Written evidence submitted by the Financial Conduct Authority

We are grateful for the opportunity to submit evidence to the Committee's inquiry.

The financial services industry and the FCA face significant issues and challenges in the coming months. The pandemic has illustrated the importance of being able to act quickly to protect consumers, businesses and firms. We must also consider how the UK's regulatory and legislative framework for financial services needs to adapt to reflect the UK's position outside of the EU.

In tackling these immediate challenges, we should not lose sight of long-running issues that are reshaping financial services, and all our efforts will be underpinned by our ambitious plans to transform the FCA so that we can deliver more for consumers, firms and markets. Our transformation agenda will be reinforced by the lessons from the three independent reviews into the FCA's historic work.

For ease of reference, we have divided the questions into three sections: 1) opportunities for the UK's financial services sector after EU withdrawal; 2) development and scrutiny of financial services policy making after EU withdrawal; and 3) the current challenges facing regulators.

1. Opportunities for the UK's financial service sector after EU withdrawal

We support open markets, rooted in high regulatory and supervisory standards and shared commitments to international standards. We advocate for outcomes-based equivalence with international partners, underpinned by effective regulatory cooperation and dialogue between authorities, to support our statutory objectives and benefit UK firms and consumers. Our ability to cooperate with overseas authorities to manage cross-border risks is important for us to continue to meet our statutory objectives. We have therefore signed memoranda of understanding with competent authorities in the EEA and key non-EEA jurisdictions. We continue to take an active role in international standard setting bodies.

We welcome the Free Trade Agreement (FTA) between the UK and European Union (EU). Now that the transition period has ended, the UK authorities have new roles and responsibilities regarding the UK's trade policy. We therefore welcome the Government's decision to announce a call for evidence on the UK's overseas market access regime for financial services.[1] We recognise the importance of considering how different components of the UK's overseas market access regime are currently being used and how they can be best used in the future.

How can the UK financial services sector take advantage of the UK's new trading environment with the rest of the world?

Government is responsible for UK trade policy, which includes the negotiation of FTAs, and the Treasury can make equivalence determinations for overseas jurisdictions in relation to financial services. UK trade policy was previously made at the EU level prior to the end of the transition period. How these new responsibilities and powers are used is a matter for Government and Parliament, and it will be for the financial sector to take advantage of any resulting opportunities.

[1] https://www.gov.uk/government/publications/call-for-evidence-on-the-overseas-framework

We have an interest in ensuring that outcomes from any future trade negotiations support our objectives. In our view, the high regulatory and supervisory standards in the UK are pivotal factors in the UK's success as a financial sector. These standards build confidence and trust in our firms and markets, and the services they offer. The UK-EU trade agreement, for example, provides protections that will ensure the FCA and other regulatory and supervisory authorities will be able to act to ensure financial stability, to maintain market integrity and to protect investors and consumers, as well as commitments on the adoption of international standards.

In accordance with our objectives and remit, we have been working with the Treasury and Bank of England on the financial services elements of FTA and trade negotiations with other jurisdictions. For example, we are providing advice on the negotiation of a UK-Swiss Mutual Recognition Agreement (MRA). The Treasury intends for the MRA to improve the cross-border market for financial services between the UK and Switzerland for wholesale financial services, and for the MRA to enshrine a deep level of regulatory and supervisory cooperation. We have also supported deference to home regulators, for example, by entering into Mutual Recognition of Funds agreements with Hong Kong to smooth the process of cross-border fund distribution.

How can Government policy and the UK regulators facilitate the emergence of FinTech and new competition; develop new areas of growth for the financial services sector; and promote the UK as the best place to incubate new financial technologies and firms?

We consider FinTech to include all aspects of innovation in financial services, whether taking place within those firms commonly referred to as FinTechs, established incumbents, or those unregulated firms supporting the financial services sector – sometimes referred to as RegTechs and BigTechs - that may exist outside our perimeter.

Innovation supports each of our operational objectives, but most of our external facing innovation activities have historically been aligned to promoting effective competition in the interests of consumers, and a successful FinTech sector is also a key driver of competition in markets. Competition can take place through new start-ups, entrants from other markets or sectors, or via incumbents working in partnership or competing with FinTechs to challenge the status quo. A healthy ecosystem has both new entrants competing for business, and existing players modernising and evolving their offering. We believe regulation has a part to play in making sure the right conditions exist for that competition and also to ensure that FinTechs can scale with appropriate systems and controls.

The UK FinTech industry is growing rapidly and an increasing number of UK FinTechs are entering or exploring new markets.[2] The UK is second only to the US for Fintech investment.[3] Fintech investment in the UK more than doubled from 2018 to 2019, with £4bn invested in fintech firms in 2019. The UK FinTech sector generated £6.6bn in revenue and employed 76,500 as of the first half of 2020.

Where appropriate, Government and regulators can play a role in facilitating sustainable growth and competition within the financial services markets through FinTech, both at home

[2] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/801277/UK-fintech-state-of-the-nation.pdf
[3] https://technation.io/report2020/#12-uk-investment

and abroad. This can be through creative and ambitious trade, investment and skills and talent policy, by fostering a supportive regulatory environment, or by helping to reduce barriers to entry in both emerging and established markets.

FinTech is increasingly embedded in our digital lives and operates globally, cross-border and cross-sector. National and international consistency is therefore increasingly key to the development and export of a vibrant domestic FinTech ecosystem that is inclusive, competitive and resilient. It is important for there to be coordination and direction across Government and regulators in areas crucial to facilitating the FinTech ecosystem. This includes continued collaboration and engagement with our international counterparts to share insight and expertise, and to help influence and shape the wider global landscape.

We conduct a range of work to enable innovation in financial services. We launched our Innovate department in 2014 with a specific remit to encourage innovation in the interests of consumers. Through market-facing firm support functions such as our regulatory sandbox, advice unit and direct support, we encourage positive disruption to the market by increasing competition and allowing consumer needs to be more closely met.

Our regulatory sandbox supports firms undertaking regulated activity while they scale up towards authorisation, and we provide support until the firm becomes fully authorised. We re-engage with firms after 12 months to see how their businesses have progressed. Furthermore, sandbox 'alumni' can reach out to their case officer for an informal conversation. Based on our experience and industry feedback, our offering to firms continues to evolve to ensure we are effective in delivering our support. Whilst sandbox firms appreciate the dedicated and supportive relationship with the FCA, a recent BIS report concluded that their sandbox participation also directly affects funding.[4] Sandbox participation raises the probability of raising funding by ca. 50% and increases the average amount of funding raised by around 15% (or $700,000) over the next two years after entry to sandbox, relative to firms that did not enter the sandbox. This effect is consistent over the first five cohorts of our sandbox programme. The BIS further concluded that sandbox reduces information asymmetry (for investors) and regulatory uncertainty, enhancing competition. Internationally, our sandbox programme has inspired the foundation of 73 national sandboxes.[5]

We have also developed and launched a pilot digital sandbox offering to support earlier stage product and service offerings in the FinTech and RegTech ecosystem. This sandbox offers unique data assets and other support to help businesses to develop their propositions ahead of testing in a live market environment. We developed this sandbox in collaboration with the City of London Corporation and will be examining how to iterate and further scale this service based on learnings from the initial pilot phase.

We have a strong presence and active role within the FinTech ecosystem, we have held our own events and participated in others, and we have produced policy on innovation in financial services markets. In July 2020, the Economic Secretary to the Treasury, announced the independent FinTech Strategic Review, led by Ron Kalifa OBE.[6] We are working closely with Treasury, the Bank of England, and the review team.

[4] BIS Working Paper No 901, "Inside the regulatory sandbox: effects on fintech funding", November 2020, available at: https://www.bis.org/publ/work901.htm

[5] World Bank (2020), "Key Data from Regulatory Sandboxes across the Globe", available at: https://www.worldbank.org/en/topic/fintech/brief/key-data-from-regulatory-sandboxes-across-the-globe

Finally, our international leadership and collaboration has contributed to a developing global approach to encouraging innovation in the interests of consumers; through pioneering regulator-regulator FinTech cooperation agreements, supporting experimentation through our TechSprint programme, and by founding the Global Financial Innovation Network (GFIN) and IOSCO's FinTech network – both of which we chair.

Furthermore, regulators like the FCA need to both understand and foster desirable innovations, seek to mitigate risks arising from new technologies and innovations, and embrace technology and data-led approaches to modernise and improve the way in which we deliver on our responsibilities. Our market-facing innovation services are aligned to our own transformation initiatives, and our experience, learnings and engagement in domestic and international fintech and regtech ecosystems have benefited our programme of work to become an increasingly digitally-enabled organisation.

What should the Government's financial services priorities be when it negotiates trade agreements with third countries?

The UK's approach to trade in financial services and access to the UK's market is a matter for Government and Parliament. Ultimately, the benefits for UK firms and consumers from trade agreements will depend on the negotiated outcome. Trade agreements may take different forms, for example FTAs, as defined for the services provisions in GATS Article V, or Recognition Agreements, as set out in GATS Article VII.

We expect any trade agreement to respect our statutory objectives and regulatory and supervisory framework. In practice, this means respecting the FCA's supervisory and regulatory autonomy, while providing a non-discriminatory environment for both UK and overseas firms. This is not only important from a competition perspective; it is also necessary to promote high regulatory and supervisory standards and ensure UK firms and consumers are appropriately protected.

Where relevant, it will be important to ensure that market access is grounded in shared commitments to international standards, and equivalent regulatory and supervisory outcomes. Each agreement will need to be tailored to include appropriate regulatory and supervisory safeguards, proportionate to the level of market access which has been secured.

FTA negotiations also go beyond pure market access. For example, they increasingly provide for data to be transferred smoothly cross-border and prohibit unnecessary data localisation. We are aware that this has been a priority for some financial services firms. The provision of data transfers is entirely deliverable – and the government has already negotiated provisions to this effect – provided there are carveouts and caveats to allow regulators to have timely access to the data where required to perform our statutory objectives.

Similarly, FTA negotiations will often include provisions on regulatory transparency, for example regarding authorisations and policymaking processes. Provisions to this effect can help promote common regulatory expectations between jurisdictions and, therefore, offer considerable clarity to firms. We work closely with the Treasury on these areas, as they can have operational implications for us.

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[6] https://www.gov.uk/government/publications/independent-fintech-strategic-review-terms-of-reference

In some cases, trade agreements, including FTAs and any commitments agreed alongside them, can strengthen relationships between regulators in different jurisdictions. For example, the joint declaration on regulatory cooperation in financial services between the UK and EU sets out commitments to have enhanced cooperation as well as information sharing and bilateral dialogue.[7] This will help to ensure a durable and stable relationship between the UK and EU. Furthermore, the recently announced UK-Japan CEPA's *Regulatory Cooperation in Financial Services Annex*[8] establishes a framework for regulatory cooperation between UK and Japanese authorities, and specifically implements a forum for the parties to discuss regulatory and supervisory matters, in which regulators will participate.

Should the UK open its financial services markets to external competition from countries outside Europe, or should the UK maintain the current regulatory barriers that apply to third countries?

This is ultimately a question for Government.

From our perspective, open markets are an important enabler of healthy competition and support our objectives, if they are underpinned by appropriate standards.

The UK's existing overseas access regime already allows overseas firms, funds and market operators to access UK markets in different ways depending on certain factors, including: the type of activity that is undertaken, the type of customer targeted, and the level of physical presence in the UK.

In certain cases, access relies on equivalence and recognition regimes. UK financial services legislation also provides certain exclusions or exemptions, which allow access to UK markets. For example, if certain conditions are met, the Overseas Persons Exclusion (OPE) may allow cross-border market access by overseas firms outside our regulatory perimeter without the requirement for UK authorisation or registration.

More broadly, international firms wishing to provide financial services that require UK authorisation can serve UK customers through a branch in the UK, or they can do so from a UK-incorporated subsidiary. For entities incorporated outside the UK, the authorisation covers the whole entity, including the firm's UK and overseas offices.

We expect that there will be an increase in the number of international firms seeking authorisation, with over 1,500 firms currently registered in the Temporary Permissions Regime (TPR). To help international firms understand our expectations as they prepare for full UK authorisations, we published our approach[9] to the authorisation and supervision of international firms seeking to operate through a branch in the UK. International firms seeking UK authorisation must meet the same relevant minimum standards as UK firms, which are designed to help prevent harm.

[7] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/948105/EU-UK_Declarations_24.12.2020.pdf
[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/929179/UK-Future-Trading-Relationship-with-Japan-print.pdf
[9] https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf

The Treasury has published a call for evidence on the UK's framework for cross border financial services.[10] This will help ensure that the UK overseas access regime remains coherent and facilitates a robust and open financial services sector.

What progress has the Government and regulators made in facilitating key financial services equivalence agreements with third countries; and would an alternative mechanism serve the interests of the UK market better?

The Treasury is responsible for making equivalence decisions. The FCA and Bank of England/Prudential Regulation Authority (PRA) are responsible for providing technical advice to the Treasury and for monitoring equivalence decisions once they have been made, including those that have been onshored from the EU. Details of how the three institutions work together were agreed in a Memorandum of Understanding in 2019.[11]

The Treasury has published a guidance document[12] for UK equivalence decisions, which states the "Government will use equivalence as one of a range of tools (including Free Trade Agreements, Mutual Recognition Agreements, Financial Dialogues and Economic and Financial Dialogues with overseas jurisdictions) to support the openness of the UK's international financial services and facilitate cross border market access". The choice of which tools to deploy will depend on the circumstances. In some cases, for example, MRAs could be used as an alternative mechanism to, or to supplement, equivalence. MRAs are typically agreed on a reciprocal basis, whereas equivalence can be granted unilaterally.

In order for equivalence determinations to have their desired effect, it is important that there is close regulatory and supervisory cooperation between the UK and EU or other overseas authorities. We strongly welcome the UK and EU's commitment to agree a memorandum of understanding, as set out in the joint declaration on regulatory cooperation in financial services. It is also important that any future model of regulatory dialogue between the UK and another jurisdiction ensures transparency, appropriate consultation and clear processes around any withdrawal of equivalence to minimise the impact on markets and firms. While a regulatory dialogue should aim to ensure continuity of equivalence, if decisions are withdrawn, it is important that this is done in an orderly way and with sufficient notice to minimise disruption. This process should respect both parties' regulatory autonomy.

The UK has made significant progress in facilitating equivalence decisions. The Government 'onshored' directly applicable EU legislation into UK law, including around 40 equivalence provisions as set out in EU legislation. Over 270 equivalence decisions taken by the European Commission (EC) for non-EEA jurisdictions have been onshored into UK law under these provisions and continue to apply in the UK. The FCA is the lead regulator for 55 of these decisions.

The Treasury has taken equivalence decisions in respect of EEA States, allowing EEA firms in some sectors to continue to provide financial services in the UK; the FCA is the lead regulator for 5 of these decisions. The Treasury also confirmed in June 2020 that it had completed its

[10] https://www.gov.uk/government/publications/call-for-evidence-on-the-overseas-framework
[11] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/839966/equivalence_mou_october_2019_web.pdf
[12] https://www.gov.uk/government/publications/guidance-document-for-the-uks-equivalence-framework-for-financial-services

equivalence assessment of Switzerland in relation to Swiss stock markets (the Share Trading Obligation) and found them to be equivalent. We provided advice to the Treasury for both the EEA decisions and the Swiss assessment. In the EU, the EC has made two time-limited equivalence decisions for the UK on Central Counterparties and Central Securities Depositories.

We worked closely with key jurisdictions to ensure continuity of market access at the end of the transition period. For example, we worked with the US Commodity Futures Trading Commission (CFTC) to ensure firms operating cross-border within US and UK derivatives markets can continue to do on similar terms as the EU. We continue to cooperate with the CFTC on advancing further agreements in this area.

We agreed cooperation arrangements, including memoranda of understanding with EU authorities, which allow us to continue to meet our objectives when supervising cross-border business with EEA states. We have also agreed various memoranda of understanding with many non-EEA jurisdictions.

We advocate for clear and robust international standards and we are at the forefront of developing and maintaining standards which support cross-border activity and equivalence. We are an active participant in global standard setting bodies, such as the International Organisation of Securities Commissions (IOSCO) and the Financial Stability Board (FSB).

Through participation in IOSCO we have supported work to reduce market fragmentation and improve equivalence assessments. We were a key participant in the work of the in the development of IOSCO's "Good Practices on processes for deference" report[13], published in June 2020. This report outlines 11 ways in which jurisdictions and regulatory authorities can deliver outcomes-based assessments in an efficient way. We are continuing to work with regulatory counterparts through IOSCO to improve cross-border supervision. This will increase the confidence and trust authorities need to expand equivalence.

2. Development and scrutiny of financial services policy making and regulation after EU withdrawal

We welcome the Government's consultation on the second phase of its Financial Services Future Regulatory Framework (FRF) Review.[14] This considers how the UK's regulatory and legislative framework for financial services needs to adapt to reflect the UK's position outside of the EU.

Post-EU legislative framework

We welcome the Government's proposal for a post-EU legislative framework, which includes Parliament delegating responsibility for setting and amending most firm-facing requirements to the FCA in our role as an expert and independent regulator, with appropriate oversight. With many areas of financial services policy-making moving back to the UK, we think it is important to ensure that UK authorities can act effectively and efficiently to maintain, develop, and amend policy where required. There are many detailed firm-facing requirements in retained EU law, which, without change to the framework onshored from the EU, would require primary

[13] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD659.pdf
[14] https://www.gov.uk/government/consultations/future-regulatory-framework-frf-review-consultation

legislation to change. This will make it difficult to keep pace with the changing needs of firms, markets and consumers over time.

The Financial Services and Markets Act 2000 (FSMA) provides a framework that already enables the FCA to set and amend firm-facing requirements, subject to consultation and a wide range of other accountability obligations. Having responsibility for most firm-facing requirements enables us to act quickly to address emerging consumer harm and reflect market developments. The Covid-19 pandemic has illustrated the importance of enabling us to act quickly to protect consumers, businesses and firms during the crisis.

We support the need to consider whether changes are needed to the way that Parliament sets the overall policy direction for financial services. There are important policy and practical considerations when adapting the framework to achieve this. These include:

- balancing the greater scope for Parliament to direct regulators' focus without unduly limiting regulatory independence,
- ensuring that additional provisions add value to the policy-making process so that rule changes deliver the intended outcomes proportionately,
- avoiding creating unnecessary costs, which are ultimately borne by firms and consumers,
- avoiding unnecessary complexity and confusion by creating multiple different framing regulatory principles across an already complex regulatory regime.

Getting this wrong could make us less effective, particularly where the objectives push in opposite directions, or if their application or their prioritisation is unclear, or if the level of detail or prescriptiveness limits our ability to achieve the intended outcomes.

A sector-based approach to setting policy priorities in legislation through, for example, additional regulatory principles (or 'have regards'), could be particularly challenging for the FCA and firms. We consider this would artificially split the sectors we regulate and does not reflect the way firms and markets operate. This is particularly true in wholesale markets, for example, where multiple types of firm engage in similar activities, and where boundaries between sectors are unclear, could become out of date, or where different treatment could lead to regulatory arbitrage. The framework to enable Parliament to set the overall policy direction should reflect the way firms and markets operate, which is often more flexible than can be reflected in a sector and activity-based focus.

We support the Treasury's intention to review the existing FSMA regulatory principles. Where policy considerations are relevant to many areas of regulation, we consider it more appropriate for these to be reflected in cross-cutting regulatory principles rather than in individual areas of framework legislation. If appropriately framed, we consider it likely that most "have regards" would be more effectively and efficiently maintained at this cross-cutting level, applying across all regulatory activity.

Enhanced accountability and scrutiny

As a public body, we consider that robust accountability and scrutiny is an essential part of an effective regulatory regime. The current legal and regulatory framework provides an extensive range of accountability, scrutiny, transparency and engagement mechanisms. Through these formal, and further informal, mechanisms, we are committed to exercising our functions in an open, transparent and accountable way to our broad range of stakeholders, including Parliament. Ensuring accountability is also a core part of our transformation programme. We set out below a non-exhaustive range of some of the key ways in which we are scrutinised by and accountable to Parliament and our wider industry and public stakeholders. These include both internal operational requirements, and the external requirements through which we are held to account. All contribute to ensuring accountability and democratic input.

Discharging our general and policy-making functions

Operationally, when discharging our general functions (including the making of rules), we are required by FSMA to act (ex-ante) in a way that is compatible with our strategic objectives and advances at least one of our operational objectives. We are required to:

- consult publicly on making rules and guidance, with cost benefit analyses, before making rules,
- publish our responses to consultation feedback,
- have regard to eight regulatory principles,
- have regard to aspects of Government policy set out in the remit letter recommendations sent in each Parliament,
- consult, and consider representations from, a wide range of statutory panels (consumer and practitioner) on the extent to which our general policies and practices are consistent with our duties,
- set out in general guidance how we will advance our operational objectives in relation to different categories of authorised persons or regulated activity.

In addition to FSMA cost benefit analyses, we are also subject to broader accountability and scrutiny under the Enterprise Act. We must in some cases publish impact assessments, which are scrutinised by the Regulatory Policy Committee.

And, as co-chair of the Regulatory Initiatives Forum, we contribute to, maintain and review the Regulatory Initiatives Grid.

Ensuring transparent and clear organisational responsibilities

- In exercising our legislative functions (including making rules), we must act through our governing body, the FCA Board.
- The Treasury Select Committee (TSC) has a duty to scrutinise a person appointed to be CEO.
- The Treasury makes appointments to the FCA Board, and FCA Board members may be removed for incapacity, conflicts of interest, or serious misconduct.
- We are required to publish our FCA Board minutes.

Accounting for our activities

We are also held to account (ex-post) externally for our actions. This happens in several ways, before several forums.

To Parliament and Government:

- We are regularly called before the TSC, which can publish reports and call on us to respond to its concerns (such as its inquiry on the regulatory perimeter) and publish certain documents (such as the skilled persons report into RBS's GRG).
- The Treasury can appoint an independent person to conduct a review of the economy, efficiency and effectiveness of the FCA's use of its resources in discharging

its functions.

- We are required to make an annual report to the Treasury on the discharge of our functions and advancement of our objectives, which must be laid before Parliament.
- As appropriate, we are also regularly called to give evidence to other Parliamentary Committees such as the Work and Pensions Select Committee.

To stakeholders:

- We are required to hold annual public meetings, which consider the annual reports.
- Our statutory independent Panels report annually on their activities, and we respond to the issues raised in these reports.

To other public bodies:

- The National Audit Office (NAO) examines, certifies and reports on our accounts, and the certified accounts and report are laid before Parliament. It can also conduct studies and investigations – we have been included in four NAO studies since 2014.
- Judicial review or appeals to the Upper Tribunal.
- The Complaints Commissioner may investigate complaints about the FCA's relevant functions.
- The Information Commissioner can oversee complaints against the FCA in relation to obligations under the GDPR, DPA 2018 and FOIA.

We think it important to carefully consider all existing mechanisms, and to be clear on what each is seeking to achieve, before adding new measures. This could also help to inform possible improvements to, and rationalisation of, existing measures. Similarly, we consider it important to be clear on what any new mechanism would be seeking to achieve over and above what is already in place. And where there may be a case for adding a new mechanism, or strengthening or re-purposing certain existing mechanisms, we would be concerned if any additions created overlapping or conflicting obligations, or duplicative mechanisms, prevented a balanced representation across all our stakeholders, reduced our operational and regulatory effectiveness to address emerging harm or meet changing circumstances, or introduced additional costs that would be borne by firms and consumers.

In this context, especially when considering adding new oversight mechanisms, it will be important to remember that the governing body of the FCA is its Board, through which the FCA is accountable to Parliament. The chair, the chief executive and at least one other member is appointed by the Treasury, and two non-executive members are appointed jointly by the Treasury and the Secretary of State for Business, Energy and Industrial Strategy (BEIS). The Board sets the strategic direction for the FCA, closely oversees how the organisation operates, and holds the FCA executive accountable through their respective roles that support the FCA in meeting its statutory objectives.

Through what legislative mechanism should new financial regulations be made?

The Treasury is proposing to transfer the ability to maintain and make firm-facing rules from the onshored Level 1 and Level 2 EU Regulations, and Treasury legislation, to the regulators. This is in line with the existing FSMA model of regulation, and our rule-making powers. The detail of the legislative mechanism is for Parliament to decide, but we support this proposal: without this transfer, changes to these rules would likely require primary legislation.

This transfer of responsibility will require primary legislation, and perhaps also secondary legislation. Whatever the approach, it will require a significant legislative programme, supported by the regulators, which will likely take several years.

Our priorities remain that we have the appropriate powers and flexibility to maintain a regulatory regime that is coherent, responsive to changing circumstances, and appropriately addresses the needs of UK consumers (to whom we are ultimately accountable), markets and firms. It is important that however the transfer of responsibility is achieved, it is not left incomplete, as this will impact the coherence of the regime.

What changes should be made to the UK's financial services regulations and regulatory framework once the UK is independent of the European Union?

Changes to regulations

The Financial Services Bill contains a number of measures, including provisions similar to those in 'in-flight' EU financial services legislation, which were not operative at the time of exit, and therefore were not incorporated into UK laws by the European Union Withdrawal Act 2018. The core measures, included in the Bill, relevant to the FCA include: the introduction of the UK Investment Firms Prudential Regime (IFPR); powers to ensure the transition away from LIBOR runs smoothly; establishing an overseas fund regime; and establishing more robust market access arrangements for Gibraltar. Other measures of FCA interest include amendments to the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation and Breathing Space. We welcome the introduction of this Bill, which will help to maintain the standards that have made the UK a global centre for finance.

Changes to framework

The EU framework for drafting and developing legislation is multi-layered and complex. Increasingly, prescriptive requirements have been set in EU legislation with the aim of making financial services regulation maximum harmonising across EU Member States. However, this model of legislative rule-making has become progressively less suited to the fast-moving marketplace. It is also less suited as a model for a single sovereign state.

These requirements now form part of retained EU law in the UK. Should any changes be needed to the requirements, this may require primary legislation. We are concerned it could prove practically challenging to adapt legislation as frequently and quickly as is likely to be optimal given changes in markets, technologies, and the emerging needs of consumers and firms, without taking significant parliamentary time. We therefore support the Government's proposals to move away from this EU model, and back to the UK FSMA model, where regulators develop firm-facing rules.

We consider that this approach would give the UK's regulatory regime more flexibility and the ability to respond to market developments in an agile way. We also support the aim to move away from the EU file specific model, where detailed rules apply often to a particular sector or type of firm or product, with a view to being able to take a more holistic view.

What role does Parliament have to play in influencing new financial services regulations?

Parliament is sovereign, and we are accountable to it. Parliament already has a role in objective-setting and high-level policy-making, which is set in primary legislation. We agree with the Treasury's proposals to build on the FSMA model, whereby overall policy direction is set by Parliament in primary legislation, and detailed firm-facing rules are the responsibility of the regulators. Under the Government's proposals, Parliament will determine the framework legislation under which we will be tasked with designing and implementing the regulatory requirements that apply to firms, and will hold us (and Government) to account – as it does now. We consider that the framework enabling Parliament to set the overall policy direction should reflect the way firms and markets operate, which is often more flexible than can be reflected in a sector or even single-activity-based focus.

How should new UK financial regulations be scrutinised?

We support the Treasury's review of the existing accountability, scrutiny and transparency mechanisms to ensure that they remain robust, effective, and appropriate for the long term.

Today, we are accountable to a broad range of stakeholders, and consider the FSMA framework strikes a good balance between robust accountability and transparency, and ensuring that regulators have the flexibility to act where necessary. Where it is found that substantive legislative improvements may be needed, we consider it important to ensure that the design of these mechanisms preserves the benefits of regulatory dynamism and independence, and adds value to the existing framework. We recognise Government is considering whether to add to the existing accountability mechanisms. We think it is important to consider the existing arrangements, and how any additional mechanisms would interact with what these are seeking to achieve, and to avoid duplicating existing arrangements, adding cost, complexity or delay into the system. The design of any new accountability mechanisms should operate effectively with existing mechanisms.

Should the mandate and statutory objectives of the financial services regulators change to include wider public policy issues?

We note that the Government has not proposed changes to our statutory objectives in its consultation. We consider that our existing objectives are appropriate, already support achievement of the intended outcomes, and are sufficient and flexible to adapt in light of technological or market developments. They also provide clarity in our mandate, and it is important not to detract from this clarity of purpose.

Under the Government's FRF proposal for developing framework legislation, we will likely need to have regard to a wider range of factors when fulfilling our responsibilities, including public policy issues such as competitiveness. The current, and previous, remit letter already requires us to have regard to important economic and competitiveness issues, for example. The Government's proposals also include more frequent use of these remit letters, which we consider would better deliver requirements for us to consider wider public policy matters, which can, and do, change over time.

How important is the independence of regulators and how might this best be protected?

Regulatory independence is important because it helps to support the integrity of the UK financial system (and financial stability), thereby ensuring that the relevant markets function well. It also demonstrates the UK's commitment to sound, expert regulation that is consistent with the consensus on best practice for financial services regulators across the globe and in other sectors.

FSMA established the FCA as an operationally independent regulator with a clear set of statutory objectives, the relevant powers to deliver those objectives in an appropriate and accountable way, and a system of funding that does not have significant conflicts. These elements need to be maintained to safeguard regulatory independence. The Government's FRF proposals seek to build on the strengths of FSMA and the role of independent financial services regulators. We believe that we have the relevant expertise to develop and deliver the rules, and our more market-facing experience and responsiveness can be brought to bear when setting firm-facing requirements.

While we support the role for Parliament in setting the overall policy framework, we believe that it should be done in a way that preserves and promotes our status as an independent regulator.

What are the strengths and weaknesses of the European Union model of scrutinising financial services legislation?

See our response to the question below.

Should the UK seek to replicate the EU's model for drafting and scrutinising financial services regulation?

There are useful lessons from the EU model for scrutinising financial services legislation. In particular, there is a dedicated, expert European Parliament committee for financial services, the Committee on Economic and Monetary Affairs (ECON), which scrutinises the European Commission's legislative proposals for financial services. The Committee may hear evidence from external experts, interest groups, and Commission representatives, and drafts amendments to Commission proposals. The Committee is well resourced (over 80 MEPs, supported by expert policy assistants, and a secretariat), meets regularly (at least once a month), and its debates are held in public.

Expertise and dedicated resourcing have been of value in the EU scrutiny process. For this reason, we consider the creation of a new joint parliamentary committee focusing on financial services and its regulation would deliver benefits to the UK regulatory landscape. However, there is a variety of ways of best supporting the parliamentary scrutiny process, and the choice amongst these is properly a matter for Parliament.

3. Current challenges facing regulators

Technological, social and macroeconomic developments present major challenges for consumers and businesses who rely on financial services, for financial services firms, and for the FCA. We are undertaking a major transformation programme, in response to both these external factors and internal challenges around people, data and technology. This transformation programme seeks to ensure that the FCA can perform two key roles

1. *Ensuring appropriate consumer protection from bad actors*

With 60,000 firms within our remit and a volume of unauthorised activities carried on by other actors, we need to make further investments in a digital and data-enabled approach, to allow us to intervene sooner and reduce harm to consumers from bad actors. This is particularly important due to the rise of digital marketing – which enables bad actors to cause large amounts of harm in short time periods. Whilst we are improving our capability, we will never deliver a zero-failure regime. We want to ensure consumers put an appropriate level of trust in firms we have authorised, whilst remaining conscious of their own responsibilities, their rights to redress, and the fact that we do not shadow-manage 60,000 firms. In the medium term, reducing harm from bad actors should reduce the FSCS levy.

2. *Improving how financial markets function overall*

Financial markets are changing rapidly, with the pace of digitisation likely to accelerate as a result of the response to Covid-19. We want to enable markets to develop in the best interests of consumers, ensure technology is harnessed to provide better services and products, promote effective competition in the interest of consumers, and that sufficient provision is made for the most vulnerable in society. As sales and marketing tactics change, we want to ensure that customers receive fair value and that firms do not take advantage of behavioural biases or sludge practices. We must also ensure that wholesale markets continue to work well post-Brexit and that the UK is able to influence global standards. Green finance offers an important opportunity for the UK financial sector, and for UK consumers. We are working closely with industry and government to ensure this develops in a sustainable way.

We will be required to make prioritisation choices both in respect of the level of protection we provide against bad actors, in respect of improving overall outcomes, and across these activities. We aim to deliver a step-change in our accountability, making clear public statements on what we aim to achieve, what we cannot achieve, and publicly measuring our effectiveness against this.

We will focus on our data and people capabilities, and will respond to findings in recent regulatory failure reports. Digitisation of our model will enable us to act faster, reduce harm caused by bad-actors, make more informed and effective market-wide interventions. We will also develop the capabilities of our people, with a focus on data, on business-model analysis and ensuring we benefit from a diverse and inclusive workforce.

How should financial services regulators be funded?

Legislative framework

We are wholly funded by the industry we regulate. FSMA gives us powers to make rules to raise fees to recover the costs of delivering our statutory objectives. We are required to consult on those fees rules.

Under FSMA we are accountable to the Treasury and are required to report on, among other things, the extent that we have met the principles of good regulation.[15] These include considering the need to use our resources in the most efficient and economical way. That report to Treasury is laid before Parliament, published as our Annual Report and Accounts[16],

[15] https://www.fca.org.uk/about/principles-good-regulation

and discussed at our Annual Public Meeting. Our accounts are audited by the National Audit Office.

Fees structure

Our Business Plan[17], published in April, alongside our fees rates consultation paper (CP), sets out how our annual funding requirement (AFR) will deliver our statutory objectives. Our AFR is recovered through periodic fees, paid annually. The periodic fees structure is based on the allocation of our AFR across a series of 24 fee-blocks that reflect broad sectors of the industry based on the regulated business activities firms undertake. Firms can be in more than one fee-block depending on the overall mix of their regulated business. The AFR allocated to the fee-blocks is recovered from the firms within those fee-blocks based on a measure of their size. This ensures larger firms pay more than smaller firms. We use size as a proxy for the impact risk on our statutory objectives should firms fail.

Each fee-block has a minimum size threshold and if a firm falls below that threshold in all the fee-blocks it is in it only pays a minimum fee (which range from £106 to £1,151). The most common measure of size used in fee-blocks is income where the minimum size threshold is £100,000. Around 71% of firms only pay the minimum fee.

Our periodic fees structure has been developed through many previous consultations and enables the recovery of our AFR to be proportionate across fee-blocks, relative to the risks the regulated activities they cover pose to our statutory objectives. The recovery of the AFR allocated to fee-blocks based on the size of the firms within them further enables our fees structure to be proportionate.

Financial penalties

Under FSMA we must pay the financial penalties we receive from firms to the Treasury, net of certain enforcement costs incurred in the financial year in which the penalties were received (retained penalties). The retained penalties are applied to the benefit of firms through rebates to their periodic fees in the following year, other than to the fees levied on the penalty payers themselves.

Annex 1 contains a table setting out the breakdown of funding recovered from financial services firms.

Challenges

We have taken on more responsibilities (including the regulation of claims management companies and pre-paid funeral plan providers, expected to enter our regulation in Summer 2022) and there is an increasing need to prioritise as an organisation. To support prioritisation, and earlier identification of issues, we are using our data strategy to develop and improve our capabilities and efficiency while controlling our costs overall.

The biggest driver of increasing costs of regulation at the current time is the increasing Financial Services Compensation Scheme (FSCS) levies. With regards to investments the UK's

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[16] https://www.fca.org.uk/publication/annual-reports/annual-report-2019-20.pdf
[17] https://www.fca.org.uk/publications/corporate-documents/our-business-plan-2020-21

compensation scheme provides broader coverage than compensation schemes in other jurisdictions, reflecting the difference in the investment advice market in the UK compared to other countries. This protection ensures consumers are protected from harm and have the confidence to do business with financial services firms, benefiting all firms in the industry. As with fees more generally, FSCS costs are allocated across different funding classes relating to the type of business that a claim for compensation involves. A firm's levy is based on the overall levy costs for the class, its eligible income and the eligible income of other firms in the class. Drivers of the FSCS levy increase include historic redress issues that have come to light. It remains too early to know what the full impact of the weakening of some firms' financial resilience during the pandemic, will be on the FSCS levy; and this uncertainty is reflected in the FSCS's plan & budget for 2021/22.[18]

The key way to reduce the FSCS levy for a particular fee group is to prevent the redress liabilities from occurring. This may mean that we invest more in proactive supervision measures, although this also has cost implications. There are other steps that can be considered such as stronger capital requirements, professional indemnity insurance (PII) cover and more stringent gateway checks, all of which could reduce the probability of firms failing with large redress bills outstanding. These options also have implications for the firms we regulate. We are currently considering these issues in the Consumer Investments Markets through the Call for Input.[19]

The Financial Ombudsman Service *(*FOS) is currently transitioning from the mass complaints handling required for PPI to a model with fewer but more complex cases across a variety of markets. FOS costs are driven by the volume of complaints they forecast that they will need to manage over the next year both for general casework and PPI. FOS also recoup a proportion of their costs directly through the case-handling fee charged to firms.

Overarching options on funding financial regulation

Striking the right balance between proactive prevention and adequate support and compensation will remain a challenge regardless of where the funding comes from. If we were not funded by a levy on industry, the other main options would appear to be either funding through general taxation or a levy on consumers of financial services.

How can the balance between lighter touch regulation and prudential safeguards be best secured?

We are responsible for the prudential regulation of some 49,000 financial services firms. This makes us the largest prudential regulator by number of firms in Europe.

Our prudential requirements are typically set on the basis of the regulated activities of a firm, such as providing investment advice. These prudential requirements have been developed and implemented over many years, and reflect a desire to ensure the requirements are proportionate for firms.

Currently only around 19,000 firms operate on prudential regimes which set quantitative standards, and many of these firms are only required to hold a simple base level of financial

[18] https://www.fscs.org.uk/news/fscs-news/plan-budget/
[19] https://www.fca.org.uk/publications/calls-input/consumer-investments

resources that typically includes initial capital and a proportion of overheads. We need to consider whether the current balance with safety and soundness is struck in the right place for the challenging times that lie ahead for the consumers of financial services, for the firms that service them, and for the markets in which they operate.

We have identified a number of prudential drivers of harm relevant to regulated firms that, if they crystallise, could harm consumers or markets and undermine our operational objectives:

- firms without adequate financial resources may be more incentivised to engage in poor conduct to drive returns
- firms without adequate financial resources may not be able to pay money they owe (i.e. redress they owe consumers or return client money)
- poor financial resilience at a firm and system-level can increase the risk of disruption to market functioning
- poor financial resilience can increase the risk of disruption to continuity of service

We are now seeking to better align the design of our prudential regimes with these drivers of harm. We consider it important that all firms have the capacity to wind-down or exit the market in an orderly manner, and that those that pose a risk to market functioning or consumers (through inability to pay redress, for example) hold adequate financial resources to mitigate this. It is important that the owners of financial services firms have enough 'skin in the game' to act as a disincentive to engage in poor market practice. For example, we consider it important that the amount of capital that a firm is required to hold for regulatory purposes should take into account the returns that the firm is making from its regulated activities. The use of cost-benefit analysis will help us to determine where this balance may now lie in each particular case.

We look to achieve proportionality by designing regimes that 'scale' requirements. With higher expectations where the risk of harm posed by a firm is higher. This may be built into the regime, such as with the forthcoming Investment Firms Prudential Regime (IFPR) – which forms part of the Financial Services Bill. We are also working with Treasury and the Bank of England on the review of the payments landscape following the UK's withdrawal from the EU as another good example of the balance we seek to achieve, between setting prudential standards to protect consumers and markets from potential firm failures, while ensuring new firms are able to enter the market and compete effectively.

How should consumer interests be taken into account when considering potential regulatory changes?

We have a strong mix of regulatory tools which together enable us to fulfil our statutory objectives to ensure an appropriate degree of protection for all consumers, and to protect their interests through promoting competition in the markets we regulate. Alongside our supervisory and enforcement powers under FSMA, we also have concurrent powers under consumer protection and competition legislation, enabling us to look at unfair contract terms and carry out market studies.

These powers and objectives provide a strong foundation for us to support consumer interests and we would not wish to see them removed.

Regulatory change must reflect the needs of consumers and tackle consumer harm. Understanding the consumer experience and building in challenge to the regulatory process is essential to achieving this – our regulatory framework should protect the diverse needs of consumers across the whole of the UK. This points to a data-driven approach built on evidence of the consumer experience of the market, including where it is causing harm, alongside effective channels for engagement with consumers. For example, our Call for Input on Consumer Investments provides us with the opportunity to assess on the basis of our own evidence and feedback from a range of stakeholders, whether the current framework for financial promotions provides sufficient protection for consumers against unsuitable investments marketed online.

We have a range of means within our regulatory approach that enable consumer interests to be considered when considering regulatory changes, and our data strategy[20] is a key component of our transformation programme. Our draft vulnerability guidance[21] provides a good example of how our consumer policy is developed by reference to consumer interests as well as those of firms.

Key elements of our approach

It is important that any regulatory changes reflect the needs of the diversity of consumers of financial services, and tackle the potential and actual harms experienced by consumers using different financial products and services.

To achieve this, any proposed changes should be developed and informed by data sources and intelligence that evidence the problems and risks faced by consumers of financial services, particularly those who may be vulnerable to harm.

Proposals need to be subject to challenge and scrutiny by those who work closely in the interests of consumers and understand their financial lives. This will help ensure they are effective and do not have any unintended consequences.

How do we do this?

We have a variety of channels for understanding the needs and experiences of consumers of financial services which inform our policy development. We invest in research to understand consumers' attitudes, situations and experiences of engaging with financial services. We provide regular opportunities for challenge and input to our policy development so that it reflects consumer needs.

Our data strategy is a key part of our transformation agenda as we increasingly become a data-driven regulator. Consumer insight is important in giving us a good picture of consumers in these markets.

Research

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[20] https://www.fca.org.uk/publications/corporate-documents/data-strategy

[21] https://www.fca.org.uk/publications/guidance-consultations/gc20-3-guidance-firms-fair-treatment-vulnerable-customers

- Our Financial Lives Consumer Market research surveys over 13,000 consumers and looks at every aspect of their finances from income to product holdings alongside their financial circumstances more generally. We have increased the regularity and scale of our research during Covid-19 to understand how things are changing for people. As a regulator for the whole of the UK we are able to break down the emerging insight into regional and national, ethnicity, age, gender and vulnerability. We take steps to ensure our consumer research - both qualitative and quantitative - reflects those who are harder to reach or vulnerable.
- We also carry out focused consumer research to inform our competition and consumer policy development – for example on access to cash and credit payment deferrals – and to examine firm practices and impact in sectors subject to our supervision.
- We can draw in intelligence on consumers' financial circumstances from a wide variety of external data sources such as credit reference agencies, external consumer research, social media and the databases of consumer helplines including Citizens Advice to which we apply our data analytics tools including on consumer behaviour.
- We use the complaints data we receive from firms to help assess how well firms are treating their customers and how their performance changes over time. We also use this data to guide our work in supervising firms and markets and to highlight potential concerns with specific financial products. We compare the complaints we receive from firms against FOS complaints received and uphold rates.

Engagement

- Our Consumer Network comprises an expanding group of organisations such as charities, community groups, and academics. This includes large national consumer champions such as Which? and MoneySavingExpert as well as issue-focused groups such as Age UK and Shelter. Our innovative approach enables sometimes resource-stretched organisations to engage with our policy development and consultations in a dynamic way to provide ongoing insight and challenge.
- The Consumer Network is an important part of our consumer communications strategy and works to delivery key messages to diverse consumer audiences.
- We also communicate key messages to consumers via appropriate media on a regional and targeted basis. This includes warnings on scams and investment fraud and messages on our interventions further to Covid-19.
- Our programme of regional visits by our Executive – currently run on a virtual basis – enables us to understand the experience of financial services across the UK and enables our senior staff to hear first-hand about the local picture and challenges.
- FSMA provides for an independent Consumer Panel which gives early scrutiny and public challenge on policy development from the perspective of the consumer and conducts and publishes its own research to help ensure our approach is in the best interests of the consumers for whom we regulate.
- Our Supervision Hub provides a direct line for consumers to get help and be signposted to more tailored support. This also provides a rich source of up to date data on consumer harm and needs.

Diversity and Vulnerability

Across the markets we regulate, there is a diverse range of consumers, in different circumstances and with a range of needs. Therefore, it is important to consider the impact of potential regulatory change on the affected consumer base; this may differ based on a range of factors, such as how the different consumers interact with financial services, digitally or in person, or if the consumer displays characteristics of vulnerability that impacts their ability or willingness to engage.

As outlined in our draft vulnerability guidance, we want vulnerable customers to experience outcomes that are as good as those for other customers, and to receive consistently fair treatment across the firms and sectors we regulate. The draft guidance sets a framework for what firms should do to ensure that vulnerable consumers needs are met and they are treated fairly.

Alongside finalising the guidance, we are embedding the guidance framework into our own judgements, policies and processes to ensure we are taking a consistent approach to vulnerability across the FCA. We will monitor how firms respond to our guidance. Firms need to be able to demonstrate how they ensure the fair treatment of all consumers, including those who are vulnerable.

We conduct Equality Impact Assessments on our policy interventions to understand the potential positive and negative impacts on consumers with protected characteristics. Diversity of thought in financial services firms, and an inclusive approach to diverse views, helps firms to understand and meet the needs of consumers from diverse segments of society. This, in turn, leads to a reduced risk of harm to consumers and to market integrity and encourages innovation, through the development of products and services designed to meet the needs of all types of consumer.

Joining up with the wider regulatory landscape for consumers

Consumers' financial lives are impacted by markets beyond those we regulate. To understand the wider experience of consumers and the challenges they face we are actively engaged with the UK Regulators' Network (UKRN) which enables cross-cutting and joined-up working in the public interest – including on vulnerability. We also sit on the Consumer Protection Partnership, chaired by BEIS, to manage the wider consumer landscape, along with responsible consumer bodies and advocates, to share intelligence and experience and support a joined-up approach across the UK.

Duty of Care

Some stakeholders have voiced concern that our regulatory framework may not be sufficient, or applied effectively enough, to prevent harm to consumers. Consequently, in 2018, we launched a discussion paper on a duty of care and potential alternative approaches to consider whether our regulatory framework, or the way we apply it, could be strengthened.

In our feedback statement[22] to the discussion paper, we committed to reviewing how we apply the regulatory framework. We are now considering this and intend to consult on potential options in Q1 2021.

February 2021

[22] https://www.fca.org.uk/publications/feedback-statements/fs19-2-duty-care-and-potential-alternative-approaches

Annex 1: Breakdown of funding recovered from financial services firms

Organisation	2018/19		2019/20		2020/21	
	£m	YoY %	£m	YoY %	£m	YoY %
FCA	543.3	3.1%	558.5	2.8%	589.9	5.6%
PRA	262.0	-11.7%	255.3	-2.6%	280.3	9.8%
FOS	24.5	0.0%	44.5	81.6%	106.0	138.2%
FSCS	407.6	28.9%	551.4	35.3%	649.0	17.7%
Money & Pensions Service (i)	N.A.	N.A.	107.4	N.A.	144.2	34.3%
Devolved Authorities (ii)	N.A.	N.A.	7.8	N.A.	11.5	46.7%
Money Advice Service (iv)	86.0	28.2%	N.A.	N.A.	N.A.	N.A.
Pension Wise Service (i) (iv)	17.5	1.8%	N.A.	N.A.	N.A.	N.A.
Illegal money lending levy (ii)	5.6	12.1%	5.7	1.4%	6.2	7.5%
Payment Systems Regulator	13.9	15.7%	15.6	12.4%	16.8	7.6%
Financial Reporting Council (iii)	13.2	-1.5%	13.5	2.3%	14.9	10.2%
Total	**1,373.5**	**7.4%**	**1,559.8**	**13.6%**	**1,818.7**	**16.6%**

Notes:

(i) For the Department for Work and Pensions

(ii) For HM Treasury

(iii) Board members appointed by the Secretary of State for Business, Energy & Industrial Strategy

(iv) The levies previously raised for the Money Advice Service and Pension Wise Service are raised for the Money and Pension Service and the Devolved Authorities (debt advice levy only)