

THE ARCHITECTURE FOR REGULATING FINANCE AFTER BREXIT



The International Regulatory Strategy Group

The International Regulatory Strategy Group (IRSG) is comprised of leading UK-based figures from the financial and related professional services industry. It is one of the leading cross-sectoral groups in Europe for the financial and related professional services industry to discuss and act upon regulatory developments.

Within an overall goal of sustainable economic growth, it seeks to identify opportunities for engagement with governments, regulators and European and international institutions to promote an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views.

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FOREWORD

The UK has long played a leading role in the creation and implementation of strong global, EU and domestic financial services regulatory frameworks. These benefit businesses and customers alike. As the UK continues to negotiate its new trading relationship with the EU and determines its future post-Brexit, we must also consider the important domestic implications of no longer being part of the EU's regulatory and supervisory architecture.

Building on the recommendations highlighted in the IRSG's report 'The Great Repeal Bill: Domesticating EU law', which considered the effects of Brexit on domestic law more generally, this report considers the impact of leaving the EU on the current UK regulatory and supervisory system for financial services. In many ways, this means reverting to the pre-crisis regulatory settlement, with relatively more influential UK regulators as the EU Withdrawal Bill gives broad powers to amend retained EU law to the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA). While the degree of change to the UK's current system will depend on what is agreed about the future UK/EU relationship, it is important that a transparent and accountable process for managing public policy is in place and power is not concentrated in a single actor or body. This transparency and accountability will lead to enhanced confidence in the system and better regulatory outcomes, for customers and clients.

This report does not make any recommendations on the specific content of financial regulation; instead, it asks whether the checks and balances built into the system are adequate for the UK post-Brexit. The report proposes principles for assessing the effectiveness of the regulatory framework including regulatory independence, regulatory accountability, coherence, flexibility and clear and appropriate regulatory objectives. These principles have been used to develop the report's recommendations and inter alia analyse how to strike the balance between competing regulatory objectives and ensure ongoing consideration of broader public policy objectives.

The recommendations should not be treated as a blueprint for reform, but rather a menu of options for consideration once there is more clarity on the future UK/EU relationship. Overall, we conclude that the UK regulatory system is and will remain largely fit for purpose. There is however an opportunity for targeted reform following the UK's withdrawal from the EU in order to maintain and enhance the UK's position as an international financial centre underpinned by a trusted and globally leading regulatory system, that delivers the best possible outcomes for customers and clients.

We are grateful for the support of all contributors to this report.

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EXECUTIVE SUMMARY

Background

The UK has a well-regarded system of financial regulation based on the 'twin peaks' regulatory structure. It administers regulation that has been developed domestically as well as a large volume of regulation derived from the EU. Leaving the EU means that the UK's financial regulators will be operating in a different context, and this report is concerned with ensuring that the UK's regulatory architecture remains robust and fit for purpose after Brexit.

When the UK withdraws from the EU, it will be able to choose whether to amend, retain or remove EU-derived regulation adopted pursuant to the European Union (Withdrawal) Bill, and whether to diverge in the future from its current status of close regulatory alignment with the EU. Such policy choices will, of course, be affected by the terms of any future relationship with the EU. Nevertheless, the UK institutions will have greater powers and responsibilities than they currently have within the framework of the EU legislative system and the European system of financial supervision (ESFS).

Principles for an effective regulatory framework

The report begins by outlining five principles by which an effective regulatory system should be judged:

- **Regulatory independence:** Regulators should be impartial and free from political influence. They should pursue clear, rational objectives that balance relevant conflicting interests, and they should be widely seen and understood to be doing so.
- **Regulatory accountability:** Accountability is needed to balance the privileges of independence. Regulators should be accountable both to the public, primarily through elected representatives, and to those whom they regulate.
- **Coherence:** Where there are multiple regulators, the division of responsibilities should be clear and transparent and regulatory powers should be allocated appropriately so that those responsibilities can be met. Cooperation between the regulators is essential. Coherence between domestic and international regulatory frameworks is also necessary.
- **Flexibility:** A regulatory system needs sufficient flexibility to anticipate and respond to market developments and innovations. It also needs to recognise that a one-size-fits-all approach does not always result in proportionate regulation.
- **Clear and appropriate regulatory objectives:** Given their significant powers and their independence, regulators need to be guided by a small number of clear and appropriate objectives.

The impact of Brexit on the UK system of financial regulation

To explore the impact of Brexit on the current system of financial regulation in the UK, the report first highlights the key features of the EU, UK and international frameworks for financial regulation which together make up the institutional framework for regulation within the UK. The EU system of regulation is driven by similar objectives to the UK system, with the added need to bring about a single internal market, creating a level playing field and reducing opportunities for regulatory arbitrage. These factors lead to a tendency to legislate in a detailed, prescriptive manner, in order to ensure consistency across all the EU's Member States. By contrast, the UK regulators have considerable rule making powers delegated to them and are also responsible for enforcement. Alongside both the EU and the UK are the international bodies responsible for setting global standards, in most of which the UK and its regulators play a prominent part.

Leaving the EU will, of itself, change the UK system of financial regulation. The European Supervisory Authorities (ESA) will no longer have a direct role in the way that the UK interprets and applies EU-derived regulations. Leaving the EU will involve a transfer of power and of functions to the UK, which will need to be allocated appropriately as between the FCA, the Bank of England/PRA, HM Treasury, or Parliament. The processes by which new regulation is made (or existing regulation amended) will be the UK's processes, not the EU's processes, with the result that there may be more flexibility to change rules, but less political oversight.

RECOMMENDATIONS FOR THE FUTURE

Following on from this analysis on how withdrawal from the EU will change the UK regulatory architecture, the report makes 14 recommendations. These are aimed at keeping the UK's architecture of financial regulation aligned with the regulatory principles identified above in the post-Brexit context. The recommendations are not intended as a comprehensive blueprint for a new regulatory architecture. Instead, they build on the existing domestic regulatory system.

The recommendations divide themselves into four categories:

- (i) Those intended to ensure the powers and resources of the regulators will remain appropriate. We conclude that, in the interests of flexibility, the regulators should assume general responsibility for financial regulation derived from EU law after withdrawal. However, we also propose a mechanism to prevent this from inadvertently jeopardising mutual market access arrangements set out in the IRSG report 'A new basis for access to EU/UK financial services post-Brexit'.
- (ii) Those that would contribute towards accountability by ensuring that the regulators' expanded powers are appropriately framed. We recommend introducing an additional regulatory objective and increased engagement by HM Treasury, where appropriate, over what the regulators must take into account when exercising their powers.
- (iii) Those that would enhance accountability by increasing general scrutiny of the regulators, both by the public (through their elected representatives) and stakeholders. We make recommendations about how this might be achieved without compromising regulatory independence, suggesting refinements of existing structures.
- (iv) Those that concern how financial regulation is made. We recommend reforms that could improve the quality of regulation, including through specialist scrutiny mechanisms that fill a gap in current mechanisms for regulatory accountability and by providing more systematic opportunities to assess regulatory coherence and flexibility.

THE RECOMMENDATIONS

Powers and resources of the regulators

1 The regulators should as a general rule be able to amend regulation derived from EU law

After Brexit, the PRA and the FCA should have broad powers to amend the body of retained EU law relating to financial services, subject to the terms of any future agreement with the EU. Given the need to be able to respond to developments speedily and flexibly, it would be impractical for the UK Parliament and/or government alone to have the power to amend financial regulations derived from EU law.

2 Any material divergence with the EU should be a matter of public policy

Decisions that the UK should (or should not) have broadly equivalent regulatory outcomes to the EU, where divergence might affect rights of access to the EU Single Market, are too politically significant for the regulators to make in isolation. Accordingly, government, with parliamentary oversight, should be responsible for decisions of this kind, with technical advice from the regulators.

3 The regulators will need increased resources for policy development and international engagement

This should focus on further relationship building with international bodies as well as the EU and other international financial centres.

4 The regulators and HM Treasury will need increased resources for new operations

Responsibilities and functions currently exercised by EU institutions will be transferred to the UK institutions and the bodies assuming those responsibilities will need to be appropriately resourced.

Framing the responsibilities of the regulators

5 The need to maintain and enhance the financial services ecosystem could be reflected in the regulatory objectives

The role that globally leading regulatory standards play in sustaining and promoting the financial services industry in the UK should be emphasised, and as a secondary regulatory objective, a focus on maintaining and enhancing the financial services ecosystem in the UK would meet the concern that regulators might otherwise be constrained by their objectives towards taking a protective and conservative approach which, cumulatively, could have a negative impact.

6 Policy letters from HM Treasury could be made more frequent and, where appropriate, more detailed

An obligation on HM Treasury to indicate public policy considerations more frequently to the regulators may be an effective way to increase accountability.

General scrutiny of the regulators

7 Interaction between the regulators and Parliament could be enhanced

We recommend considering whether accountability mechanisms should be strengthened in light of the new functions and powers of the regulators, for example through specific parliamentary committees appropriately resourced to focus on financial regulation.

8 The role and visibility of statutory panels could be strengthened

The PRA and FCA's statutory panels serve an important function but their remit and composition might be reviewed.

9 The PRA could hold annual public meetings, like the FCA

This would enhance the PRA's public accountability and encourage a culture of greater transparency.

Legislative and regulatory processes

10 A Financial Regulatory Policy Committee could be established

A specialist review body could focus on improving the cost benefit analyses on which regulatory policy changes are based and examine regulatory change proposals from the perspective of the broader better regulation agenda.

11 Consultation mechanisms could be improved

Greater transparency could be achieved by establishing and publishing clear frameworks defining which consultation mechanisms will be used in which circumstances and by publishing individual responses to consultations.

12 A Joint Regulatory Committee could be established

The arrangements for cooperation between the regulators could be formalised and made more transparent.

13 Review mechanisms could be made mandatory

Formalising requirements to review new rules or legislation within an appropriate period would provide the opportunity to improve regulatory outcomes.

14 Financial services legislation could be simplified and consolidated

Although there is no desire for comprehensive reform at this stage, ensuring that the legislation underpinning the regulatory framework is not unnecessarily complicated may be a worthwhile exercise.

1.0 INTRODUCTION

Over the last decade, the EU has been the predominant source of financial regulation in the UK.¹ UK authorities have played a key role in shaping European regulators and supervisory standard. When the UK leaves the EU and reassumes full regulatory competence, the UK's legislators, executive and regulators will have new powers and responsibilities and face new choices. This report considers whether the drivers of regulatory policy and the balance of powers and responsibilities within the UK architecture of financial regulation will remain appropriate after the UK has left the EU.

The UK needs to maintain processes for making and implementing financial regulation that are robust, effective and capable of responding to market developments. Will the regulatory architecture need to be adjusted to ensure that the UK retains rigorous and world-leading financial regulation in the post-Brexit environment? This report explores the need for enhancements to the UK's system of financial regulation by:

- Considering the principles by which regulatory architecture should be judged. **(Chapter two)**
- Outlining key features of the current UK system. This has an EU element and a domestic element. The EU will cease to play a direct role in UK financial regulation after the UK withdraws from the EU although it could remain a point of reference for UK rule makers; the domestic element will remain.² **(Chapter three)**
- Analysing the implications of changes to the regulatory system resulting from the UK's withdrawal from the EU. **(Chapter four)**
- In light of the key issues identified in chapter four and the principles outlined in chapter two, suggesting possible reforms that would build on the strengths of the domestic component of the UK system and maintain the effectiveness of UK financial services regulation after the UK withdraws from the EU. **(Chapter five)**

The overall conclusion of the report is that while the UK regulatory system is likely to be broadly fit for purpose after Brexit, it would benefit from targeted reform when the legislative agenda permits.³ Given the significant transfer of powers and responsibilities to UK regulators and the loss of legislative and supervisory scrutiny at the EU level, mechanisms to ensure accountability, coherence and flexibility will need to be enhanced. It is also appropriate to consider how additional objectives might help the UK system to adapt to a future outside the EU.

¹ This report is concerned solely with the system of financial regulation in the UK. It does not consider the Crown Dependencies (the Bailiwicks of Jersey and Guernsey and the Isle of Man) or British Overseas Territories (e.g. Gibraltar).

² Annexes I and II contain more detailed analysis of these two elements of the UK system.

The future of UK financial regulation significantly depends on what the UK and the EU agree in any withdrawal and/or future partnership agreement. One possible outcome of Brexit negotiations would result in the UK having no obligation to maintain alignment with EU regulation and pursuing an entirely independent policy. At the other end of the spectrum, a European Economic Area (EEA) style arrangement would likely require the UK to continue to apply the relevant EU law in its entirety. The IRSG, in its paper 'A new basis for access to EU/UK financial services post-Brexit', proposed a new model that would allow for mutual market access based on broad regulatory alignment. In this report we take this model and, in particular, its suggested Forum for Regulatory Alignment as a base case scenario for illustrative purposes.⁴ However, many of the proposals in this report would also be relevant in the context of a different agreement or outcome.

This report is about regulatory process and structure, and particularly about how rules are made and implemented in the UK. As such, it makes no recommendations about the content of financial regulation. The recommendations would not change the fundamental 'twin peaks' framework of regulation by the Bank of England/PRA and the FCA, or the way in which they supervise business, but could help the UK's system of financial supervision to maintain its effectiveness in a changed context. They are not intended to be treated as a package of reforms, but rather as a range of options that could be adopted in a variety of combinations in light of the UK's future relationship with the EU in the financial services sector, once this becomes clearer.

³ We recognise that Parliament, government and the UK regulators alike face significant time and resource constraints in the run up to the UK's withdrawal from the EU. The proposals in this report are not necessarily 'Day 1' reforms but should be implemented as soon as possible thereafter.

⁴ IRSG 'A new basis for access to EU/UK financial services post-Brexit' (September 2016), available at: <https://www.irsg.co.uk/assets/IRSGNewBasisForAccessweb.pdf>.

2.0 PRINCIPLES OF AN EFFECTIVE REGULATORY FRAMEWORK

We believe that anyone assessing the robustness and effectiveness of a regulatory framework will need to consider, at a minimum, five principles: regulatory independence, regulatory accountability, coherence, flexibility and clear and appropriate regulatory objectives.

2.1 Regulatory independence

Market participants need to know that regulators are impartial and free from political influence. They should be pursuing clear, rational objectives that balance relevant conflicting interests, rather than following disguised political or industry-driven agendas, and they should be widely seen and understood to be doing so.

In a regulatory context, ‘independence’ typically means independence from the government (but sometimes also Parliament). Regulators should not feel pressured or coerced into making regulatory policy or decisions against their better judgment, especially in relation to individual cases, as a result of political interventions whether by a minister or other parliamentarian and whether at a domestic or international level.

Regulators should, of course, also be independent from those they are regulating, avoiding ‘regulatory capture’. This does not mean staying aloof from industry: they should consult industry where appropriate and must understand the people and businesses they are regulating if they are to perform their role properly, for instance to ensure that regulatory objectives can be achieved in the most efficient way.

2.2 Regulatory accountability

Accountability is needed to balance the privileges of independence. There is also widespread agreement that accountability can improve regulatory performance. Knowing that its decisions and reasoning will be subject to outside scrutiny is a powerful incentive for a regulator to act having taken all – and only – relevant considerations into account. Regulators should be accountable to the public, primarily through elected representatives, and to those whom they regulate.

2.2.1 Regulators are public bodies. Parliament gives them powers – often very significant powers – for use in the public interest and in accordance with their constitutions and objectives. The public interest includes both the interests of consumers and potential consumers of financial products and services, and the interest that society more broadly has in regulatory outcomes such as financial stability and financial inclusion. Parliament and the government should monitor regulators to ensure that those powers are being used as intended.

2.2.2 Natural justice, and confidence in a fair system, also require some form of accountability to those who are or could be affected by a regulator’s actions. This includes institutional mechanisms through which the regulator can explain its reasoning and be informed of its impact, as well as processes for appeals and complaints.

To be accountable, regulators must be transparent, although there are clearly instances where there are overriding reasons for privacy.⁵

There is, inevitably, tension between the independence and accountability principles. The law can go some way to address this, for example by strictly limiting the powers of government to give directions to regulators or remove them from office. More generally, the distinction between political scrutiny of decision-making processes and broad outcomes (on the one hand) and of particular decisions (on the other) must be respected. The former ensures that a regulator performs its job correctly, through mechanisms for democratic accountability, whereas the latter has the potential to undermine a regulator's authority.

2.3 Coherence

The regulatory system must also be coherent. Where there are multiple regulators, the division of responsibilities should be clear and transparent and regulatory powers should be allocated appropriately so that those responsibilities can be met. Cooperation between the regulators is essential. In addition, within individual regulators with a broad remit, appropriate governance mechanisms and internal controls are needed to ensure that different policy teams are not undermining one another, for example by striking different balances between competing regulatory objectives, thereby creating uncertainty for stakeholders and, potentially, incoherent outcomes.

Coherence between domestic and international regulatory frameworks is also necessary. To maintain its pre-eminent position in financial services, the UK will need, as a minimum, to ensure that its domestic framework is coherent with international regulatory frameworks. International regulatory cooperation and standards that are coherent with international norms facilitate international trade in the sector. As Andrew Bailey recently observed, "where markets are global or cross-border, we should cooperate to ensure frameworks are consistent in terms of outcomes and that opportunities for regulatory arbitrage are minimised. And, where markets are local, we should share best practice and common approaches wherever appropriate."⁶

⁵ The classic example is the need to ensure stability during a financial crisis. Of course, the regulators also have strict duties of confidentiality in relation to information they receive in the discharge of their functions under section 348 FSMA.

⁶ Andrew Bailey, 'Speech at the Official Monetary and Financial Institutions Forum' (29 September 2017).

2.4 Flexibility

The last several decades have seen financial markets develop rapidly, with new customer needs, new products and new ways of delivering them. We can expect the high pace of change to continue, given increasing interaction between finance and information technology. A regulatory system needs sufficient flexibility to anticipate and respond to market developments and innovations. It also needs to recognise that a one-size-fits-all approach does not always result in proportionate regulation. For example, as the Bank of England has highlighted, applying EU capital requirements legislation to small banks and investment firms may be considered disproportionate.⁷

The need for regulators to be able to respond to changing circumstances must be balanced against the need for certainty and predictability which provide the necessary foundation for businesses to plan effectively and make investment decisions. A constant iterative flow of regulatory change can be a drain on resources and does not provide the stable platform that is desirable for investment and growth.⁸

2.5 Clear and appropriate regulatory objectives

Given their significant powers and their independence, regulators need to be guided by a small number of clear and appropriate objectives. Since regulators must act in accordance with their objectives, the objectives must be chosen carefully to produce the intended outcomes, coherent and comprehensive when taken together, and flexible enough for them to apply in light of technological and market developments. Where there are multiple objectives which could come into conflict, they should be organised in a hierarchy, to ensure that the regulatory system remains coherent and predictable.

Regulators also need parameters set around how they pursue their objectives, that is, general matters they must take into account whatever decision they are taking.

⁷ Bank of England 'Response to European Commission Call for Evidence on EU Regulatory Framework for Financial Services' (February 2016), available at: <http://www.bankofengland.co.uk/financialstability/Documents/regframework/detailedanswers010216.pdf>.

⁸ CBI 'Smarter Regulation: Strengthening the UK economy with Fit for Purpose Regulation of our Financial Services' (October 2016).

3.0 THE CURRENT UK SYSTEM OF FINANCIAL REGULATION

The current UK system of financial regulation combines EU and domestic regulation. EU policy is primarily focused on promoting the Single Market in financial services and ensuring its integrity by means of harmonising rules, with supervision and enforcement being left largely in the hands of national competent authorities (in the UK's case, the PRA and the FCA) but with a coordination role and some supervisory functions being carried out by the ESAs.

The European Communities Act 1972 incorporates directly applicable EU regulation into UK law. UK legislation and PRA and FCA rules implement other aspects of EU law as well as policies of domestic origin.

This chapter provides a very brief summary of these two elements of the UK system to provide context for the analysis and recommendations that follow. A more detailed analysis of the EU and UK elements of the UK's current system, drawing out some of the features relevant to the regulatory principles outlined in chapter two, can be found in Annexes I and II. The EU and UK systems of financial regulation each work within the broader international context of global standards and multilateral cooperation. Key elements of the international dimension are also summarised below.

3.1 The EU element

Diagram A illustrates some of the important features of how financial services regulation and guidance is made at the EU level. Diagram B provides an overview of regulatory supervision at the EU level.

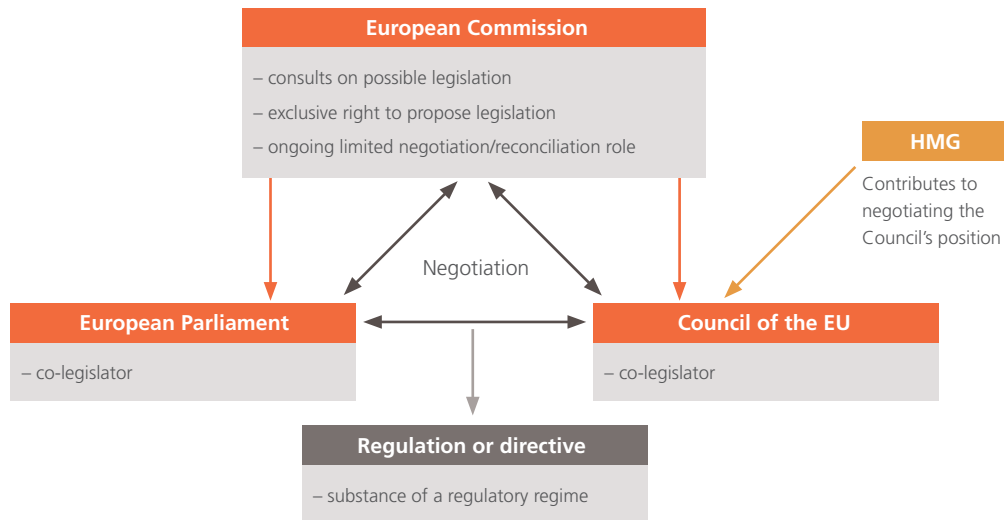
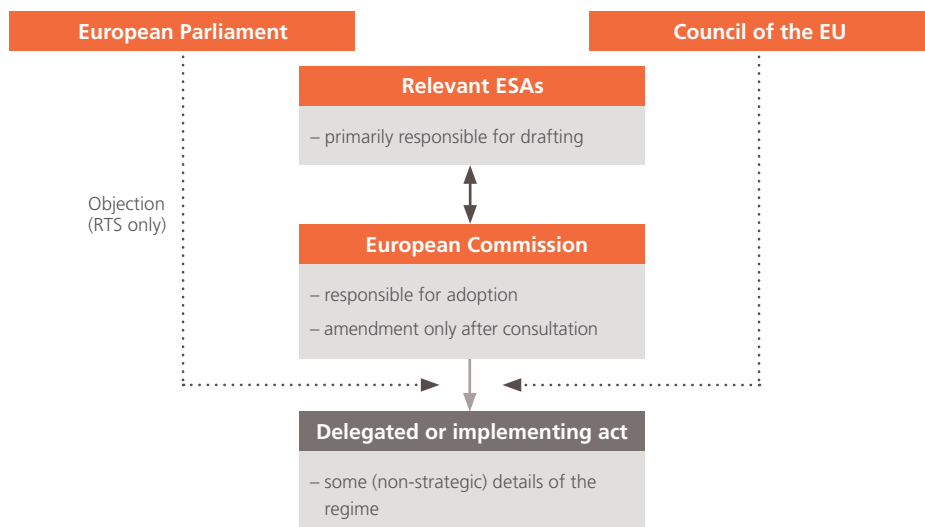
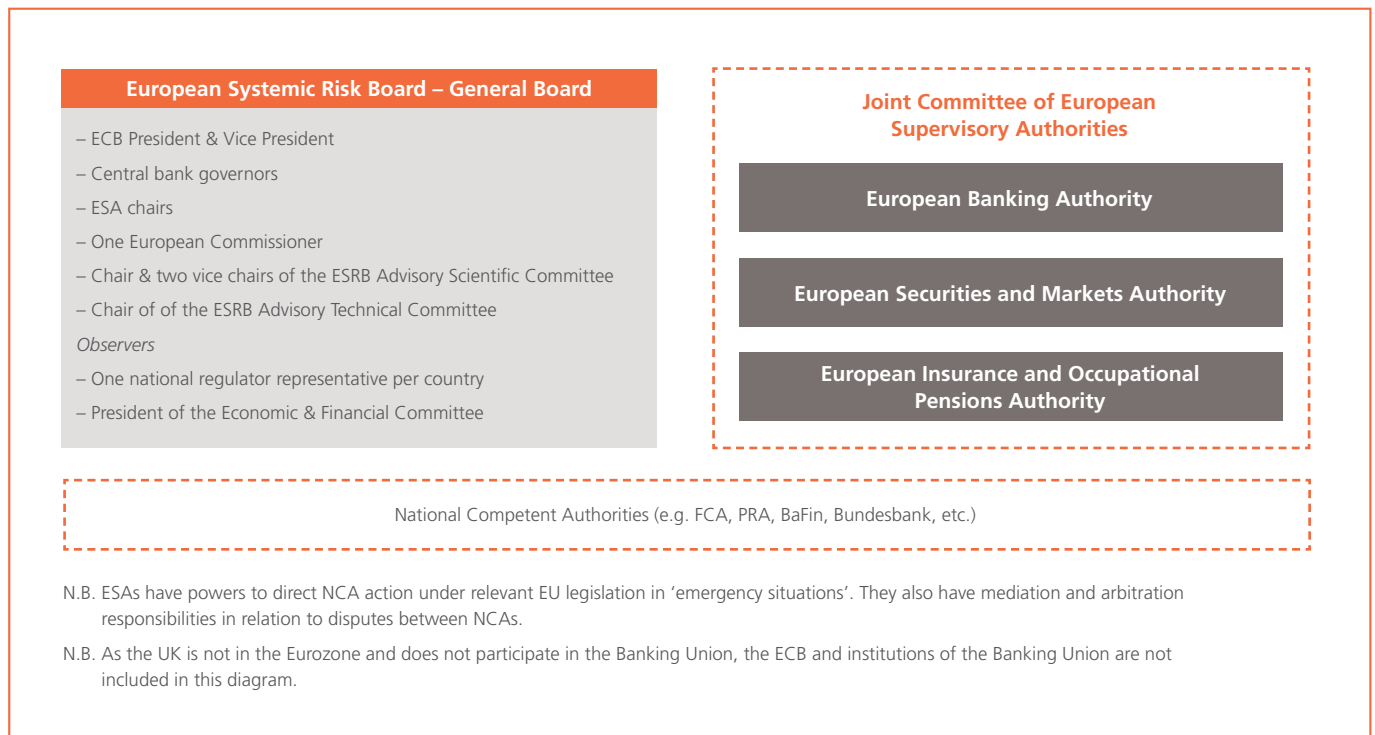
Diagram A: EU financial rule making**Level 1: Ordinary Legislative Procedure** (Articles 289 and 294 TFEU)**Level 2: Regulatory and Implementing Technical Standards** (Articles 290 and 291 TFEU; Articles 10 to 15 of Regulation 1093-1095/2010)**Level 3: Guidance** (Articles 16 of Regulations 1093-1095/2010)

Diagram B: European system of financial supervision

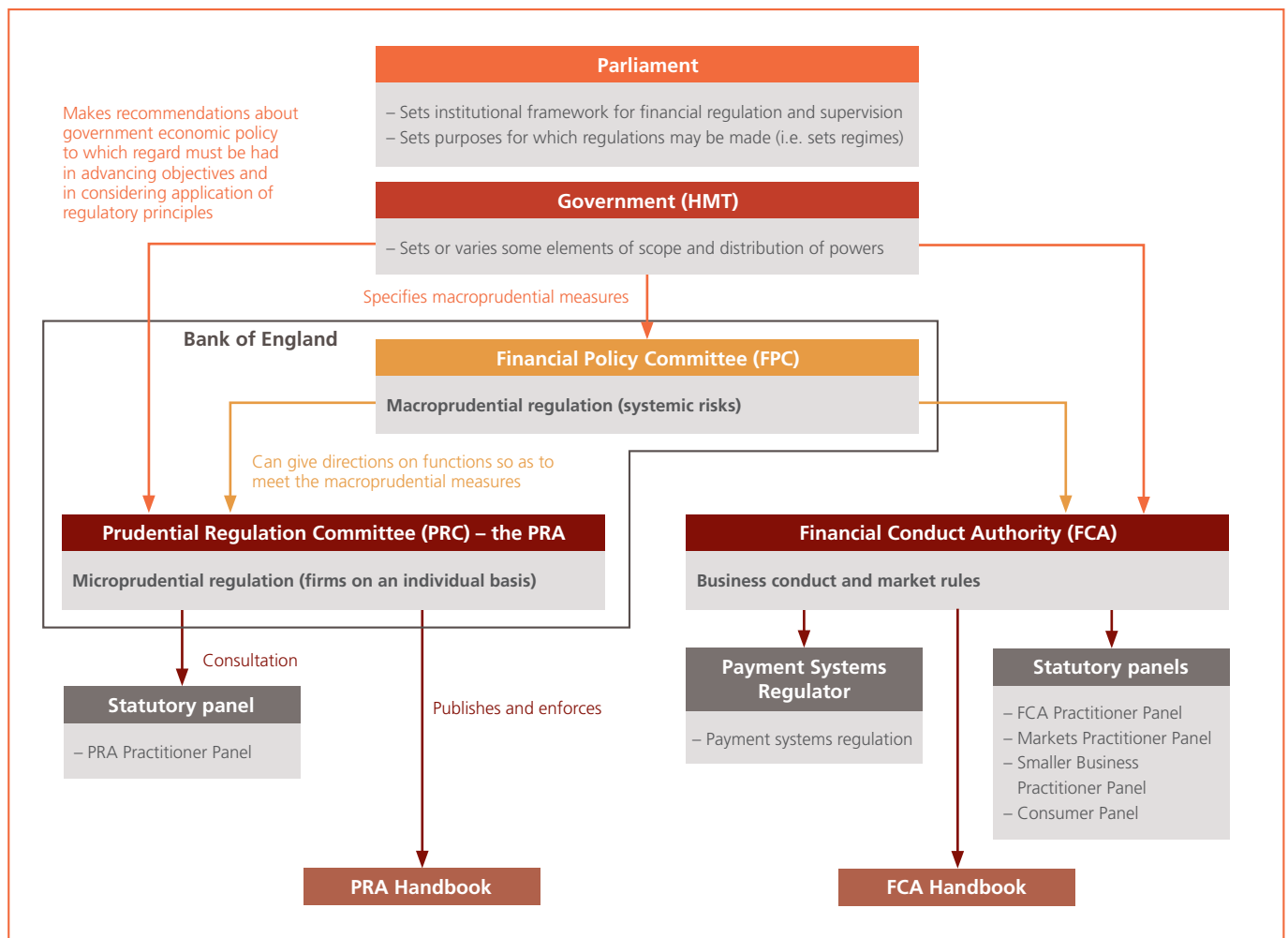
Key characteristics of the EU element within the UK system are:

- A drive towards harmonised regulation throughout the EU where necessary to bring about a single internal market offering a stable and level playing field and seeking to ensure market integrity, promote competition, reduce opportunities for regulatory arbitrage and promote economic growth.
- Rule making through the standard EU legislative processes, leaving relatively little discretion for national regulators.
- ESA regulatory competences normally being limited to the production of guidance and the coordination of National Competent Authorities (NCAs), with most supervision at the level of individual businesses conducted by the NCAs.
- A sectoral division of responsibility between the ESAs (e.g. different regulators have responsibility for banks, insurers and credit rating agencies).

3.2 The domestic element

Diagram C is a high-level illustration of the domestic architecture for financial regulation and supervision in the UK.

Diagram C: UK financial rule making



Key characteristics of the domestic element within the UK system are:

- A high degree of delegation of rule making and supervision by Parliament to independent regulators.
- A regulatory scope decided by the government (HM Treasury), in some cases with parliamentary endorsement.
- The regulators being responsible for enforcing the rules that they make.
- A primarily functional, not sectoral, division of responsibility between the regulators.
- Cooperation by regulators among themselves, given that individual businesses may be subject to regulation and supervision by more than one regulator.

3.3 The international dimension

The UK system does not exist in a vacuum. There are several institutions that play an important role in setting and monitoring the implementation (by the EU, by the UK and other countries) of global standards, core principles and guidance. Global standards are not legally binding but are developed by consensus amongst the most significant governments and financial regulators and compliance with them is generally high. The need for consensus, however, also means that the level of detail of global standards varies significantly from one policy area to another. This means that the extent to which the standard, core principle or guidance agreed by each standard setter can be converted into legislation varies greatly. Some standards are very detailed and can be readily incorporated into legislation, while others are highly general and need converting and amplification in order to be turned into legally binding instruments.

The most important standard setting bodies whose output is relevant to UK regulation include:

- The Financial Stability Board. This body was set up by the G20 and aims to coordinate policy among the world's largest financial centres. It also establishes principles of cross-sectoral relevance itself. HM Treasury, the Bank of England and the FCA are members.
- The Basel Committee on Banking Supervision. The Bank of England and PRA are members.
- The International Organization of Securities Commissions. The FCA is a member.
- The International Association of Insurance Supervisors. The PRA and the FCA are members.
- The Financial Action Task Force. This is concerned with money laundering, terrorist financing and other threats to the global financial system. The UK is a member.
- The Committee on Payments and Market Infrastructure. The Bank of England is a member.
- The International Association of Deposit Insurers. The Financial Services Compensation Scheme is a member.
- The International Accounting Standards Board. The Board members are independent experts.
- The International Auditing and Assurance Standards Board. The Board members are independent experts.

The UK and its regulators have a prominent profile in these international institutions. This is partially due to the scale, depth and global significance of the UK's financial and capital markets, but also because of the UK regulators' reputation for being proactive and valuable contributors. They will remain members after the UK withdraws from the EU.

4.0 THE IMPACT OF BREXIT ON THE UK SYSTEM OF FINANCIAL REGULATION

Leaving the EU will, of itself, change the UK system of financial regulation. The UK will no longer be directly subject to EU legislation. The ESAs will no longer have a direct role in the way that the UK interprets and applies EU-derived regulations.

The UK will need to make numerous modifications to the body of EU law retained under the European Union (Withdrawal) Act to ensure that it functions appropriately. As argued by the IRSG and Linklaters in 'The Great Repeal Bill: Domesticating EU law', to avoid overburdening industry and for reasons of time and capacity, this 'domestication' process should be kept separate (as far as possible) from making policy changes.

Apart from making any necessary modifications, the UK should assess its system of financial regulation against the principles of a robust regulatory framework. The regulatory system and institutions will retain their character and strengths, but the UK has the opportunity to consider improvements to the design of the system, subject to maintaining coherence and mutual recognition with the EU framework to the degree required under any agreements governing the future UK/EU relationship.

In this chapter we reflect on some of the key changes that will result from withdrawal from the EU and consider what they might mean for the overall quality of the UK system of financial regulation. We focus on where changes may have a negative impact on the UK system in terms of the principles for an effective regulatory framework outlined in chapter two. This does not, however, mean that all changes to the UK system resulting from the withdrawal of the UK from the EU are negative. Indeed, we see probable gains in its flexibility, as sections 4.1 and 4.3 imply.

4.1 Ability to amend regulations derived from EU law

Under the European Union (Withdrawal) Act, EU financial regulations will be domesticated. They will become part of a special category of UK law known as 'retained EU law'. While EU financial regulations can currently only be amended through EU legislation using the processes outlined in Annex I, in future the UK will be able to amend retained EU law unilaterally. This is a transfer of power to the UK. However, it will be necessary to determine who will be able to exercise this power, enabling UK regulation to diverge from EU regulation, and what the objectives of and potential constraints on any such divergence should be.

As the Bill stands, the FCA and PRA would have broad powers to amend the body of retained EU law. This is because it provides that "any power to make, confirm or approve subordinate legislation which was conferred before exit day is to be read... as being capable of being exercised to modify... any retained direct EU legislation."⁹ The distinction between Level 1 and Level 2 regulation is irrelevant for these purposes, as 'retained direct EU legislation' includes EU Regulations and 'tertiary legislation'.¹⁰

⁹ 'European Union (Withdrawal) Bill 2017-2019' (2017) Schedule 8, Part 1, paragraph 3(1). The Bill has a broad definition of 'subordinate legislation' which includes rules made under any Act. It therefore includes the rule making powers of the PRA and the FCA under FSMA.

¹⁰ 'Tertiary legislation' is defined as delegated and implementing acts under Articles 290 and 291 TFEU. In the context of the Lamafalussy process for financial services, these acts are known as regulatory technical standards (RTSs) and implementing technical standards (ITSs) respectively.

This means that the PRA and FCA will be able to use their existing powers under the Financial Services and Markets Act 2000 (FSMA) to modify those financial services regulations currently contained in EU regulations, regulatory technical standards (RTSs) and implementing technical standards (ITSs). While any modifications would need to fall within the scope of the regulators' powers under FSMA, those powers are sufficiently broad to ensure that most relevant regulations and technical standards will be covered.¹¹ The constraints on the exercise of amendment powers under the Bill – for example, the power under clause 7 only being available to correct deficiencies arising from withdrawal and being subject to a sunset period – do not extend to the exercise of existing powers outside the Bill to amend retained EU law.

After withdrawal the PRA and FCA would – subject to the terms of any future relationship agreement – also be free from the obligation to ensure that their rules comply with EU law. They would therefore have freedom to amend any of their current rules that are based on EU law using their existing powers (subject to any agreement or policy commitment requiring continued alignment with EU law).

The powers and responsibilities of the regulators may thus dramatically increase under the Bill's provisions, unless specific measures are taken to limit them. There is a tension here between two principles. On the one hand, the UK system would become significantly more flexible. The EU legislative process is lengthy, focused primarily on strengthening the Single Market and mechanisms for enforcing it, and there is a crowded agenda, extending far beyond financial services, which means that change takes a long time. The ability for the regulators to modify retained EU law using their pre-existing rule making powers would make the UK regulatory environment more open to rationalisation and innovation. On the other hand, it is reasonable to question whether existing accountability mechanisms and the current regulatory objectives are sufficient and appropriate given the increased power that the regulators would be exercising. If not, there may be a case either for strengthening and adding to those mechanisms or for circumscribing the regulators' powers.

¹¹ But not all: on some occasions, the UK has removed specific powers that have become redundant because of a new EU regulatory regime. For example, when the Market Abuse Regulation (MAR) came into force, the UK repealed provisions of Part VI FSMA which gave the FCA power to make rules concerning disclosure and handling on inside information by issuers. However, it would be difficult to argue that rules concerning market abuse could not be made under the FCA's section 137A general power to make rules in furtherance of its objectives, including the market integrity objective.

4.2 Transfer of powers from EU institutions to the government and regulators

EU financial services legislation gives functions to, among others, the European Commission and the ESAs. While some functions only relate to establishing the initial legal framework and do not need to be exercised after the legislation has been implemented, there are many ongoing functions which must be performed if the legislation is to operate effectively or sensibly. After the UK leaves the EU, these functions will no longer be performed for the UK by EU institutions. As a result, they will need to be allocated to appropriate UK institutions under the Bill.

In 'The Great Repeal Bill: Domesticating EU law', the IRSG and Linklaters recommended a staged approach. Firstly, in the interest of speed and legal certainty, all functions under legislation for a particular sector would be transferred to the government department responsible for that sector. For financial services, this would be HM Treasury. Secondly, powers would enable the relevant government departments to reallocate those functions as appropriate when there is time and resource to do so.

Whatever approach is taken under the Bill, however, the government will need to decide the appropriate destination for reallocated EU law functions. The functions will need to be divided and shared across different UK bodies. This will not be a simple one-to-one mapping because the responsibilities of the ESAs, unlike the UK regulators, are allocated by industry sector. European Insurance and Occupational Pensions Authority (EIOPA), for instance, has some functions relating to insurers with a conduct/market purpose and some relating to insurers with a prudential purpose. EIOPA's functions should be classified in this way and then transferred to the FCA and PRA respectively. In some circumstances functions may have dual purposes, and in these cases a policy choice will need to be made.

An example: What it might mean to transfer functions of EU institutions under European law to UK bodies.

The two major pieces of European legislation on banking – the Capital Requirements Regulation (CRR)¹² and the Capital Requirements Directive IV (CRD IV)¹³ – together provide good examples of what will be involved in transferring functions from EU institutions to UK bodies on withdrawal from the EU.

Under the CRR, the European Banking Authority (EBA) has a range of functions. For example:

- Monitoring the quality of own funds instruments issued by banks and notifying the Commission where there is evidence that they do not meet criteria for eligibility as Common Equity Tier 1 instruments (or the equivalent for mutual and other similar institutions).¹⁴
- Monitoring the range of practices for specified ways in which firms may exclude securitised exposures from risk-weighted exposure calculations.¹⁵

Functions like these are clearly granted for prudential purposes, and it would be most appropriate for them to be transferred to the PRA.

Of course, some of the legislative detail would require amendment for those functions to operate sensibly; this will be a matter for the European Union (Withdrawal) Bill and subordinate legislation made under it. In the first example above, for instance, it would not make sense for the PRA to continue notifying the Commission after the UK has left the EU. It may be that the notification element can be deleted, given that the PRA itself would already have the regulatory tools available to act upon its findings (for example, by amending the definition of 'own funds').

Certain other functions, which effectively provide peer review mechanisms for proposals by national competent authorities, will simply have no place in the UK system.

CRD IV shows where greater complications may arise. It contains requirements for banks relating to a range of issues including capital adequacy, liquidity, licensing, passporting, systems and controls, governance, fitness and propriety, and remuneration. The latter three (governance, fitness and propriety, and remuneration) touch upon prudential and conduct matters alike, which means they are relevant to both the PRA and the FCA.¹⁶

CRD IV gives the EBA functions in these hybrid areas. It must issue guidance¹⁷ on:

- internal governance arrangements¹⁸
- sound remuneration policies¹⁹
- specified matters relating to the management body.²⁰

The government will need to decide how responsibility for such guidance will be allocated in the future. This does not mean that responsibility will need to go to one of the regulators to the exclusion of the other: FSMA already offers a number of models for sharing jurisdiction in particular areas.

¹² European Parliament and European Council 'Regulation (EU) 575/2013' (June 2013).

¹³ European Parliament and European Council 'Directive (EU) 2013/36' (June 2013).

¹⁴ European Banking Authority 'Capital Requirements Regulation' (June 2013) Article 80(1).

¹⁵ Ibid. Article 243(6).

¹⁶ Indeed, the implementation of CRD IV in the UK involved setting out rules in the handbooks of both regulators.

¹⁷ Although these are described by the legislation as 'guidelines', they are significant as national competent authorities and financial institutions are required to make every effort to comply with EBA guidelines and recommendations under Article 16(3) of Regulation (EU) 1093/2010 (the regulation establishing the EBA).

¹⁸ European Banking Authority 'Capital Requirements Directive, CRD IV' (June 2013) Article 74(3).

¹⁹ Ibid. Article 75(2).

²⁰ Ibid. Article 91(12).

Not all functions of EU institutions should be transferred to the regulators. Some, typically those that belong to the Commission, may have special political significance and would sit more appropriately with HM Treasury (although perhaps only exercisable after consultation with the regulators).²¹

An example: Transferring a more political function of EU institutions under European law to UK bodies.

One type of function that recurs throughout EU financial legislation is decision-making on whether third countries' systems of regulation are 'equivalent' for particular purposes. These include decisions such as whether third countries' generally accepted accounting principles (GAAP) are equivalent for the purpose of the financial information required in prospectuses and whether prudential and business conduct standards in third countries that are applicable to investment service providers are equivalent for the purpose of providing services to wholesale clients.

The EU regulation on over-the-counter derivatives, central counterparties and trade repositories (EMIR) provides a good example of how these kinds of functions might be transferred. EMIR enables the Commission to:

- determine that trade repositories authorised in a third country comply with legal requirements and guarantees of professional secrecy equivalent to those in the EU and are supervised effectively on an ongoing basis.
- having made that determination, submit recommendations to the Council for the negotiation of an agreement on mutual access to, and exchange of information on, derivative contracts held on trade depositories in the EU and in the third country.

The Council may then negotiate the mutual access agreement. After the agreement has been concluded, the European Securities and Markets Authority (ESMA) must establish cooperation arrangements with the national regulator of the third country.

Both the Commission's determination power and the Council's negotiation power could sensibly be transferred to HM Treasury, although perhaps only after requesting and receiving a positive assessment from the relevant regulator or regulators. Thought might also be given to whether Parliament should have any special function in or oversight of negotiations.

The FCA would be best placed to take on ESMA's function of establishing cooperation arrangements with other national regulators.

Overall, the transfer of functions from the EU will increase the powers of the UK regulators. This strengthens the case for reviewing UK regulatory objectives and accountability mechanisms.

²¹ However, the fact that a function currently lies with the Commission does not necessarily mean that it should be transferred to HM Treasury. For example, the Commission is currently responsible for approving IAS as EU standards (with or without modifications). This role would most sensibly be transferred to the FRC given its current responsibilities (however, see our recommendations at section 5.1.2 on controlling regulatory divergence with the EU).

4.3 Legislative processes

The EU's ordinary legislative process is relatively lengthy and timescales are often unpredictable. Timing for first reading of Level 1 legislation is not fixed at the European Parliament (EP) stage and agreement in Council can depend upon the priorities of the different presidencies. By comparison, the UK domestic system allows relatively quick legislative action. For example, prompted by events in 2008 and 2009, the UK introduced a regime on short selling of securities in 2009, while it was not until 2012 that the EU's corresponding legislation came into force.²²

However, longer lead times in the development and implementation of legislation give stakeholders more time to engage with the legislative process and businesses more time to prepare for the impact of change. The EP provides a high level of scrutiny and the rapporteur system means that industry, consumer organisations and civil society groups are able to interact effectively with Members of the European Parliament (MEPs). Consequently, many MEPs are well informed about the impacts and effects of proposed legislation from the perspective of market practitioners and other stakeholders. Longstanding membership of the ECON Committee has enabled some of them to build up extensive experience on financial services issues, improving legislative scrutiny. The consultation process at Level 2 also tends to give a high level of scrutiny to the development of the more detailed aspects of the regime and provides opportunity for industry participants and others to give input both through open meetings and through formal consultations. In these respects, the EU system reflects a tradition of transparent law-making. The Council, consisting of the relevant ministers of the Member States or their delegates, enables HM Treasury ministers and officials and their European counterparts to shape legislation in line with public policy considerations and regulatory principles. This would be lost when rule making reverts to the regulators.

There are fewer access points for industry participants and other stakeholders to contribute towards regulatory rule making in the UK. This is largely because rule making is concentrated within single regulators rather than being spread across the Commission, the EP, the Council and the ESAs. Without compromising regulatory independence, interaction with and feedback from industry, consumer organisations and other relevant bodies is vital if regulators are to be properly informed about where reform may be needed and about the impact of their actions. Having many points in the legislative process at which stakeholders can participate is not by itself a guarantee that policy will adequately take their contributions into account, and the complexity of the EU system means there are elements of opacity (for example, the trilogue process). Nevertheless, the existence of multiple avenues for making viewpoints known and debating them in a robust fashion is seen by some market participants as an advantage of the EU system.

²² European Parliament and European Council 'Regulation (EU) 2012/236' (March 2012). Another example concerns FCA rules made in 2012 in response to the LIBOR controversy; these will be replaced in 2018 by the Benchmarks Regulation (Regulation (EU) 2016/1011).

4.4 Commission involvement in policymaking

The Commission, which has the exclusive right to propose new EU legislation, does not have clear and legally binding regulatory objectives for financial services. By contrast, the PRA and FCA have specific objectives which were set in 2012, after the financial crisis and assumption of greater regulatory responsibility by the EU. The question arises: do the Commission's powers to propose financial services legislation reflect objectives that have no equivalent in the statutory objectives of the UK regulators? If so, does this matter?

The Commission is the 'guardian of the treaties' and the treaties commit to the development of the internal market, including through the 'approximation of laws'.²³ This has gained momentum since the financial crisis with the drive for a 'single rulebook'. This means having one set of rules across all Member States, laid out in directly applicable legislation, rather than implemented separately by national authorities. This approach constrains the flexibility of the national regulators and the one-size-fits-all approach may result in regulation which the UK regulators might (in isolation) regard as a poor fit for the UK market. However, it brings benefits for businesses operating in multiple jurisdictions and their customers by increasing regulatory consistency and reducing costs. Much of the effort of the ESAs is, in accordance with their constitutions, directed to ensuring supervisory convergence among national regulators with different levels of experience in particular issues, and preventing regulatory arbitrage. The current proposals that ESMA should take responsibility for approving certain types of prospectuses rather than this being done at home state level is an example of the increasing trend towards direct supervision to meet these objectives.

There is nothing in the UK regulatory system that corresponds to this objective of facilitating internal market activity, but neither is there a need for it.²⁴ In other respects, the objectives of EU financial services legislation often resemble those of the UK regulators – for example, consumer protection and financial stability. Indeed, in many cases, EU regulation has closely followed existing UK rules. However, as the Commission does not have specific regulatory objectives, it is able to take a more holistic approach to financial services regulation, acknowledging the broader economic and social context.

The UK's policymaking institutional capacity may need to be reviewed after the UK's withdrawal from the EU, since most UK financial regulation in recent years has come from the EU, and has been developed and proposed (at least at Level 1) by the Commission, often with the help of expert groups and its Regulatory Scrutiny Board.

The Commission also negotiates free trade agreements with third countries on behalf of the EU and its Member States. The UK, by contrast, has no recent experience in doing this. The regulators may need to increase their capacity to assist the Department for International Trade (DIT) in identifying and promoting British interests and negotiating positions in relation to regulatory cooperation and market access.

²³ See in particular: European Union 'Treaty on European Union' (May 2008) Article 17 and European Union 'Treaty on the Functioning of the European Union' (October 2012) Articles 26 and 114. It is notable that financial stability itself is not a Treaty objective.

²⁴ Financial services activity does not fall within any of the devolved competences of Scotland, Wales or Northern Ireland.

4.5 Review mechanisms

Under the Lamfalussy process it is standard for legislation to be reviewed after five years.²⁵ Given the usual two year period between publication of Level 1 legislation and its coming into force, this can result in a review being launched after only a year or two of operation. Cumulatively, across a number of pieces of legislation, this means that firms can be in a perpetual state of regulatory change. However, it is in principle sensible to review how regulation is working on a periodic basis, and to have clear expectations for how this will be carried out.

There is no equivalent review mechanism under the domestic model, although ad hoc reviews of markets – as opposed to rules – can lead to regulatory changes. The Financial Advice Market Review, conducted by HM Treasury and the FCA and published in March 2016, is a recent example. It was not specifically about regulation, but made 28 recommendations, some of which concerned amendments to rules and the regulatory perimeter.

4.6 Scrutiny by peers

To prevent regulatory arbitrage across the EU, the ESAs monitor Member States' national regulators and challenge them where they diverge in interpretation and implementation. This will cease when the UK withdraws from the EU. Although the primary rationale for such scrutiny will also have disappeared (ensuring legal consistency within the Single Market), this change nevertheless represents a decrease in peer review.

Another peer-review mechanism is the European Systemic Risk Board's (ESRB) power to issue recommendations and warnings about financial stability. These are not necessarily made public, but the UK was one of eight Member States to receive a warning over medium-term vulnerabilities in the residential real estate sector in the second half of 2016.²⁶ While this could be viewed as duplicating the work of the Financial Policy Committee (FPC) (see Annex II), additional monitoring of risks to and alternative views about financial stability should in principle always be welcomed.

²⁵ The Lamfalussy process is described in Annex I.

²⁶ European Systemic Risk Board 'Warning of the European Systemic Risk Board on medium-term vulnerabilities in the residential real estate sector of the United Kingdom' (September 2018), available at: http://www.esrb.europa.eu/pub/pdf/warnings/161128_ESRB_UK_warning.en.pdf.

5.0 RECOMMENDATIONS FOR THE FUTURE

As the UK withdraws from the EU, it does so with professional and internationally respected financial regulators and a statutory framework that takes into account the principles outlined in two. Wholesale change will be neither necessary nor desirable. But as the previous chapter highlighted, withdrawal from the EU will bring about some major differences in the UK system of financial regulation. Although these differences would not prevent the system from functioning and do not call for any action as part of preparations for the period immediately following withdrawal, we believe that Parliament, the government and the regulators themselves should each consider, as soon as time permits, how the parts of the system under their control could be adjusted to ensure that the UK system remains as closely aligned as possible to the principles outlined in chapter two in the new context. Doing so would help the UK to maintain its pre-eminent position in international finance, as well as send a signal to the wider world that it supports robust and effective regulatory processes.

This chapter presents a number of recommendations for reform, grouped in four broad categories: those that affect regulatory powers and resources; those that contribute towards accountability through the appropriate framing of regulatory responsibilities; those that enhance general scrutiny of the regulators; and those that aim at improving legislative and regulatory processes for financial services. Most of the recommendations are about building on and refining existing mechanisms and practices, in keeping with our general conclusion that the UK system will be broadly fit for purpose after withdrawal from the EU. They do not constitute a single blueprint for adapting the regulatory architecture. Once the question of the UK's future relationship with the EU is settled, they can be considered as possible further components of that architecture so that it continues to be robust and effective and satisfies the principles set out in chapter two.

5.1 Powers and resources of the regulators

5.1.1

The regulators should as a general rule be able to amend regulation derived from EU law

As explained in section 4.1, under the current provisions of the European Union (Withdrawal) Bill, and assuming that the UK does not enter into an EEA style arrangement with the EU that means that it will need to continue applying EU law domestically,²⁷ the PRA and the FCA will have broad powers to amend the body of retained EU law relating to financial services after Brexit. On balance, we consider that this is necessary and appropriate.

It would be impractical to suggest that, for the foreseeable future, Parliament and/or government alone should have the power to amend financial regulations derived from EU law. Given the volume and range of financial regulation as well as its complexity, the regulators are currently best equipped to do so, as and when appropriate. The regulators also have the ongoing advantage of their political independence, of their ability to

²⁷ If the UK were to remain aligned with EU regulation there would be no call for wholesale amendments (except for modifications made necessary by withdrawal itself). Nevertheless, in this scenario there may be a need to amend existing retained EU law in order to reflect changes at EU level that take effect after the exit date – see section 5.1.2.

respond more quickly to market and technological developments and of clear regulatory objectives to guide them. Such considerations are at the heart of the domestic model of UK financial regulation and give it its characteristic flexibility.

As a result, the majority of the other recommendations in this chapter aim at reinforcing existing checks and balances with enhanced regulatory accountability mechanisms, refined regulatory objectives and closer engagement with the principles of better regulation. However, there is a case for circumscribing regulatory power in one specific context – that of controlling divergence from the EU under a future trade agreement.

5.1.2

Any regulatory divergence with the EU should be a matter of public policy

The IRSG report ‘A new basis for access to EU/UK financial services post-Brexit’ set out a proposal for a free trade agreement between the UK and the EU, providing for mutual market access for financial services conditional on maintaining broadly aligned regulatory outcomes.

Under this proposal, there would be a UK/EU Forum for Regulatory Alignment. A party contemplating a regulatory change would be required to assess its likely impact on regulatory alignment and notify the Forum if the change was potentially material from the perspective of EEA market access. The forum would then decide whether it would have a material adverse impact.²⁸ It could not prevent either party from introducing such a change, but the other party would gain the right to withdraw market access for the affected activity or activities.

This approach poses a challenge for the autonomy of the regulators in the domestic element of the UK system. The regulators are responsible for the rules and their enforcement, and it is the rules and the way that they are applied and enforced that will largely determine whether the UK provides broadly equivalent regulatory outcomes to the EU. On the other hand, the decision that the UK should – or should not – have broadly equivalent regulatory outcomes to the EU is one too politically significant for regulators to make in isolation.

We suggest that it should be a policy matter for HM Treasury to decide, subject to parliamentary oversight and drawing on the technical advice of the regulators. Material divergence should only be permitted by HM Treasury order approved by Parliament under the affirmative procedure.

Unintended material divergence could arise either by:²⁹

- The UK regulators making rules or otherwise acting in a way that would cause material divergence.
- Regulators failing to take steps to ensure that alignment is maintained in response to proposed changes in EU financial regulation (whether because they consider it inappropriate to do so or for some other reason).

²⁸ The Forum would have other roles, including suggesting amendments to regulatory proposals to prevent a material adverse impact from arising.

²⁹ The UK will also need to consider how it manages convergence with or divergence from other major jurisdictions, and this may involve making trade-offs between access to a range of markets. These issues are beyond the scope of this report.

In response to the first issue, in relation to the PRA and the FCA, we recommend that the statutory consultation process under FSMA for making or amending rules should include a new requirement to consider whether the changes could prove material for market access by EEA persons. If the regulator considers that they could, it would be obliged to submit the proposals to the Forum and it would be unable to make the rules until either the Forum had cleared them or HM Treasury had sanctioned them by order approved by Parliament under the affirmative procedure. Similar changes would need to be introduced for other bodies whose actions could lead to divergence, for example the Financial Reporting Council (FRC) in relation to accounting standards.³⁰

In response to the second issue, we recommend that HM Treasury should be able to direct the regulators to take such action as may be necessary to reflect agreements reached in the Forum by order approved by Parliament under the affirmative procedure.³¹

Of course, these mechanisms for ensuring that divergence with the EU remains a matter of public policy, rather than regulatory discretion, would not be relevant if the UK and EU did not agree on a framework for mutual market access in financial services. Neither would they be appropriate if the UK were to enter into an EEA style arrangement with the EU: in those circumstances, it would be more sensible to use a power such as that in the European Communities Act 1972 to ensure regulatory alignment.

5.1.3

The regulators will need increased resources for policy development and international engagement

The need for policymaking capacity will increase after Brexit. Such capacity at the international level should be given special consideration, while the UK regulators already feature prominently in this field, global standards in financial regulation will only increase in importance over the coming years. The regulators should therefore focus on maintaining and even bolstering their capacity to influence European and international developments, and particularly their ability to do so in concert.

There are a number of ways this could be achieved. For example, they could establish missions in key overseas markets and hubs to forge international regulatory alliances and develop new means of canvassing industry opinion over the direction of international regulation.³² There may be scope for strengthened and institutionalised coordination with each other and with relevant government departments for negotiations over international standards and mutual market access.³³ A focus on developing relations with major

³⁰ The UK will need to decide on a domestic mechanism for incorporating IFRS standards in the future and whether or not it wishes to remain equivalent in accounting standards to the EU27. EU accounting standards, while based on IFRS, are not identical to them. Divergence will potentially have implications for access to EU capital markets so a decision to diverge should certainly require this level of political authorisation. The arrangements for auditing will also need to be assessed for equivalence to maintain access to EU27 capital markets.

³¹ This power could also be used where a UK regulator has implemented rules that diverge from the EU that it (wrongly) considered would not have implications for market access and which are subsequently disputed at the Forum.

³² Where possible, greater transparency over memoranda of understanding and regulatory dialogues between the UK regulators and their foreign counterparts would be welcomed by industry.

³³ The regulators might look to join the Chancellor's annual bilateral Economic and Financial Dialogues (EFDs) with China, India and Brazil. FCA CEO Andrew Bailey regularly joins the EFDs but it might be useful to formalise the role of the FCA and include regulatory and supervisory engagement as a standing agenda item. Another example where the regulators and government could work together is through HM Treasury's annual official-level dialogues with Singapore, South Korea and (shortly) Japan.

developing countries that have maturing financial services sectors could be particularly effective. However, such a focus should not detract from ongoing cooperation with their counterparts in the EU27, as well as with the ESAs and the European Central Bank (ECB) (as prudential supervisor of the larger Eurozone banks).

These and other opportunities for maintaining UK influence in European and global financial regulation after withdrawal from the EU are the subject of a forthcoming report from the IRSG.

5.1.4

The regulators and HM Treasury will need increased resources for new operations

Additional resources will be needed not only to take on a greater role in policy development but also to assume responsibilities currently with EU institutions. Once it is clear how functions will be allocated under the European Union (Withdrawal) Act, as outlined in section 4.2, they will have to assess what additional resources they will need. Although many of these functions will not be very burdensome, some will require significant investment, for example, the supervision of credit ratings agencies and the making of equivalence decisions.

Of course, if the UK and EU were unable to agree on mutual market access, significantly more resources would be needed for increased regulation and supervision of EU27 firms which currently passport into the UK.

5.2 Framing the responsibilities of the regulators

5.2.1

The need to maintain and enhance the financial services ecosystem in the UK could be reflected in the regulatory objectives

We would recommend that sustaining and promoting an environment where financial services can flourish in their global context should be made a secondary regulatory objective.

This should be distinguished from a drive for lower standards which could allow excessive risk to develop within the financial system. Industry does not want a regulatory race to the bottom. Indeed, it would welcome explicit statutory recognition of the role that globally leading regulatory standards play in sustaining and promoting the financial services industry in the UK, for example, by facilitating negotiated access to foreign markets for UK-based businesses.

Adding this secondary objective would meet the concern that if the regulators are only able to use a wider set of powers in furtherance of regulatory objectives which are protective and conservative in nature, the cumulative impact of regulation on the ecosystem will be increasingly negative. Its inclusion would empower the regulators to work with stakeholders, where appropriate, to make the UK a better place to do business (including as a home market for international providers of financial services) and more attractive for international consumers of financial services.

Such an objective could draw inspiration from overseas examples, such as the Australian Securities and Investments Commission Act 2001, which requires the Australian regulator to 'strive to' (among other things):

- "maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy"³⁴
- "administer the laws that confer functions and powers on it effectively and with a minimum of procedural requirements."³⁵

An alternative to introducing a new objective would be to reinstate the former requirement to have regard to the international character of financial services and the desirability of competitiveness as one of the regulatory principles. This would place current government economic policy (as communicated in the most recent policy letters from HM Treasury to the PRA, FCA and FPC) on a permanent footing.³⁶

5.2.2

Policy letters from HM Treasury could be made more frequent and, where appropriate, more detailed

A further measure to enable HM Treasury to influence the direction of regulatory policy and supervision would be more active use of policy letters. This could ensure that public policy considerations that HM Treasury brings to the Council under the EU's ordinary legislative procedure are not lost, broadening the rule making process beyond meeting the regulators' statutory objectives.

At present, HM Treasury only has the obligation to officially inform the PRA and the FCA of the government's economic policy once every Parliament.³⁷ Given the Fixed-term Parliaments Act 2011, this is likely to be only once every five years.

Because the regulators must have regard to government policy expressed in the letters, they would need to account for any proposed departure from it. We would recommend making the letters an annual obligation (as they are in the case of the FPC). We would also recommend including further detail where relevant in the context of withdrawal – for example, the government's satisfaction or dissatisfaction with the operation of areas of retained EU law that are subject to the regulators' rule making powers. This would serve as an additional but flexible accountability mechanism for the regulators without compromising their independence. It might also be used by HM Treasury to encourage greater coherence across the regulators.

³⁴ 'Australian Securities and Investment Commission Act 2001' (2001) Section 1(2)(a) Emphasis added.

³⁵ 'Australian Securities and Investment Commission Act 2001' (2001) Section 1(2)(d) Emphasis added. Keeping procedural requirements to a minimum is one way in which a regulator could seek to make doing business under its jurisdiction more attractive.

³⁶ HM Treasury 'Recommendations for the Prudential Regulation Committee' (March 2017), available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597419/Prudential-Regulation-Committee-Spring-Budget-2017.pdf. HM Treasury 'Recommendations for the FCA' (March 2017), available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597668/Recommendations_Financial_Conduct_Authority_Spring_Budget_2017.pdf. HM Treasury 'Remit and recommendations for the FPC' (March 2017), available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597021/FPC_remit_Spring_Budget_2017_final_web.pdf.

³⁷ Bank of England 'The Bank of England Act 1998' (1998) section 30B and 'Financial Services and Markets Act 2000' (2000) section 1JA, respectively.

5.3 General scrutiny of the regulators

5.3.1

Interaction between the regulators and Parliament could be enhanced

As explained in section 2.1 of Annex II, the UK financial regulators are already directly accountable to Parliament, primarily through the Treasury Select Committee in the House of Commons. However, we recommend considering whether the accountability mechanisms should be strengthened when the regulators inherit functions previously performed by EU institutions and the scope of their pre-existing statutory powers extends to modifying retained EU law.

For example, the Treasury Select Committee could set up a sub-committee with a particular focus on the regulators. Such a sub-committee would need appropriate staff to provide MPs with the technical support that they would need. This would ensure that, notwithstanding the Committee's broad remit and busy schedule, the regulators would be subject to sufficient scrutiny in the House of Commons at a time when their powers and responsibilities have grown.

In addition, the EU Financial Affairs Sub-Committee in the House of Lords could be repurposed when the UK leaves the EU. This expert Sub-Committee has considerable experience in scrutinising the development and implementation of technical financial regulation that might be difficult to replicate in the House of Commons. The Sub-Committee, with its current support staff, would be well placed to complement the more general scrutiny provided by the Treasury Select Committee.

5.3.2

The role and visibility of statutory panels could be strengthened

The PRA and FCA statutory panels each have the same formal remit – to consult over the extent to which the relevant regulator's general policies and practices are consistent with its general duties.³⁸ They serve an important role in the current UK system of financial regulation.

The FCA panels are particularly active. They are independent of the FCA but have close working relationships with it and amongst themselves. They are publicly committed to standards of good governance and act transparently. The latest annual report of the FCA Consumer Panel indicates that it, in particular, submits numerous consultation responses, publishes position and discussion papers and takes a proactive approach in canvassing public opinion. The practitioner panels tend to be less involved in these types of activities since their constituents are more likely to respond directly and make their own voices heard.

While the PRA Practitioner Panel (the PRA's sole external panel) provides valuable early input into the PRA policy formation process, its terms of reference indicate that it has a more circumscribed remit for scrutinising and publishing its findings than its FCA counterparts (including its direct analogue, the FCA Practitioner Panel).³⁹ We recommend HM Treasury and the PRA actively consider whether its panel could be strengthened and

³⁸ The panels are discussed in Annex II as part of the domestic element of the UK system.

³⁹ PRA Practitioner Panel 'Terms of Reference' November 2013, available at: <http://www.bankofengland.co.uk/practitioner/about/practitionerterms.pdf>.

made more prominent. Another feature of the PRA Practitioner Panel which may be worth reviewing is its broad composition, which may prevent adequate representation of a full range of views within particular PRA-regulated sectors. Establishing additional panels for the PRA could address this.⁴⁰

In addition, depending on how responsibilities for amending retained EU financial services regulation will be allocated under the European Union (Withdrawal) Act, there may be another possible role for the panels. If HM Treasury is given such responsibilities, we would recommend requiring it to consult the relevant panels in respect of them. This would promote an even quality of scrutiny across regulatory policies, irrespective of their origin (domestic, European or global).

5.3.3

The PRA could hold annual public meetings, like the FCA

As noted at section 2.3 of Annex II, the FCA must hold an annual public meeting to consider its annual report. This provides those attending an opportunity to question the FCA about how it has discharged, or failed to discharge, its functions. There is currently no equivalent for the PRA, which only has an obligation to consult on its annual report and publish a general account of the responses.

We recommend introducing an annual public meeting for the PRA. This would enhance its public accountability, both through the chance it would afford market participants and the public to engage publicly with it, but also by encouraging a culture of greater transparency.

5.4 Legislative and regulatory processes

The UK and US governments, among others, have in recent years tried various ways to improve regulatory processes. In the EU the Commission has adopted its Better Regulation Agenda, with the objective of repealing outdated or redundant regulation. In light of the greatly increased volume of financial regulation for which the UK will assume responsibility, Parliament, the government and the regulators should consider addressing the administrative burden of the current system by adopting new approaches and building on existing ones specifically within financial services, learning from experience in other sectors and jurisdictions. The following sections make recommendations to that effect.

5.4.1

A Financial Regulatory Policy Committee could be established

The regulators are normally required to conduct a cost-benefit analysis when making a regulatory proposal.⁴¹ Cost-benefit analyses improve the transparency and quality of decision-making by making a regulator set out reasoned arguments about the impact of their rules and policies. However, their effectiveness depends in part upon the degree to which they are subject to scrutiny, especially given the inherent risk that regulators may

⁴⁰ We also note that while the FCA Consumer Panel has a statutory right to communicate its views on any matter to the PRA (section 1Q(5A) FSMA) the PRA is under no obligation to consider them. We would recommend introducing such an obligation.

⁴¹ 'Financial Services and Markets Act 2000' (2000) Sections 138I(2)(a) and 138J(2)(a).

underestimate costs – particularly negative externalities – and overstate benefits where they have already settled on a course of action.

The UK's existing Regulatory Policy Committee (RPC) is an independent public body that scrutinises impact assessments from government and regulators including the FCA, challenging assumptions and omissions, and rejecting inadequate analysis. However, the RPC does not have specialist expertise in financial regulation and is often engaged late in the policy-making process. We recommend that Parliament and the government should consider whether a body specific to, and with greater links to, the financial regulators would be appropriate. A Financial Regulatory Policy Committee, with specialist sub-committees and representatives of the full range of stakeholder interests, could not only scrutinise regulatory cost-benefit analysis with the benefit of background knowledge but also review the content of regulatory proposals themselves (including, for example, from the perspective of internal and external regulatory coherence and the broader better regulation agenda). It might also find a role in any legislative review mechanism. Such a committee would need to be independent and could report to HM Treasury and the Treasury Select Committee.

5.4.2

Consultation mechanisms could be improved

The UK regulators make use of policy papers, roundtables and other methods of 'pre-consultation', which stakeholders welcome, although it may not always be obvious why certain methods are or are not used in particular cases. We recommend establishing and publishing frameworks which clearly set out what mechanisms will be used in which circumstances, and how those mechanisms will feed in to the statutory consultation processes, so as to enhance the consistency and transparency of consultation procedures.

In addition, at present (and unlike the ESAs) the UK regulators do not publish individual responses to consultations. Publishing the actual responses at the request of the contributor, and not just a summary, may give market participants greater confidence that their opinions have been considered.⁴² As a transparency measure, it would also make it easier to hold the regulators to account: there would be a better public record of issues and concerns that had been brought to the regulators' attention.

5.4.3

A Joint Regulatory Committee could be established

While the ESAs work together in a Joint Regulatory Committee, there is no equivalent for the PRA and FCA in the UK. While the regulators have statutory duties to consult each other, maintain a memorandum of understanding and benefit from some institutionalised overlap in governing personnel,⁴³ there may be a case for more institutionalised coordination. A permanent committee, with senior representatives of the two main regulators and the Payment Systems Regulator (PSR), tasked with ensuring coherence in regulation and supervisory approach and with public minutes, may be worth exploring.

⁴² It is important that only responses that the contributor requests to be made public are published, to ensure that businesses can share commercially sensitive information with the regulators.

⁴³ See Section 2.4 of Annex II.

5.4.4

Review mechanisms could be made mandatory

We would recommend introducing a statutory requirement for the regulators to review the impact of a new rule or of a material amendment to a rule within five years of its operation, leaving the regulator with discretion as to when exactly within that period a review would be appropriate. These reviews could include a public consultation and result in a comparison between the predictions of the impact assessment and actual outcomes. As well as ensuring that individual regulations keep up with a rapidly changing business and technological environment, this would give regulators the opportunity to reflect on how well the regulatory process itself is functioning.

A formal review mechanism would also give regulators the opportunity to address broader questions about the regulation in question, for example, whether the correct balance has been struck between a rules-based and a judgment-based approach, or whether it contributes or detracts from the overall internal coherence of the UK's regulatory system.⁴⁴

5.4.5

Financial services legislation could be simplified and consolidated

Having been heavily amended on numerous occasions, FSMA is a notoriously complicated statute. It is supplemented with subordinate legislation that has been equally amended. Both the statute and the subordinate legislation are likely to be further amended as a result of the UK withdrawing from the EU, for example under the European Union (Withdrawal) Act. Simplifying or consolidating FSMA could make the UK regulatory system more transparent in the longer term and would provide an opportunity for reducing rules that potentially cut across each other. However, bearing in mind the need for regulatory stability and certainty, any such reforms should be focused on deregulation and simplification rather than any more comprehensive reform programme.

⁴⁴ We recognise that there is no one correct answer as to where this balance might lie. A rules-based approach promotes accountability and independence through its transparency and predictability; a judgment-based approach is more flexible and can make coherence easier to attain.

ANNEX I

THE EU ELEMENT OF THE UK SYSTEM REGULATION

1 Introduction

A substantial proportion of the UK's financial services law and regulation is derived from the EU. The EU's role in the regulation of financial services has developed over the last decade from a primarily legislative role to one which, through the ESAs, encompasses both rule making and supervision.⁴⁵

The ESAs are the ESMA, European Banking Authority (EBA) and EIOPA. The initial role of the ESAs was focused on the development of the 'Single Rulebook' in their respective areas, through contributing to the legislative process. They are also responsible for assessing risks, promoting supervisory convergence and some areas of direct supervision.⁴⁶

2 EU legislative process for financial services

In 2001, the Final Report of the Committee of Wise Men on the Regulation of European Securities Markets (known as the Lamfalussy Report), led to a new approach to the development and adoption of EU financial services legislation (the Lamfalussy Process). The Lamfalussy Process was first adopted for securities measures, but has since embraced banking, insurance and pensions legislation.

The Lamfalussy Process

Level 1 – Legislation

Framework legislation is proposed by the European Commission (the Commission) and adopted by the Council and the EP.⁴⁷ This is generally under the ordinary legislative procedure (see section 3.3 for further details). Lamfalussy framework directives contain sunset clauses relating to the Commission's power to adopt implementing measures at Level 2.

Level 2 – Implementing and technical legislation

More detailed implementing measures, prepared by the ESAs, serve to supplement the Level 1 framework legislation. These measures are adopted by the Commission and endorsed by a qualified majority of Member States.

Level 3 – Recommendations and guidance

The Level 3 Committees (which consist of representatives of national supervisory authorities) will prepare joint interpretation recommendations and guidelines.

Level 4 – Ensuring consistency

At Level 4 the Commission ensures compliance by Member States with legislation and where required, pursues enforcement action. The Commission works in close cooperation with Member States, the regulatory authorities involved in Level 3, and the private sector to ensure that EU law is applied consistently.

⁴⁵ One area in which the EU is becoming particularly prominent is banking. However, as the UK is not a member of the Eurozone and has opted not to participate in the Single Supervisory Mechanism or Single Resolution Mechanism, this report does not further consider these institutions or the European Central Bank.

⁴⁶ The European Commission has recently published proposals to extend the scope of direct supervision by ESAs, removing some responsibilities from national competent authorities.

⁴⁷ The Council consists of a ministerial representative of each EU Member State, the relevant minister depending on the matter being discussed. It is not the same as the European Council, another EU institution which brings together the heads of state or government of EU Member States.

3 The ordinary legislative procedure

The ‘ordinary legislative procedure’ involves the Commission, the EP and the Council in agreeing legislation.⁴⁸

3.1

Proposal. The Commission has responsibility for proposing new legislation at Level 1 under the Lamfalussy Process. This is normally after an extensive consultation process, which may be conducted in various ways (for example, impact assessments, reports by experts, consultation of national experts, international organisations and/or non-governmental organisations and the use of Green and White Papers). External consultation processes have been enhanced since May 2015 with the adoption by the Commission of its Better Regulation Agenda. A consultation process is also launched among the different Commission departments in order to ensure that all aspects of the matter in question are considered (the ‘Inter-service Consultation’). The Commission’s proposal is adopted by the College of Commissioners on the basis of either a written procedure (no discussion among Commissioners) or an oral procedure (the dossier is discussed by the College of Commissioners), and is published in the Official Journal of the EU.

3.2

National Member State Parliaments. The legislative proposal is presented to the EP and the Council and made available to the Parliaments of the Member States. Within eight weeks, chambers of national Parliaments may send a reasoned opinion on whether a draft legislative act complies with the principle of subsidiarity to the presidents of the EP, the Council and the Commission. If sufficient chambers object, the Commission must reconsider its proposal;⁴⁹ if the proposal is maintained, the Commission must provide a reasoned opinion to the EP and Council, who must each vote on whether the proposal is compatible with subsidiarity. A proposal that fails in either of these votes cannot proceed.

3.3

Scrutiny by the EP. Legislative proposals received from the Commission are considered by EP committees before being voted in plenary session. EP committees are each responsible for a particular area of focus and are constituted of members representing each political group in the same proportion as the groups are represented in the plenary. A lead committee will appoint a rapporteur who will draft a report on the proposal. Other relevant committees (if any) may issue opinions on the proposal. The report provides the basis for discussion, and proposes amendments. The lead committee will discuss and vote on the amendments and the report as a whole before it goes in final form to the plenary.

⁴⁸ The following account assumes that the legislation is passed at its first reading (as is usually the case).

⁴⁹ Where a national Parliament consists of one chamber, that chamber has two votes; where it consists of two chambers, each chamber has one vote. In the ordinary legislative procedure, a successful rejection requires a simple majority of votes allocated to Parliaments. See Protocols 1 and 2 to the Treaties.

3.4

Negotiation in Council. The text of a legislative proposal is negotiated by the Council's Working Groups, COREPER and Ministers in parallel with the EP process. Once the EP has approved its position, trilogue meetings will be held between the EP, the Council and the Commission to try to reach a compromise text of the proposed legislative act.⁵⁰ The Presidency of the Council usually prepares these compromise texts. The compromise text will be enacted if, following its official adoption by the Council, the EP either endorses it or takes no action. The legislation will ordinarily come into force 20 days after being published in the Official Journal.

4 The European System of Financial Supervision

The European System of Financial Supervision (ESFS) was developed in accordance with the recommendations of the de Larosière expert group report of 2009. The ESFS consists of the ESRB, the ESAs and the national supervisors.

The main objective of the ESFS is to ensure that the rules applicable to the financial sector are adequately implemented across Member States with the purpose of:

- preserving financial stability
- promoting confidence
- providing protection for consumers.

The ESFS has additional, standalone objectives of:

- developing a common supervisory culture
- facilitating a single European financial market.

The ESRB is responsible for the macroprudential supervision of the EU financial system. Its objective is to prevent and mitigate systemic financial stability risks in the light of macro-economic developments. Its functions include: the collection and analysis of relevant information; identifying and prioritising systemic risks; issuing warnings and recommendations and monitoring their follow-up; providing an assessment to the Council when it determines that an emergency situation may arise; cooperating with other parties to the ESFS; coordinating its actions with international financial organisations such as the International Monetary Fund (IMF) and the FSB; and carrying out tasks specified in other EU legislation. The ESRB is supported by two advisory bodies (the Advisory Scientific Committee and the Advisory Technical Committee).

⁵⁰ Although trilogues are an important aspect of the ordinary legislative procedure, they are not officially mandated in the Treaties. They have been criticised for their secretive nature, although this may be the cost of having an efficient system of reconciling different positions on sensitive topics.

Under the Lamfalussy process, the ESAs play an important part in developing a single rulebook for the EU's financial markets. They draft the Level 2 legislation in the form of ITSs and RTSs. The scope and objectives of the Level 2 legislation is mandated in the Level 1 legislation and the ESAs generally conduct full consultations on the proposed legislative texts.

Microprudential oversight is performed by the ESAs, which coordinate through the Joint Committee. The Joint Committee works in the areas of microprudential analysis of cross-sectoral developments, risks and vulnerabilities for financial stability, consumer protection, supervision of financial conglomerates, accounting and auditing, and on measures to combat money laundering and terrorist financing.

ESMA is also the direct supervisor of credit rating agencies and of trade repositories.

The ESAs each act through their respective Board of Supervisors, who are responsible for policy decisions. The Boards are composed of a chairperson and of representatives of each of the 28 national supervisory authorities, as well as representatives of the ESRB, the Commission, and the other ESAs.

The ESAs are accountable to the EP where they may be required to attend formal hearings of the Economic and Monetary Affairs Committee, and they also report annually to the Council and Commission.

Consultation with stakeholders is facilitated by the ESAs' respective stakeholder groups. These are appointed by an open process and include, as relevant, industry representatives, financial market participants, consumers, beneficiaries and academics.⁵¹

⁵¹ See, for instance: ESMA 'Procedure: ESMA Stakeholder Group Renewal Procedure 2016' (March 2017), available at: https://www.esma.europa.eu/sites/default/files/library/2017_esma_rules_of_procedures_smsg_selection_2017.pdf.

ANNEX II

THE DOMESTIC ELEMENT OF THE UK SYSTEM

1 Introduction

With the Bank of England Act 1998 (BEA) and the FSMA, the UK broke decisively with the regulatory architecture of the Big Bang era. In 2017, the Bank of England is celebrating 20 years of operational independence in setting monetary policy. However, this period also saw it lose its role as the regulator of the banks: the many sector-specific regulators of the past were superseded by one comprehensive Financial Services Authority (FSA). There was also a move away from 'self-regulation' as not being sufficient to serve the public interest.

BEA and FSMA, although heavily amended, remain the overall UK framework for financial regulation and supervision. The most significant changes to the system were made under the Financial Services Act 2012, which split the original Financial Services Authority into the current PRA and FCA.

2 Roles in the domestic element of the UK system

2.1

Parliament

Parliamentary supremacy means that there are no limits on how deeply involved Parliament could be in making financial regulation. However, in the domestic element of the UK system, Parliament has delegated substantial powers to independent regulators and (to a lesser extent) the government. It retains the important role of specifying the purposes for which regulation may or must be made. In other words, it authorises or mandates regulatory regimes.

The purposes for which powers are given are very broad and overlap. For example, section 137A FSMA gives the FCA a general power to make rules applying to authorised persons that appear to it 'necessary or expedient for the purpose of advancing one or more of its operational objectives' (see below). Section 137G FSMA grants an equivalent power to the PRA. These general powers mean that more specific rule making powers granted to the FCA and PRA under FSMA are, from a legal perspective, superfluous. More specific powers and obligations, however, demonstrate Parliament's intentions in greater detail and provide a strong steer or specific mandate as to where regulators should direct their attention (see box on page 49).

In addition to authorising and mandating regimes, Parliament has also occasionally provided the impetus for entirely new regulatory approaches. For example, the Parliamentary Commission Banking Standards (an ad hoc joint committee of the House of Commons and the House of Lords) proposed what eventually became the Senior Managers and Certification Regime (SMCR).

Perhaps the most important ongoing role of Parliament in the domestic element of the UK system is providing scrutiny through the Treasury Select Committee in the House of Commons. Standing Order 152 gives select committees a remit to 'examine the expenditure, administration and policy of the principal government departments... and associated public bodies'.⁵² The Treasury Select Committee has consistently viewed the regulators as public bodies associated with HM Treasury and therefore scrutiny of them as an integral part of its mandate. There is regular contact between the Committee and each of the CEO of the FCA and Governor of the Bank of England. Although the Committee can 'send for persons, papers and records'⁵³ its role is facilitated by a number of statutory requirements for key documents produced by the regulators to be laid before Parliament.⁵⁴

The National Audit Office (NAO), a body reporting directly to the Public Accounts Committee, audits the FCA and has functions in relation to the audit of the Bank of England (and thereby the PRA).⁵⁵ It may also examine and report on the economy, efficiency and effectiveness with which the regulators use their resources.⁵⁶

Development of a regulatory regime: regulating the cost of credit in the UK

Section 137C FSMA (*FCA general rules: cost of credit and duration of credit agreements*) is a good example of how Parliament interacts with the independent regulators by authorising and mandating regulatory regimes. Section 137C was introduced by the Financial Services Act 2012 to ensure that the FCA had the same power as the Financial Services Authority previously had to regulate the key terms of credit agreements. The section clarified that the power of the FCA to make general rules to meet its objectives under section 137A included the power to make rules regulating the key terms of credit agreements.

The section was arguably unnecessary, as the section 137A powers are very broad, but Parliament had provided a clear mandate for a regime capping interest rates. In any case, the FCA did not initially use this power.

In response to public pressure, the government proposed primary legislation to amend section 137C. The Financial Services (Banking Reform) Act 2013 inserted a subsection that required the FCA to make use of its powers "in relation to... the provision of high-cost short-term credit, with a view to securing an appropriate degree of protection for borrowers against excessive charges."

With a regime now mandated and not merely authorised by Parliament, the FCA developed rules which came into force in 2014 and had a significant impact on the operations of payday lenders.

⁵² House of Commons 'Standing Orders 2002(2)' (July 2002) Standing Order 152(1).

⁵³ House of Commons 'Standing Orders 2002 (2)' (July 2002) Standing Order 152(4)(a).

⁵⁴ These include the FCA's annual report and audited accounts, the PRA's annual report and the memorandum of understanding between the FCA and the PRA on regulatory cooperation. Other statutory provisions require publication of important documents without also requiring that they be laid before Parliament, for instance the minutes of the FCA governing body and the report of the FCA's annual public meeting.

⁵⁵ 'Financial Services and Markets Act 2000' (2000) Paragraph 15, Schedule 1ZA and Bank of England 'The Bank of England Act 1998' (1998) section 7ZA respectively.

⁵⁶ 'National Audit Act 1983' (1983) Section 6 and Bank of England 'The Bank of England Act 1998' (1998) section 7D respectively.

2.2

The Bank of England

The Bank of England is one of the two principal financial regulators.⁵⁷ Formal responsibility for most of its regulatory activity lies with two statutory committees:

- The FPC, which is responsible for macroprudential regulation.
- The Prudential Regulation Committee (PRC), which is responsible for microprudential regulation. The PRA is the Bank of England acting through the PRC.⁵⁸ A significant number of Bank of England staff are allocated to PRA work.

The FPC has two statutory objectives. Its primary objective is to contribute towards protecting and enhancing the stability of the UK financial system.⁵⁹ It is to do this by identifying, monitoring and removing or reducing systemic risks.⁶⁰ The secondary objective of the FPC is to support the economic policy of the government.⁶¹

Aside from issuing recommendations and reports, the FPC performs its role by giving directions to the PRA and the FCA.

The PRA has three statutory objectives:⁶²

- Promoting the safety and soundness of those it regulates (the general objective).⁶³
- Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders (insurance objective).⁶⁴
- (Subordinate to the first two objectives) facilitating effective competition in the markets for services provided by those it regulates (the 'secondary objective').⁶⁵

To meet its objectives, the PRA makes and enforces rules set out in the PRA Handbook using its powers under FSMA.

The PRA has a statutory duty to consult with the independent PRA Practitioner Panel on whether its general policies and practices are consistent with its objectives.⁶⁶ It must consider representations made by the panel and from time to time publish its responses.⁶⁷

There are also more specific statutory duties to consult. Before making any rules, the PRA must publish a draft. The draft must usually be accompanied by a cost-benefit analysis as well as an explanation of the purpose of the proposed rules. The PRA has a duty to consider any representations made by the public and, if it makes the rules, it must publish

⁵⁷ There are, of course, other regulators who are relevant to the financial services industry – most prominently the Competition and Markets Authority (CMA) and the Financial Reporting Council (FRC). However, as these regulators are not specifically focused on the financial services industry, they are not considered in this report.

⁵⁸ Prior to 28 February 2017, the PRA was a wholly owned subsidiary of the Bank.

⁵⁹ Bank of England 'The Bank of England Act 1998' (1998) Sections 9C(1)(a) and 2A(1).

⁶⁰ Ibid. Section 9C(2).

⁶¹ Ibid. Section 9C(1)(b).

⁶² Where HM Treasury designates an activity as a PRA-regulated activity by order (see below), it can use the same order to add a further objective in relation to that activity. This power has not, however, been used.

⁶³ 'Financial Services and Markets Act 2000' (2000) Section 2B.

⁶⁴ Ibid. Section 2C.

⁶⁵ Ibid. Section 2H.

⁶⁶ Ibid. Section 2L.

⁶⁷ Ibid. Section 2N.

a general account of the representations made and its response to them. A significant change between the proposed and the actual rules must be described and accompanied by a cost-benefit analysis.⁶⁸

The PRA must also consult on its annual report. It invites representations on it, the way the PRA has discharged or failed to discharge its duties and the extent to which the PRA has advanced its objectives and considered the statutory regulatory principles.⁶⁹ The PRA must then publish a report about the consultation describing, in general terms, any representations made.⁷⁰

Other regulatory responsibilities of the Bank of England

The Bank of England has been designated the resolution authority for failing UK-incorporated banks, building societies, investment firms, central counterparties and their group companies. This function ultimately derives from the EU's Bank Recovery and Resolution Directive.⁷¹

The Bank of England also has responsibility for regulating and supervising a range of financial market infrastructures (FMIs). While the legal frameworks for regulating securities settlement systems and central counterparties come from the EU, the framework for payment systems is domestic. Departing from the domestic model, the relevant legislation does not explicitly set out objectives for the Bank of England in this field. However, the criteria for determining the scope of the regulatory regime clearly show its purpose: to prevent deficiencies in payment system design and disruptions in their operation that could either threaten the stability of or confidence in the UK financial system or have serious consequences for the real economy.⁷²

The Bank of England has a number of tools for regulating payment systems at its disposal. These include publishing principles and codes of practice; requiring payment systems to establish, maintain and modify internal rules; and giving them specific binding directions. The Bank of England has the power but not an obligation to do these things, giving it wide discretion. It has, for instance, decided against using codes of practice.

2.3

The Financial Conduct Authority

The FCA is responsible for regulating business conduct and the daily operation of the financial markets and markets for financial services.

The FCA has a more complex set of objectives than either the FPC or the PRA. It has a strategic objective of ensuring that financial markets and markets for financial services operate well.⁷³ In addition, it currently has three operational objectives:⁷⁴

⁶⁸ Ibid. Section 138J.

⁶⁹ Ibid. Paragraph 20, Schedule 1ZB.

⁷⁰ Ibid. Paragraph 21, Schedule 1ZB.

⁷¹ European Parliament and European Council 'Directive (EU) 2014/59' (March 2014).

⁷² Bank of England 'Banking Act 2009' (2009) Section 185.

⁷³ 'Financial Services and Markets Act 2000' (2000) Section 1B (2).

⁷⁴ A fourth objective is expected to come into effect with the ring-fencing regime: to the extent that ring-fenced services are not regulated by the PRA, protecting the continuity of the provision in the United Kingdom of those services (the continuity objective). Ibid. Section 11A, inserting section 1EA where appropriate.

- Securing an appropriate degree of protection for consumers (consumer protection objective).⁷⁵
- Protecting and enhancing the integrity of the UK financial system (integrity objective).⁷⁶
- Promoting effective competition in the interests of consumers in the markets for regulated financial services and certain services provided by a recognised investment exchange (competition objective).⁷⁷

FSMA fleshes these out in some detail: the FCA must have regard to eight principles when considering what an appropriate degree of protection for consumers might be; it must consider five aspects of the integrity of the UK financial system; and it may have regard to five principles when considering the effectiveness of competition.

In addition, when advancing the consumer protection objective, the integrity objective or the continuity objective, the FCA must so far as possible act in a way that promotes effective competition in the interests of consumers.⁷⁸

The FCA meets its objectives primarily by making and enforcing the rules set out in the FCA Handbook using its powers under FSMA.

Like the PRA, the FCA has a statutory duty to consult on its general policies and practices.⁷⁹ There are four panels: the FCA Practitioner Panel, the Smaller Business Practitioner Panel, the Markets Practitioner Panel and the Consumer Panel. The Smaller Business Practitioner and Consumer Panels play a particularly important role given that they represent stakeholders which typically have less time and resources to respond to consultations. Despite their formal remit, the panels are not limited to consulting on the 'general policies and practices' of the regulators. The FCA Consumer Panel, for instance, conducts independent research into matters affecting consumers of financial services and makes specific recommendations to the FCA. It also responds to consultations and calls for evidence from the FCA and other public bodies.⁸⁰

The FCA must also go through the same consultation process as the PRA when making rules – i.e. it must publish draft rules, ordinarily with a cost-benefit analysis and explanation of their purpose, consider any representations, and (if the rules are made) publish a general account of the representations made and its response to them. Any significant differences between the proposed and actual rules must be described and accompanied by a cost-benefit analysis.⁸¹ The FCA supplements its statutory consultation obligations with ad hoc pre-consultation mechanisms, for example publishing policy

⁷⁵ 'Financial Services and Markets Act 2000' (2000) Section 1C.

⁷⁶ Ibid. Section 1D.

⁷⁷ Ibid. Section 1E. The FCA also has competition powers concurrently with the CMA under Part 21A FSMA. Interestingly, the FCA's objectives – including its competition objective – do not apply to its exercise of these functions. This is to ensure that the FCA and the CMA have an aligned approach to their use. We do not further consider these concurrent powers in this report, as they are really general competition law powers conferred on an industry specialist.

⁷⁸ 'Financial Services and Markets Act 2000' (2000) Section 1B(4).

⁷⁹ Ibid. Section 1M.

⁸⁰ The FCA Consumer Panel has also specifically been granted the power to raise matters with the PRA where relevant, although the PRA is under no obligation to consider its representations. Ibid. Section 1Q(5A)-(5B).

⁸¹ Ibid. Section 138I.

papers and hosting roundtables. Industry also generally considers the FCA to be reasonably accessible to individual businesses who have queries or concerns about the application of regulations.

The FCA has the power to give guidance, whether generally or to individuals or classes of individuals.⁸² Where guidance is not given on an individual basis, the FCA must first publish a draft and take into account any comments submitted. The FCA must notify HM Treasury on making or altering most types of guidance.⁸³

Finally, the FCA must publicise and hold an annual public meeting to enable the public to scrutinise its annual report.⁸⁴ The meeting must provide a reasonable opportunity for those attending to question the FCA about how it has discharged, or failed to discharge, its functions over the previous year. It must subsequently publish a report of the meeting.⁸⁵

The Payment Systems Regulator

The FCA ordinarily regulates markets and supervises businesses directly. However, it also has a subsidiary responsible for an additional layer of regulation and supervision of payment systems – the PSR.

The PSR has three objectives:

- Promoting effective competition in the interests of those who use or are likely to use payment systems (competition objective).⁸⁶
- Promoting the development of, and innovation in, payment systems in the interests of those who use or are likely to use payment systems, with a view to improving their quality, efficiency and economy (innovation objective).⁸⁷
- Ensuring that payment systems are operated and developed in a way that takes account of and promotes the interests of those who use or are likely to use payment systems (service-user objective).⁸⁸

The PSR has a number of specific powers for meeting these objectives, including issuing directions and guidance. Consultation requirements are similar to those for the PRA and FCA and include a statutory panel.

2.4

Interaction between the regulators

One difficulty with having separate regulators for different policy goals is that individual businesses may face regulation from more than one regulator.

In the domestic element of the UK system there are a range of tools to promote coherence. Both main regulators are subject to a duty to ensure co-ordinated exercise of their functions.⁸⁹ They must maintain and review a memorandum of understanding

⁸² Ibid. Section 139A.

⁸³ Ibid. Section 139B.

⁸⁴ Ibid. Paragraph 12, Schedule 1ZA.

⁸⁵ Ibid. Paragraph 13, Schedule 1ZA.

⁸⁶ 'Financial Services (Banking Reform) Act 2013' (2013) Section 50. Like the FCA, the PSR has competition powers concurrent with the CMA, but to which its objectives do not apply.

⁸⁷ Ibid. Section 51.

⁸⁸ Ibid. Section 52.

⁸⁹ Ibid. Section 3D.

as to their respective roles, where there is common regulatory interest.⁹⁰ If this system of collaboration fails, HM Treasury can by order provide that one or the other regulator has sole or primary responsibility for specified matters.⁹¹ The PRA can, under certain circumstances, restrain the FCA from taking action.⁹²

There is also some overlap in senior personnel of the two main regulators. For example, the Deputy Governor of the Bank for Prudential Regulation and the CEO of the FCA sit on both the PRC and the governing body of the FCA.

There are special provisions for payment system regulation because there are four rather than two regulators. The Bank of England, the PRA, the FCA and the PSR are all under a duty to ensure co-ordinated exercise of their functions and they must maintain a memorandum of understanding.⁹³ The Bank of England, the PRA and the FCA each have a power to restrain the PSR from taking action.⁹⁴

However, the volume and complexity of financial regulation (especially new regulation) as well as the number of businesses regulated makes the task of maintaining coherence in the domestic element of the UK system a difficult one without greater institutionalised cooperation mechanisms.

2.5

Her Majesty's Treasury

In keeping with the need for regulatory independence, the government has relatively few powers in the domestic element of the UK system.⁹⁵ Those it does have are normally 'fine tuning' that relate to the scope and distribution of the regulators' powers.

HM Treasury specifies the scope of financial regulation by defining what activities are to be regulated.⁹⁶ It can make limited adjustments to the FCA's statutory objectives by amending (among other things) the definitions of 'regulated financial services', 'credit institution' and 'consumer' and it can give the PRA special objectives in relation to particular regulated activities. As already noted, HM Treasury has the power to hand either the FCA or the PRA primary or sole responsibility where their functions overlap.

Scoping powers take on particular importance for certain parts of the regulatory system, for example the FPC and FMI regulation:

- Aside from issuing recommendations and reports, the FPC's only power is to give directions to the FCA or PRA, requiring them to exercise their functions so as to ensure the implementation of 'macroprudential measures'. These macroprudential measures are specified by HM Treasury, subject to parliamentary scrutiny.⁹⁷

⁹⁰ Ibid. Section 3E.

⁹¹ Ibid. Section 3G.

⁹² Ibid. Section 3I.

⁹³ 'Financial Services (Banking Reform) Act 2013' (2013) Sections 98 and 99.

⁹⁴ Ibid. Sections 100 to 102.

⁹⁵ In a formal sense, the regulators are primarily accountable to HM Treasury, in that they must deliver their annual reports and audited accounts to HM Treasury (which subsequently lays the relevant documents before Parliament).

⁹⁶ 'Financial Services and Markets Act 2000' (2000) Section 22. The result is the FSMA (Regulated Activities) Order 2001, which is frequently amended.

⁹⁷ Ibid. Sections 9L and Bank of England 'The Bank of England Act 1998' (1998), 9N. The parliamentary scrutiny takes the form of the affirmative procedure.

- Individual payment systems must be ‘recognised’ by order of HM Treasury before the Bank of England can regulate them using its powers under Part 5 of the Banking Act 2009 and ‘designated’ by order of HM Treasury before the PSR can regulate them using its powers under Part 5 of the Financial Services (Banking Reform) Act 2013.

HM Treasury also has several ‘soft’ powers which can be used to influence, though not direct, regulatory outcomes.

HM Treasury may at any time write to the PRC or FCA respectively “to make recommendations... about aspects of the economic policy of Her Majesty’s government” but must do so at least once in every Parliament.⁹⁸ There is a statutory duty on the PRC and FCA to have regard to these recommendations when considering how to act in accordance with their statutory objectives and regulatory principles. This is a new feature, introduced by the Bank of England and Financial Services Act 2016. The most recent letters, sent on 8 March 2017 to coincide with the Budget, identify aspects of government economic and industrial policy that are relevant for the regulators and express support for certain recent commitments and initiatives by the regulators.⁹⁹

In addition, HM Treasury may at any time write to the FPC to set out government policy¹⁰⁰ and make recommendations about (among other things) its responsibilities in relation to its objectives¹⁰¹ and must do so at least once every year. The FPC must respond to any recommendations made by HM Treasury.

Just as Parliament can examine the economy, efficiency and effectiveness in the use of the regulators’ resources through the NAO, so too can HM Treasury through independent appointees.¹⁰²

⁹⁸ Bank of England ‘The Bank of England Act 1998’ (1998) Section 30B and ‘Financial Services and Markets Act 2000’ (2000) section 1JA, respectively.

⁹⁹ HM Treasury and The Rt Hon Philip Hammond MP ‘Recommendations for the Prudential Regulation Committee: Spring Budget 2017’ (March 2017), available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597419/Prudential-Regulation-Committee-Spring-Budget-2017.pdf.

HM Treasury and The Rt Hon Philip Hammond MP ‘Recommendations for the Financial Conduct Authority: Spring Budget 2017’ (March 2017) available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/597668/Recommendations_Financial_Conduct_Authority_Spring_Budget_2017.pdf.

¹⁰⁰ ‘Financial Services and Markets Act 2000’ (2000) section 9D.

¹⁰¹ ‘Financial Services and Markets Act 2000’ (2000) section 9E.

¹⁰² ‘Financial Services and Markets Act 2000’ (2000) section 7F and ‘Financial Services and Markets Act 2000’ (2000) section 1S.

Policy development in the UK: the Senior Managers and Certification Regime

The SMCR shows how the UK developed and implemented a significant new financial regulatory regime without EU input.¹⁰³ It is therefore a good illustration of how the domestic element of the UK system works – and could continue to work – after the UK leaves the EU.

Responding to scandals, Parliament established the Parliamentary Commission on Standards in Banking in July 2012. This was an ad hoc joint committee of the House of Commons and the House of Lords. During its investigations, the Commission became concerned that banking regulation was too focused on corporations rather than the individuals – the senior managers – who were responsible for mismanagement. On 19 June 2013 it published its findings in its report *‘Changing banking for good’*.¹⁰⁴ One of its key recommendations was the replacement of the former Approved Persons regime with a Senior Persons Regime “which would ensure that the key responsibilities within banks are assigned to specific individuals, who are made fully and unambiguously aware of those responsibilities and made to understand that they will be held to account for how they carry them out.”¹⁰⁵

The government responded to the Commission’s report in July 2013, accepting all of its principal recommendations. It announced that it would amend a banking bill currently before Parliament to introduce a Senior Persons Regime; the Financial Services (Banking Reform) Act 2013 duly amended FSMA to mandate the SMCR.

In keeping with the domestic model, the statutory provisions are relatively high level. They offer a broad characterisation of a ‘senior management function’ but give the regulators the task of specifying them. They provide that only those approved by a regulator may take on such functions, the regulators having considerable discretion in how they manage the process. The regulators may give conditional and time-limited approvals, the only constraint being that each must develop and publish a policy on their use. They are also given a broad power to develop rules of conduct for senior managers. The most specific provision simply states that an application for approval must be accompanied by a statement of responsibilities, which must subsequently be kept updated.

The regulators have put ample flesh on these bones. For example, they have identified 18 different senior management functions; specified a list of 27 ‘prescribed responsibilities’ that must be allocated to specific senior managers; drafted the conduct rules and policies as required by the Act; and introduced a requirement for a comprehensive ‘responsibilities map’ that leaves no gaps in accountability for the operations of the authorised person and that is consistent with the senior managers’ statements of responsibility.

The SMCR came into force in March 2016 and applied to UK deposit takers, UK branches of foreign deposit takers and PRA-designated investment firms. However, in 2015, the government announced its intention to extend the regime to all authorised firms; the necessary statutory changes were made in the Bank of England and Financial Services Act 2016. The FCA and PRA have now consulted on the extension.

¹⁰³ Another recent example is the banking ring-fencing regime. This is being introduced under the Financial Services (Banking Reform) Act 2013 and has its origins in the final report of the Independent Commission on Banking (the Vickers Report).

¹⁰⁴ Parliamentary Committee on Banking Standards *‘Changing Banking for Good’* (June 2013), available at: <http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/>.

¹⁰⁵ *Ibid.* p. 8-9.

3 Historical development of the regulatory objectives and principles

Since FSMA was enacted, there have been several changes to regulatory objectives and factors that regulators must take into account (regulatory principles). The development of these is charted in this section.

3.1

Financial Services and Markets Act 2000

On its incorporation, the FSA was given four regulatory objectives:

- market confidence
- public awareness
- the protection of consumers
- the reduction of financial crime.

These regulatory objectives were supplemented by a list of seven factors to which the FSA was to have regard. These were:

- **Efficiency:** the need to use the resources of each regulator in the most efficient and economic way.
- **Managerial responsibility:** the responsibilities of those who manage the affairs of authorised persons.
- **Proportionality:** the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.
- **Innovation:** the desirability of facilitating innovation in connection with regulated activities.
- **Competitiveness:** the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.
- **Preserving competition:** the need to minimise the adverse effects on competition that may arise from anything done in the discharge of (regulatory) functions.
- **Facilitating competition:** the desirability of facilitating competition between those who are subject to any form of regulation by (the FSA).

3.2

Financial Services Act 2010

Financial stability was added as a regulatory objective.

Public awareness was demoted from a regulatory objective to one of the factors to which the FSA was to have regard.¹⁰⁶

¹⁰⁶ 'The desirability of enhancing the understanding and knowledge of members of the public of financial matters (including the UK financial system)'.

3.3

Financial Services Act 2012

The FSA was split into the PRA and the FCA and the current regulatory objectives for the two regulators came into force.

The factors of efficiency, proportionality and managerial responsibility were retained as 'regulatory principles'.¹⁰⁷ They were joined by the five new regulatory principles.

- **Sustainable growth:** the desirability of sustainable growth in the economy of the United Kingdom in the medium or long term.
- **Consumer responsibility:** the general principle that consumers should take responsibility for their decisions.
- **Appropriate discrimination:** the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (including different kinds of persons such as mutual societies and other kinds of business organisation) subject to requirements imposed by or under this Act.
- **Publicity:** the desirability in appropriate cases of each regulator publishing information relating to persons on whom requirements are imposed by or under this Act, or requiring such persons to publish information, as a means of contributing to the advancement by each regulator of its objectives.
- **Transparency:** the principle that the regulators should exercise their functions as transparently as possible.

The factors of innovation and competitiveness were removed. The need to facilitate competition became regulatory objectives for both the PRA and the FCA, while the need to preserve competition when exercising regulatory functions became a special principle in the operation of the FCA.

3.4

Financial Services (Banking Reform) Act 2013

The PSR was created and given its current regulatory objectives.

¹⁰⁷ The managerial responsibility factor was amended to read: "the responsibilities of the senior management of persons subject to requirements imposed by or under this Act, including those affecting consumers, in relation to compliance with those requirements."

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