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Submission to APPG inquiry into the role of the UK parliament in the future regulatory framework for financial services

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Pre-amble

This APPG inquiry is timely and important. The entry of the UK into what is now the EU changed fundamentally how financial regulation came into being and the terms of the inquiry identify a really key issue in relation to this. Initially, our accession did not change a great deal in terms of the extent of financial regulation. But, as described below, there was a step change in terms of process away from the traditional UK approach to developing legislation and regulation in this area and towards a model of establishing regulatory bodies which would be empowered to develop regulation without direct accountability to parliament.

However, it is notable that there has been little resistance to the development of new processes and bodies designed to regulate financial markets in the UK: we seem to have absorbed the continental approach in this field with alacrity. Furthermore, our governments have been in the vanguard of promoting greater regulation at the EU level. Also, in those areas of financial regulation not covered by EU competencies the UK has embedded the approach further and also joined with other international organisations to design, implement and enforce forms of financial regulation in ways that are not easily accountable to parliament. Much EU regulation has, of course, been gold-plated.

I would like to begin this submission with a brief history of the development of financial regulation in the UK focusing on the move away from parliamentary accountability so it will then be possible to answer the questions relatively briefly. The history, though, demonstrates the context which any new approach will either have to change or work within.

A brief history of financial regulation and parliamentary accountability in the UK

English legal development has been characterised by a blend of parliamentary legislation with the common law. The common law is to be understood as a body of law derived from decisions reached in courts by judges. It evolves from the accumulation of the precedents embodied in these decisions and in that sense is "judge-made"; it does not reflect input from either the executive or the legislature, and has often been seen as protecting individuals' freedom against the power of the state. Some of the attacks on the accrual of power in the EU have been based on the way in which it undermines our common law legal system though, as will be explained, this has also been a home-grown feature of legislative developments.

In the financial sphere the common law tradition was associated with so-called “self-regulation under the law”. A standard pattern was that the practitioners of a financial activity would form themselves into the membership of a corporate body which endorsed their professional credentials but then had authority over them. The corporate body would articulate and enforce rules of good conduct on the understanding that breaches of those rules would be sanctioned. An extreme sanction would be expulsion from membership.

This approach was important in financial markets in which the Stock Exchange was a crucial independent regulatory body: such institutions still have some residual role, but always subject to the authority of a statutory regulator. An important feature of the approach was that, in the realm of financial regulation, competition against the regulatory body was possible (so off-exchange dealing was possible, whilst rare). Interestingly, a Royal Commission inquiry in 1877-78 commented that the exchange’s rules were “capable of affording relief and exercising restraint far more prompt and often satisfactory than any within the read of the courts of law”.

The Financial Services Act 1986 was the revolutionary landmark in the change from self-regulation under the law to statutory regulation. This applied to a wide area of financial activity Although it came into force in most of the financial sector in 1988, it is often associated with the so-called “Big Bang” in October 1986. The Big Bang was a set of reforms, mostly affecting the London Stock Exchange, which are often described as “deregulation”. In fact they were nothing of the sort. They involved prohibiting certain types of regulation by private sector institutions (mainly the Stock Exchange) which were accountable to the market and replacing them with a complex set of so-called self-regulatory bodies (SROs). These bodies set some rules and supervised all aspects of financial business, covering securities markets dealing, investment products, investment management, life insurance and pensions products and the provision of investment advice. The SROs answered to the newly-founded Securities and Investment Board. The SIB was quasi-governmental, in that it was accountable to the Treasury and was staffed to some extent by civil servants.

This approach was therefore a half-way house before the establishment of the fully statutory body the Financial Services Authority under the Financial Services and Markets Act 2000. This body and its successors controlled every aspect of financial regulation (including who can practice) with very weak accountability to parliament. It also heavily regulates professional bodies and their members.

The remit of the FSA was expanded (for example, mortgages, which were previously regulated only by general consumer law, were added to its jurisdiction as was general insurance).

This trend has been replicated in every other area of financial services. Pension funds were regulated using primary regulation which was very light touch until the 1995 Pension

Act. Even after this time, it was not until 2011 that the Occupational Pensions Authority was created (without any EU pressure).

When it comes to insurance regulation, the provisions of the 1870 Insurance Companies Act (nine pages of primary legislation with nine pages of schedules) basically remained in force without significant amendment until the run up to the UK joining the EU: in other words, for a whole century. Bank capital was not regulated at all until 1988, thereafter being regulated by a whole host of international and domestic regulatory structures.

The best way to describe the evolution towards the current regulatory structures is that we started with a whole series of legal frameworks in different areas of financial services which were based on common law, contract law, simple consumer protection law or very specific and normally very simple primary legislation which continued until 1970. This approach was reinforced by very effective private sector bodies such as exchanges and professions which were accountable to the market. Parliament was able to fully scrutinise the adoption, implementation and effectiveness of all these forms of regulation and frequently did so. Regulation that was produced by parliament was simple and was interpreted by courts in a traditional British common law context.

The first move away from this approach was with the adoption of various aspects of EU regulation that required financial institutions throughout the EU to adopt certain regulatory standards. Some of these standards were perverse and possibly fossilised poor practices of risk management; indeed, they may have contributed to the failure of the Equitable Life. However, the main point as far as this APPG inquiry is concerned is that the implementation of EU regulation required not only parliamentary legislation, but also secondary legislation which was laid before parliament but not debated. One example of this would be the 1980 Insurance Company Accounts and Statements Regulations which were laid before Parliament by the Secretary of State on 25th January 1980. These regulations were several times longer than the 1974 Insurance Companies Act which empowered the Secretary of State to produce that regulation.

This was an early example of the divorce between regulation, legislation and parliamentary scrutiny. However, despite the lack of accountability to parliament, there was, at least, still direct accountability of government ministers and civil servants who were responsible for the production of the secondary legislation.

The situation we have reached now is that Financial Conduct Authority (one of the successor bodies of the FSA) and related organisations can develop regulation more or less without limit or scrutiny and do so in such volume and detail that scrutiny is impossible. There is no parliamentary accountability and this development has not happened primarily because of the EU.

The growth of statutory regulation has been highlighted by Haldane (2012). Haldane is not a supporter of deregulated financial markets in general. However, he points out that the Basel rules for determining bank capital have grown from 30 to over 600 pages. He then notes, amongst a range of other data about the growth of regulatory detail: "In 1980, there was one UK regulator for roughly every 11,000 people employed in the UK financial sector. By 2011, there was one regulator for every 300 people employed in finance." That ratio will have grown much higher since. Indeed, it might be mentioned that, if the trend growth in the ratio of regulators to people employed in finance were to continue, the number of regulators would overtake the number of people employed in finance by about 2070 – and this excludes those who enforce regulation employed by regulated firms themselves (such as compliance officers).

In 2011, the UK financial regulator brought in regulation or issued guidance, advice, discussion documents or consultations, totalling 4.3 million words – more than five times the length of the Bible. This included a 585-page consultation on the regulation of the mortgage market, which led to a 312-page document on regulations relating to the sale of mortgages. Not only were defaults on UK mortgages not implicated in the financial crash, mortgage defaults have never been responsible for a serious bank failure in the UK. As noted above, the statutory regulation of mortgages is a very recent development in the UK.

Today, the FCA has the ability to determine its own burden of proof, levy fines, and prevent people from working in any area of financial markets. It has wide-ranging enforcement powers equivalent to those adjudicated in civil and criminal courts with none of the accountability or guarantee of due process that exist in proper courts. In 2015, the FCA levied nearly £1 billion of fines (the amount of fines does vary widely and was "only" £300m in 2019). The statutory financial regulators, of which the FCA is just one, control every aspect of financial market conduct. There is no competition between regulators.

The approach to regulation in the UK has moved from one of freedom of contract, caveat emptor and primary legislation designed to address specific problems through the approach of supplementing this with secondary legislation to the creation of bodies who have more or less unlimited powers and wide-ranging objectives. The objective of the FCA, for example, is framed as follows: "to make markets work well – for individuals, for business, large and small, and for the economy as a whole. We do this by regulating the conduct of nearly 60,000 businesses. We are the prudential supervisor for 49,000 firms and we set specific standards for 19,000 firms."

The FCA is accountable to the Treasury and to parliament, but this accountability – especially to parliament - is tenuous. The FCA or Prudential Regulation Authority (PRA) is most likely to come to parliament's attention when there is a scandal or failure. The desire of Members of Parliament, the government and the regulators (including the PRA) to avoid such eventualities is likely to make them risk averse as parliament will only criticise the regulatory bodies for not regulating sufficiently or for not preventing specific events (reports of recent Select Committee inquiries confirm this). Furthermore, a body charged with regulating markets to "make them work well" will see no limits to its activity, hence the continual spawning of more and more rules. This approach contrasts with the approach of the Bank of England when regulating the banking system before 1997, when it would focus on the narrower, but achievable objective of avoiding systemic risk rather than trying to perfect markets. It was for this reason that it was prepared to allow Barings to fail with the losers being those who provided the capital for the institution. It is worth noting in passing that, within seven years of the FSA being given much wider powers, the financial crisis occurred and, for the first time in modern financial history, there was a systemic crisis in the banking system. Loss of focus and hence accountability and a move towards trying to solve every problem in financial markets perhaps led to it ill-prepared for the one problem that mattered most.

I now examine the specific questions briefly using the context of the discussion above:

What role, if any, should parliament play in the formulation of financial services policy?

How can parliament ensure that wider public policy goals are reflected in financial services regulation?

Under the systems of financial regulation that existed until the mid-1980s, there were clear lines of accountability. The regulatory bodies that evolved within markets were accountable to their members who had an interest in well-functioning markets and to market participants. If they over-regulated, costs would be higher and market participants would bypass these regulatory bodies; if they under-regulated, market confidence would be lost and, again, business would go elsewhere.

If it was felt that the general public interest was not being served, it was easy for parliament to hold inquiries from time to time and these did take place and were influential. In addition, primary legislation could be passed (as happened in relation to insider trading the prohibition of which was nine pages of the 1980s Companies' Act – with the pages being small) to address particular problems. Lines of accountability here were clear with Members of Parliament and/or ministers identifying and trying to remedy a problem where it was felt necessary in the general public interest.

Similarly, with all other parliamentary legislation in this field, the government was clearly accountable to parliament and, through parliament, to the electorate. The responsibility of ministries was also very clear and government departments were called to account when insolvencies happened as is clear from this exchange in the House of Commons on the failure of the Vehicle and General in 1971: https://api.parliament.uk/historic-hansard/commons/1971/mar/02/vehicle-and-general-insurance-co-ltd In such a situation, with these clear lines of responsibility, ministers, accountable to Parliament, can judge whether it is appropriate for regulation to be tightened (and it should not be assumed – and was not always assumed - that this will necessarily be the case).

The lines of accountability are now extremely blurred. The FCA is financed by levies on companies ultimately borne by consumers. It is supposed to serve consumers but has no line of accountability to them. It is, in theory, accountable to the Treasury and Treasury ministers are accountable to Parliament, but those lines of accountability are virtually non-existent. We have moved from the position where every single paragraph of regulation would be scrutinised by parliament to one where there is no scrutiny. When regulation is undertaken by a body designed for the purpose of perfecting markets by writing regulations which is not really accountable to anybody, it will always be tempting for the body itself to take the most risk-averse approach: neither of these groups. There is no obvious gain to the regulatory bodies from a more lightly regulated market, but there are clear costs whenever there is a failure. This is because parliament cannot scrutinise the efficacy of the regulator's as a whole, it tends only to scrutinise it in times of crisis.

It is clear from the discussion above that I believe that financial markets would be better served by a rolling back of the approach to implementing financial regulation that has developed since our joining what is now the EU (though I would not blame the EU for the problem). In answering the questions, I am going to assume that is not possible and try to propose ways of trying to ensure that the system pursues the objectives laid down by parliament.

Parliament's role in the development of financial services regulatory policy cannot be limited to the passing of an Act of Parliament every decade or so (there have been just three major acts in 34 years) and then allowing the bodies that are set up to operate under their own accord. One possibility would be to put sunset clauses in major pieces of regulation so that they had to be renewed and discussed again. It may be thought that this would just waste parliamentary time. However, parliament cannot simply regard its responsibility as having been discharged for decades at a time when a new body is set up with a remit to, more or less, regulate at will. Under this proposal, the Financial Services Act 2012 would be replaced by a Financial Services Act 2022 which would be fully debated in parliament and open to amendment even if the contents of the tabled bill were similar.

In relation to policy goals set by parliament, it is important that financial services legislation is very specific about the policy goals it expects regulators to meet. Mission creep should be avoided. Regulators should then be held to account in various ways, discussed below, to ensure that they are meeting the goals reflected in legislation.

Do you think that the role of parliament in scrutinising primary and secondary legislation on financial services needs to be changed post-Brexit? If so, in what way?

Could the role of the Treasury Committee encompass detailed scrutiny and review of financial services legislation? If so, would this be desirable?

Should the House of Lords play a greater role in the scrutiny and review of financial services legislation?

Would a joint Financial Services Scrutiny Committee help improve the quality of future financial services legislation?

The three statutory objectives of the FCA are: protecting consumers, ensuring market integrity, and promoting effective competition. I believe another objective should be added which is “ensure that consumer financial markets operate efficiently”.

Parliament must find ways of monitoring the achievement of these objectives in “peacetime” – that is when a specific crisis is not faced by the industry. Inquiries during a crisis encourage a risk-averse approach with MPs always wanting to assign blame for crises which might affect their constituents. MPs are rather averse to saying to constituents: “in a market economy, some things will go wrong at times and we cannot regulate to always prevent them doing so”. The costs of taking an approach which is too risk averse, tend to be long term and hidden and often involve impediments to competition and so it is important to analyse the impact of regulators on the efficiency of markets. The Treasury Select Committee and the House of Lords equivalent could hold regular inquiries relating to all three of the statutory objectives of the FCA and, in my view, also the fourth one I have proposed. The inquiries should be separate so as to ensure focus on the particular objective of the inquiry and involve all the main financial regulatory bodies (accepting that their objectives are somewhat different). The members of the House of Lords face different pressures and are able to investigate matters taking a different approach from that of the House of Commons. It would be helpful for the House of Lords to hold separate investigations. The relevant Ministers should be required to respond to the Select Committees’ reports and attend parliament to face scrutiny about them.

One of the problems of regulatory complexity is that regulation can become captured by vested interests. In the case of financial regulation, this can be the regulators themselves, regulated financial entities (who may see regulation as a useful barrier to entry) and consultants. There are many people in parliament, especially in the House of Lords, who may be part of a wider circle of vested interests. They may not deliberately seek to make regulation more complex or more extensive in order to promote their own interests, but they may have certain cognitive biases that lead them to favour more regulation and be sanguine about unaccountable regulatory bodies. I feel it would be better to avoid the problem of the Select Committees becoming part of that network of interests by using existing Select Committees to hold regulators to account (the Economic Affairs Committee in the House of Lords and the Treasury Select Committee in the House of Commons) rather than create new ones with a specific interest in financial services. It is important that people who can stand back from the detail are able to hold the regulatory bodies to account for meeting the policy objectives laid down by Parliament.

How can parliament best scrutinise the work of regulators with expanded powers post-Brexit?

How can parliament effectively scrutinise co-ordination between multiple regulators—including those with broader responsibilities, such as the Competition and Markets Authority and the Information Commissioner’s Office—on issues of common interest?

As I have tried to stress above, the development of EU influence on regulation is only part of the reason why regulatory bodies have been created in the UK and why regulation has become so complicated. Many of the developments are home grown. In some ways, holding regulators to account might be easier if their responsibilities were not co-ordinated. It is not clear, for example, that the merging of the Office of Fair Trading and the Competition Commission has produced a beneficial outcome. It might be better not to have a monopoly when it comes to regulation.

There could be a strong role for the National Audit Office to investigate, on a regular basis, the efficiency of the UK regulatory bodies given that they are funded by levies effectively borne by customer and also to investigate the impact of regulation on the efficiency of financial services markets. There should be a regular audit of the explicit costs of regulation, the costs of regulation on regulated firms and the costs in terms of reduced competition and innovation.

In addition, the Competition and Markets Authority should regularly investigate the impact of regulation on competition. In general, the government is not sufficiently good at looking into the effects on competition of its own actions.

Separately from this, I would suggest that firms should be able to bring products to market that are not regulated as long as they are clearly labelled as such. My suspicion is that the market in such products would not be deep. However, it might be develop in areas of innovation. As has been noted above, historically, the market has developed its own approaches to regulation which might be stifled by compulsory statutory regulation.

Addendum

It should also be noted that an important influence on UK financial regulation will remain international agreements (of which the EU will also be part). There is evidence that such international agreements are damaging to financial stability (see, for example, Romano, R. (2014) 'For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture', *Yale Journal on Regulation* 31(1): 1-76 as well as two blog posts summarising the arguments at: https://iea.org.uk/blog/the-systemic-risk-of-international-financial-regulation-part-1 and https://iea.org.uk/blog/the-systemic-risk-of-international-financial-regulation-part-2). From the perspective of accountability, international regulatory bodies are deeply problematic. Various interests (regulators, regulated firms and expert consultants and the legal profession) effectively control the participation of the UK in such bodies and there is no accountability to parliament whatsoever. When regulation was imposed at EU level, there were multiple forms of accountability through ministers and the European Parliament even if that accountability was indirect and could rarely scrutinise detail. The range of powers possessed by regulatory bodies allows them to make international agreements that are then enshrined in domestic regulation. Of course, this an execution of their domestic powers. However, it adds an extra layer of complication and can embed institutionally regulatory mechanisms that it may be almost impossible to change or amend directly. I don't think that there are other approaches to scrutiny, other than those discussed above, which are uniquely suited to examining these aspects of the regulatory process. However, those entities which I have proposed should scrutinise financial regulators should pay particular attention to the way in which international bodies shape domestic regulation. They should also examine how domestic regulatory bodies embed international regulatory agreements into such domestic regulation.