be desirable to allow firms to be more experimental with the designs of new products, by setting aside additional capital in order to compensate consumers generously if new products being tested out by a limited number of consumers turn out not to benefit those consumers as anticipated. This approach would not be without risks, and would have to be carefully designed to avoid disadvantaging smaller firms, but it is an example of the type of bold approach which the FCA should be prepared to consider.

Through the FCA's Innovation services, which include the Regulatory Sandbox, Innovation Pathways, and Digital Sandbox, we work with a range of firms to promote innovation in the interest of consumers, facilitating a regulatory environment that works well for firms as well as promoting good consumer outcomes. Our innovation offer has been replicated around the world and we are proud to be recognised as a leader in the field. However, we are conscious of the need to continuously evolve our approach; our early and high growth oversight work will allow emerging firms without the resources of larger incumbents to navigate regulation, and our TechSprints will be vital for tackling complex industry challenges.

The Regulatory Sandbox allows firms to test their innovative business models live in the market with real consumers on a controlled basis, and the ability to compensate is considered as part of their application.

In their applications, firms need to demonstrate that their innovative business model/service meets our eligibility criteria, which are: In scope, Genuine innovation, Consumer benefit, Need for support, and Readiness. For our Regulatory Sandbox, as part of the testing plan firms complete, we assess these and ensure appropriate safeguards are built into the plan, which may include transaction limits or volume of customer limits. We agree, on a case-by-case basis, the disclosure, protection and compensation appropriate to the testing activity. We ensure robust controls are in place, and that testing is conducted in accordance with the agreed testing plan.

There has been an acceleration in the digitalisation of financial markets and our work has increasingly focused on technology firms, who tend to be start-up firms who are looking to test new products and services in a controlled environment. This helps inform our policy and remove barriers to entry and innovation.

Both the regulatory and digital sandboxes are open to more established incumbents and larger firms.

In the Regulatory Sandbox 40% of the firms we support are regulated entities, and in Innovation Pathways (previously Direct Support and Advice Unit) it is nearly 30%. We have supported many large market incumbents through our innovation services, including HSBC, Lloyds, Santander, Investec, Nationwide, Barclays, London Stock Exchange, Experian and Natwest. Our support spread across retail investment, retail banking, retail lending, RegTech, Crypto, robo-advice and ESG.

Positive innovation and competition can lead to new and better design, quicker, more affordable services and greater choice. It can also help markets work well with incumbents working harder to better serve consumers. The rate of innovative developments for larger institutions has not been consistent with the rapid pace of change taking place with new market entrants.

We will be exploring how our market innovation services can be used to support more large firms in undertaking controlled testing of innovative products, with measured and, potentially, enhanced safeguards put in place. We are also supporting HM Treasury's development of a new FMI Sandbox aimed at facilitating the testing of new technologies and practices. The powers for HM Treasury and the regulators to create the Sandbox and make permanent any successful rule-changes will be included in the up-coming Financial Services Bill.

FCA Service Standards

The information the FCA has made available on how it is performing against its service standards shows a deteriorating picture. The FCA has a reputation for being too slow in its authorisation work, and this will inevitably hold back British fintech companies and crypto firms as well as larger firms. When the FCA publishes its next update on the service standards it should write to us, outlining any areas where it is still not meeting its statutory and voluntary timelines, and setting out its strategy for closing any gaps.

We recently wrote to the Committee alongside the publication of our Annual Report and Operating Service Metrics (previously referred to as our Service Standards), in light of this recommendation.

We will keep the Committee updated on the progress we are making to reduce authorisation queues Progress includes a successful additional recruitment of case officers, improvements to processes and a reduction in the time taken to allocate cases to case officers. This progress has reduced Authorisations' overall caseload by more than 40% since December 2021, from c.12,500 to c.7,000 cases at the end of July 2022. We will continue to publicly report our performance against service metrics. I look forward to providing a further update to the Committee at our next accountability hearing.

As set out to you in that letter, while we are committed to further improving our processes, the increased detailed scrutiny we are committed to carrying out at our gateway can mean that some applications take longer to process. Rigorous assessment at the gateway is essential for us to fulfil our consumer protection objective.

Over the coming year we expect Parliament will examine many of the issues raised during your inquiry into the future of financial services, including the powers, remits and objectives of the regulators, as part of the legislation required to implement the new regulatory framework. We stand ready to provide technical advice to the Committee and other parliamentarians to support this work.

Nikhil Rathi

Chief Executive

30 August 2022