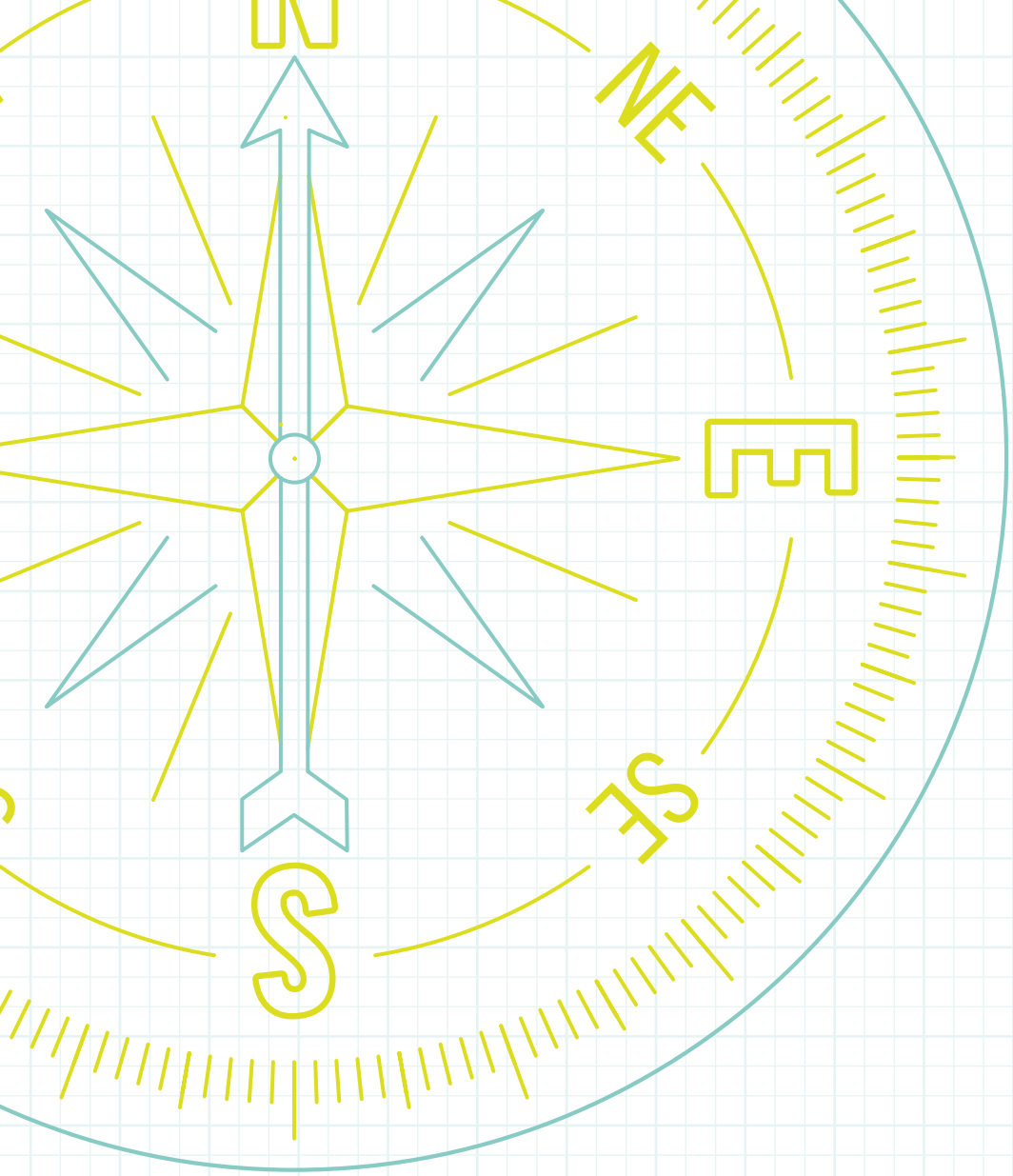

THE REGULATORY COMPASS

TOWARDS A PURPOSE-DRIVEN APPROACH TO FINANCIAL REGULATION

THE FINANCE INNOVATION LAB

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EXECUTIVE SUMMARY

We are living through a period of major political and economic uncertainty. While Brexit and new global forces reshape our economy, the rise of digital technologies could set our financial system on the path to greater fairness, responsibility and democracy – or the reverse.

It would be tempting at this point to focus on preserving our current financial system, often seen as the 'goose that lays the golden eggs' in our economy. Yet this system is arguably no more resilient than before the financial crisis, and – more importantly – it is not adequately serving its end users, channelling sufficient capital to the productive economy, or helping us address the biggest social and environmental issues of our time. Do we cling on to the status quo, with all its shortcomings? Or do we seize the opportunity to return to first principles, and reorient regulation more explicitly around the social purpose of finance?

In this report, we argue that the present moment offers an opportunity to step back and ask ourselves what outcomes we are regulating the financial system *for*, and what kind of financial system – as well as what kind of regulatory system – can best achieve those outcomes.

WHAT IS THE PURPOSE OF FINANCE?

We identify five immediate purposes served by the financial system: creating money, channelling money, looking after other people's money, sharing risk, and maintaining transaction and settlement systems.

Data on the efficiency of the financial system suggests that the 'overheads' which the industry extracts from society for fulfilling these functions have not reduced in over a century – suggesting that the system does not appear to be delivering its immediate purposes well.

But we need to dig deeper to understand the ultimate purpose of finance: how it creates, deploys and facilitates the movement of money in a way that best enables us to achieve our goals, as individuals, as communities, and as a society. The financial system should be judged not only on how efficient it is at turning money into more money, but also on the social, economic and environmental impacts of that money.

Understanding how the financial system is delivering on this ultimate purpose requires regulators to have a different mandate, mindset and set of metrics. These will need to be subject to some form of democratic debate or policy direction in order to identify the critical domains that need to be measured.

If we want a financial system that meets its social purpose, we also need to take much more of an interest in the purpose of individual businesses within that system. Purpose-driven regulation would look at business and governance models themselves, seeking to nurture those with the greatest potential to deliver positive social value and align the financial system with its social purpose.

In this report, we argue for a new **regulatory compass:** a broad framework which could guide the regulatory system, including the kind of information which regulators ask individual firms to disclose, the way regulators assess the riskiness of new products or businesses, and the criteria they use to select businesses for positive support or incubation.

THE EXPERIENCE OF SOCIAL-PURPOSE BUSINESSES

The experience of social purpose businesses in our community suggests that regulation – which is frequently assumed to be 'purpose-neutral' – is often designed around the large incumbent firms that dominate the market and are usually focused on profit maximisation. We explore three challenges this raises.

The **volume and complexity of regulation** has proven extremely challenging for smaller, social purpose banks to comply with, since they do not have the same economies of scale or large compliance teams. Capital requirements are a particularly good example of how well-intentioned regulation designed around large incumbent banks can have unintended consequences for others. We argue that the Financial Conduct Authority (FCA) should launch a standalone Diversity Hub to complement its efforts to support innovation; likewise, the Prudential Regulation Authority (PRA) should offer additional support (including a sandbox) for firms that bring diversity to the banking sector, including new community and stakeholder banks.

The **regulation of investment advice and product marketing** is still relatively poor at recognising social and environmental investment objectives. The shift to automation risks exacerbating these problems – particularly if machine learning techniques use historical data that reproduce historical biases that no longer reflect society's views. We argue that the FCA should adopt a human-centred approach to regulation, starting from the perspective of a person who has a range of objectives for their finances, rather than assuming maximum financial return is the sole aim.

Regulatory approaches to innovation tend to focus on technological developments, to the detriment of other forms of innovation, particularly new business models centred on social or environmental purpose. The authorisation process can be especially challenging for these types of firms; often the unique risks of social purpose models are considered, but not the unique benefits. We argue that regulators need a framework for thinking about the societal challenges we want innovation to solve – and thus the kinds of innovation we want to support – rather than focusing solely on increasing competition through technological innovation.

Three regulatory fallacies
We identify three fallacies that permeate current regulatory thinking:

- The fallacy of composition (if every unit in the system works, the whole system works)
- The fallacy of neutrality (current regulatory approaches are values-free and any changes to this would mean taking an unjustified moral stance)
- The fallacy of market efficiency (competition and 'market integrity' are effective proxies for the outcomes we want the financial system to serve).

We can either transfer these flawed assumptions to a new regulatory regime, or take this opportunity for a deeper reconsideration of how we regulate financial systems.

THE REGULATORY COMPASS

UK regulators – and the policymakers who instruct them – need to develop a more explicit, rounded and substantive concept of what social purpose means in the context of financial services. This should then act as a compass which guides regulation at every level.

An understanding of the purpose of the financial system as a whole should translate into an understanding of the purpose of each organisation within the system, and how that shapes and is shaped by its ownership, governance, business model, culture and incentives. Only then can regulatory bodies meaningfully measure how well the system and each firm is delivering its key outcomes.

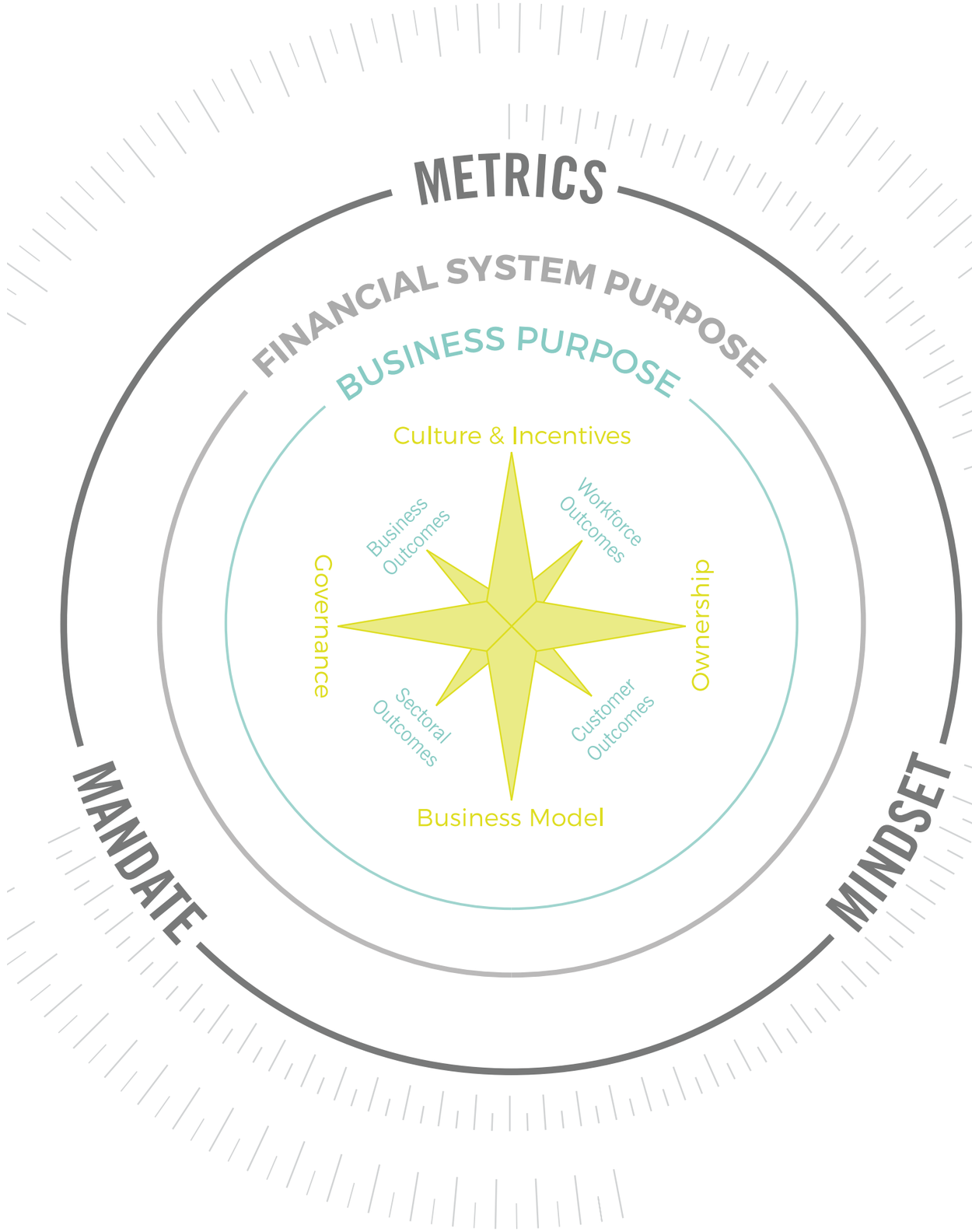
This shift demands democratic discussion. While regulators might reasonably argue that it is not their job to decide the purpose of the businesses they regulate, it *is* the job of politicians to ensure regulation is promoting the social outcomes that the public want to see.

Within this overarching framework of purpose, we identify three core dimensions of the regulatory compass:

Mandates – Ensuring that regulators have a mandate to hold the financial system to account for its ultimate purpose. This should involve full democratic consultation, including through participatory methods such as citizens' juries, to ensure that the voices of ordinary users of finance and others affected by its activities are heard.

Metrics – Creating the right measures to assess how well finance is serving its purpose. Metrics should be set at the level of the whole system, business purpose, culture and incentives, the purposes of individual users, and the contribution of financial firms to key sectors in the productive economy.

Mindset – Developing a human-centred approach to regulation and technology, driven by direct user engagement and an understanding of the role of motivation, judgement and bias in technology.



RECOMMENDATIONS

We recommend that government:

1. Conducts a review, based on full democratic consultation, to develop an agreed set of purposes for the financial system.
2. Uses the results to update the mandate of the Bank of England and the FCA.
3. Reports to Parliament on a regular basis on how these objectives are being achieved.

We recommend that regulators:

1. Adopt a new set of metrics against which to measure their success.
2. Seek to embed these purposes in their approach to assessing and managing systemic risks.
3. Identify and support the governance, ownership and business models that can best align the financial system with its social purpose.
4. Develop a mindset that sees 'consumers' as whole human beings with a range of motivations.
5. Embed an explicit understanding of social purpose into their approach to encouraging innovation and regulating new markets.
6. Embed an understanding of the value of diversity into the authorisation and regulation process, including establishing a new Diversity Hub to enable firms with atypical governance and business models to demonstrate the viability of their approach.
7. Monitor and hold firms to account for the human outcomes of technological developments.
8. Use regtech to focus time and energy on face-to-face interaction, aiming to build a deep understanding of firms' culture and business practices.

2. INTRODUCTION

We are living through a period of major political and economic uncertainty. After a referendum result which few predicted, the UK's political consensus is in flux and big questions are reopening about the kind of economy we want to have. Brexit itself is likely to substantially reshape our economy and our financial system – for better or for worse.

In many ways, current debates about the future of our economy can be seen as part of the ongoing fall-out from the 2008 financial crisis. The impacts of post-crash austerity politics are being felt more acutely across the UK, while the Brexit vote has been widely interpreted as, in part, a cry of rage from communities left behind by an increasingly London-centric economy. Many are asking why, ten years after the crash, we have not seen deeper reform in the financial and economic systems that led us to this point.

While events of the past continue to shape today's financial system, we are also seeing the emergence of new disruptive forces – not least the potential for technology to change the shape and role of the financial services industry. The rise of fintech brings with it opportunities to put people in control of their finances, but also risks of exclusion and exploitation. Decisions made now about how we regulate emerging technologies could set our financial system on the path to greater fairness, responsibility and democracy, or the reverse.

WHAT DOES THIS PIVOTAL MOMENT MEAN FOR THE REGULATION OF THE FINANCIAL SECTOR?

The present upheaval marks a decisive shift beyond the immediate post-crisis period, which was characterised by intense regulatory firefighting. The focus then was on stability – and by 2015, Bank of England Governor Mark Carney was suggesting the job was done: *"the post-crisis period is over"*[1].

Just three years later, Brexit and other global factors have generated a renewed sense of volatility and unpredictability in financial markets. The Bank of England has warned of a *"spiral of complacency"* about personal debt, amid concerns that consumer credit is reaching unsustainable levels.[2] And new dangers could be emerging in the fintech sector – with the Financial Stability Board admitting that these risks are as yet poorly understood and could escalate quickly in the future.[3]

Although banks are better capitalised, it is debatable whether ten years of regulatory firefighting have left us in a substantially better position to withstand these threats. The New Economics Foundation's recently updated Financial System Resilience Index found that the UK still has the least resilient financial system in the G7, with most indicators showing little or no improvement in recent years.[4] And the Systemic Risk Council has warned the G20 that cuts to regulation could lead to a *"worse crisis than 2008".*[5]

More importantly, the lens of financial stability is no longer sufficient to guide our judgements about whether the financial system has been 'fixed'. Deeper questions are back on the agenda, as concepts like 'industrial strategy' re-enter the lexicon, and recognition grows that large swathes of the UK economy continue to suffer from chronic under-investment.

Sustaining a system is only an unqualified good if the system is achieving the right things in the first place. If we are to rise to the needs of the moment, our aspirations for the functioning of the financial system cannot be limited to avoiding crises and catastrophes. We also need a financial system that is positively serving the economy, society and the environment – in other words, that is delivering on its purpose.

Ten years after the crisis, we are still arguably not much closer to achieving this:

- Our financial system is not focused on **supporting the productive economy**[i]: as little as 3% of lending enables socially useful, sustainable activity in the real economy (as opposed to lending against existing assets or speculation).[6]
- Our financial system is not focused on **serving its users:** conduct scandals continue to abound and less than half the population (45%) trusts the sector.[7] Over 1.5 million adults remained unbanked in 2016[8] and in 2017 the current account switching rate was just 1.4%.[9]
- And our financial system is not focused on **addressing our most pressing environmental challenges:** there is an $87bn annual gap in renewable energy financing if we are to meet internationally agreed targets to limit climate change to 2°.[10]

There is both a clear need and a clear opportunity for a shift in gear: for us to step back and ask ourselves what outcomes we are regulating the financial system *for,* and what kind of financial system – as well as what kind of regulatory system – can best achieve those outcomes.

This sense of purpose has always been at the heart of the Finance Innovation Lab's mission. We started out nine years ago with a question: 'What would a finance system that served people and planet look like?' As an independent charity, we are now actively working to build that system. We work at three levels: supporting purpose-led innovators, cultivating 'intrapreneurs' (innovators in mainstream financial institutions) and working to shift the wider regulatory and cultural landscape.

Of course, these levels are interconnected – so the lessons from our work at the first and second levels inform our perspective on the third. Our practical work with innovators, combined with our systemic approach, gives us a unique perspective on how regulation could better orient itself towards the social purpose of finance.

This paper is the product of our learning from this perspective, and from the growing body of work from inside and outside the financial sector.[11] It draws in particular on three workshops held in January and February 2017, which brought together stakeholders from within the financial services sector, academia, civil society, individuals, businesses and policymakers. It also draws on the experiences of our community of social-purpose innovators and our conversations with regulators themselves.

The paper is structured in three parts.

The first asks how we can define the purpose of finance at the system level and how regulators might reorient their thinking around this perspective. The second looks at how this relates to the purpose of individual businesses within the financial system. We look at this through the prism of three specific issues: social-purpose banks and building societies; social investment vehicles and intermediaries; and social-purpose innovators, including fintech start-ups. Finally, we draw out some wider implications and recommendations for regulators. Throughout, we acknowledge that the remit and approach of regulators is affected by many external factors, including the political environment and the social choices involved in the allocation of capital and risk.

[i] We use the term 'productive economy' to refer to the parts of the economy that support the production of socially useful and sustainable goods and services, in contrast to the parts of the economy concerned only with transactions in financial markets. While the term 'real economy' is often used in this context, we recognise that not all 'real economy' activities are socially useful or sustainable.

IN BRIEF: HOW WILL BREXIT AFFECT THE UK FINANCIAL SYSTEM?

The impact of Brexit on the UK's financial system is highly uncertain. Different Brexit scenarios, from 'soft' to 'extreme' Brexit, could have very different impacts, from maintaining the status quo ante to a complete reshaping of the sector.

One question is what will happen to the plethora of EU regulations currently governing UK finance. These include bank capital requirements,conduct regulations, pensions and investments directives, and the regulation of payment services.

If the UK remains in the single market, the current regulatory regime would remain in place. Even if it leaves, much depends on the detail of the agreements reached about passporting rights and regulatory equivalence. It is possible that the UK could remain substantially subject to EU regulation, but without a seat at the negotiating table. It is also possible that the UK could end up having to completely reinvent its regulatory architecture outside the realm of EU law, particularly under the extreme scenario where the UK crashes out of Europe without a deal. This could have major consequences for regulatory oversight as well as financial transactions and services – for example, it could suddenly preclude the sharing of trading data between the UK and EU.

But the implications of Brexit go far beyond regulations. The bigger question is what kind of economy the UK wants after Brexit – and how the financial sector itself might serve this economy. The UK currently favours a model labelled 'mutual recognition', which would not require equivalence of regulations and instead would be based on equivalence of outcomes, but there is no evidence to suggest that the EU27 think this is possible or acceptable.[12] Under most other scenarios, to varying degrees, it is likely that some wholesale financial services operations will be shifted overseas, for example to Paris or Frankfurt. Under most hard Brexit scenarios, significant disruption to the status quo seems inevitable.

The key question here is how UK policymakers respond to this. If our financial system is going to look different after Brexit, then what kind of financial system do we want to build? Do we cut taxes and regulation in a bid to attract and retain financial services firms and maintain our global comparative advantage in finance? Or do we seek to refocus our financial services sector on the domestic economy, prioritising its function as a utility serving society, the economy and the environment?

In her speech setting out the government's negotiating objectives, Prime Minister Theresa May stated that *"if we were excluded from accessing the single market, we would be free to change the basis of Britain's economic model".*[13] This was widely interpreted by commentators as a threat to transform the UK into the 'tax haven of Europe'. Pressure to move in this direction could be intensified by bank lobbying for laxer regulation, using the threat of relocation or the costs of Brexit adaptation as bargaining chips. Already, bank lobbying dominates back-room discussions in the UK and Brussels.[14] The implications of such a strategy for domestic stakeholders of the financial system – for individual consumers, small businesses, taxpayers and communities – are potentially worrying. There is also a significant risk of a public and political backlash if the finance sector is perceived to be prioritised at the expense of other sectors and issues of concern to the British people.

But the uncertainty of Brexit also brings with it an opportunity to be more imaginative – to reset our relationship with finance and rethink what we want the system to achieve. Whichever flavour of Brexit we end up with, these questions are fast becoming unavoidable.

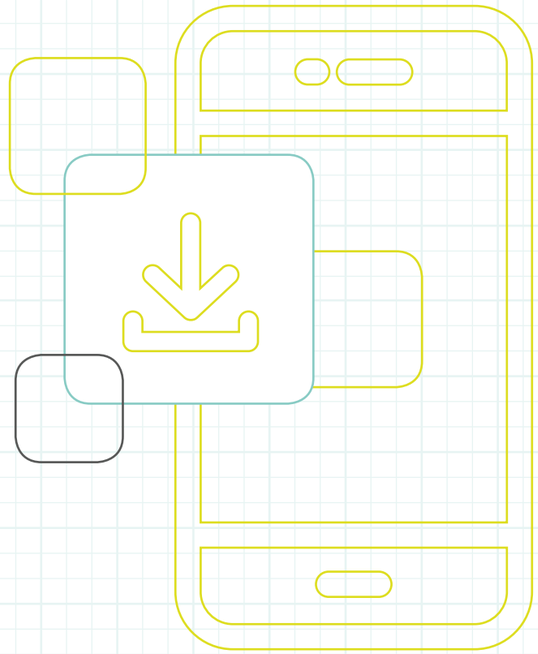
IN BRIEF: WHAT IS FINTECH?

In an increasingly digital economy, it has become dramatically easier to collect, manipulate and make sense of information about individuals' finances and spending habits. Fintech (a portmanteau of 'financial technology') refers to the collection of technologies changing finance today, including including smart phones, Application Programme Interfaces (APIs), Artificial Intelligence (AI) and blockchain.

The adoption of fintech is accelerating in the wake of new policy initiatives and regulations, such as the establishment of the Financial Conduct Authority's Innovation Hub and the Open Banking initiative, which requires the UK's biggest banks and building societies to enable customers to share their financial transaction data with new players.

With potential to drive significant efficiency gains for business, fintech is being used by start-ups, new entrants (including big tech companies) and incumbent financial institutions alike. It is relevant across the financial services value chain: payments are increasingly made digitally and through new channels, such as social media platforms, generating a wealth of transaction data; customers can download apps that offer price comparisons and switching services, and navigate complex financial markets with the support of robo-advisors; big data and advanced analytics are used to tailor products and services to customers and better assess credit risks, enabling new types of loans to be made; trading is becoming ever more electronic and algorithm-led; and even central banks are looking to fintech to improve the accuracy, efficiency and security of wholesale payments, clearing and settlement infrastructure.

Fintech could drive competition in financial services, as well as offer customers more tailored and affordable services, but much depends on the purposes that the technology serves. As Sir Mark Walport (UK Government Chief Scientific Adviser) has said: *"[F]intech is neither good nor bad in itself. It is the specific uses of the technology that can be good or bad."*[15] There are reasons to fear that the data revolution in finance and increasing automation could increase information asymmetry and complexity, reduce customer control, and exacerbate exclusion and discrimination.

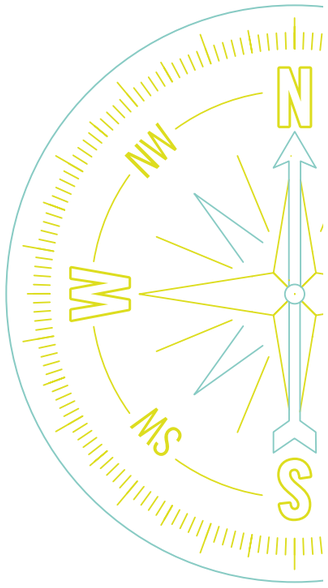


3. THE SYSTEM-LEVEL CHALLENGE: DEFINING THE PURPOSE OF FINANCE

3.1 WHAT IS THE PURPOSE OF FINANCE?

It has become customary in recent decades to think of finance primarily or even solely as a sector in its own right. In this frame, the financial sector is the 'goose that lays the golden eggs' for the rest of the economy – selling financial services across the world and thereby generating jobs, profits and tax revenues. Likewise, in 2014 the Chancellor George Osborne announced his desire for *"the UK to lead the world in fintech"*[16] and government commitment to support the sector has persisted since.

There is a danger that this perspective obscures an understanding of the financial system as a utility – an essential service upon which the functioning of the rest of our economy depends. **Ultimately, finance is not an end in itself. It is a system that fulfils a certain set of critical functions for the rest of the economy, and by extension for society and the environment.** Our dependence on the financial system to fulfil these functions is only becoming greater as our economy becomes more financialised (for example, as private personal pensions increasingly replace state-funded pensions) and digitised (for example, with the growing dominance of 'cashless' payment systems).



We can identify five key purposes served by the financial system[17] – or, to put it another way, five social responsibilities with which the system is entrusted:

1. **Creating money:** around 97% of the UK's money supply is created by banks in the form of new loans[18]
2. **Channelling money:** both banks (in deciding where to lend the money they create) and investment firms (in deciding where to invest their clients' money) play a crucial role in determining where credit and capital flow in the economy – and where it doesn't [ii]
3. **Looking after other people's money:** for example, in bank accounts and savings vehicles
4. **Sharing risk:** both across populations and over time; for example, through insurance and pension products
5. **Maintaining the economy's 'plumbing':** the systems that connect buyers with sellers and settle payments, enabling us to transact.

In recent times, many of these functions have been fulfilled by a small number of large universal banks. But as Mark Carney noted in a recent speech[19], developments in fintech have the potential to shake up this landscape and disaggregate finance into a new constellation of players fulfilling distinct functions – for example, with the entry of new payment service providers, peer-to-peer lenders and trading platforms. Incumbent banks are developing different strategies to deal with this emerging threat to their dominance – whether by collaborating with or acquiring new fintech players, or by investing directly in developing their own technologies. Arguably, these developments make it all the more important to have a clear view of the purposes being served both by the financial system as a whole, and by different actors within that system.

[ii] Included within this role is the important function of maturity transformation: for example, banks transform short-term deposits into long-term loans; stocks and shares (at least in theory) transform short-term liquid securities for investors into long-term investment capital for companies.

These distinct functions also have distinct implications for those carrying them out: who should they be accountable to and for what? For example, institutions that primarily steward the savings of others (such as pension funds and investment managers) should arguably be accountable primarily to the people whose money they are managing, and this should be reflected in their governance. This is not always the case at present; hence the ongoing debate about the extension and interpretation of fiduciary duties in the investment chain.[20]

The creation and allocation of credit has such profound impacts on the shape and size of the economy that it should arguably be accountable to wider society and should reflect its needs and priorities, for example through regulatory and democratic channels. Payment systems could be regarded as essential infrastructure, akin to the electricity grid or transport networks, and therefore answerable to the public interest in maintaining both universal access and reliable functioning of that infrastructure.

But we need to dig even deeper to truly answer the question 'what is the purpose of finance?' After all, these functions are themselves only a means to an end. For example, a pension is not an end in itself, but a means to the end of a secure and prosperous retirement. A small business loan is not an end in itself, but a means to the end of providing a good or service – be it opening a café or growing a manufacturing plant.

As such, the functioning of finance affects almost everything else in our lives and in the economy, from our ability to feel secure in old age, to the affordability of housing, to our ability to meet challenges such as climate change. We can therefore distinguish between the 'immediate' purpose of finance and its 'ultimate' purpose. The immediate purpose of finance is to create, deploy and facilitate the movement of money (or capital). Its ultimate purpose is to do this in a way that best enables us to achieve our goals, as individuals, as communities, and as a society.

3.2 HOW WELL IS THE FINANCIAL SYSTEM SERVING THESE PURPOSES?

Since the financial crisis, there has been a growing chorus of concern that the financial system is not serving either its immediate or ultimate purposes effectively. A string of publications by eminent economists and former regulators[21] have argued that there is something fundamentally wrong with the way the financial system creates, allocates and stewards our money. The effects are clear to see:

"Not only did the financial crash lead to the deepest and longest recession in modern history; nearly a decade later, few advanced economies have returned to anything like a normal or stable condition... Even during the pre-crash period when economic growth was strong, living standards for the majority of households in developed countries barely rose. Inequality between the richest groups and the rest of society has now grown to levels not seen since the nineteenth century. Meanwhile continued environmental pressures, especially those of climate change, have raised profound risks for global prosperity."

– Jacobs and Mazzucato, 2016[22]

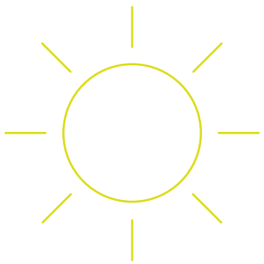
Many of these authors suggest that the instability exposed by the 2008 crisis is inseparable from this deeper malaise. If this is true, even regulators who are purely concerned with avoiding harm cannot escape the question of how well the system is fulfilling its positive purpose.

3.2.1. IMMEDIATE PURPOSE: THE CANARY IN THE MINE

One way of looking at how well the financial system is serving its immediate purposes is through efficiency measures: identifying the 'overhead' the industry extracts from society for fulfilling these functions through transaction costs and fees. Recent work by US economist Thomas Phillippon[23] has found that the costs of financial intermediation have not fallen at all over the past 130 years. In other words, the financial system has not been subject to the kind of improvements in productivity and efficiency which we are told that markets and technology should deliver over time. Even on the narrowest of terms, the system does not appear to be delivering well.

The starkness of this data gives us a hint that finance may have lost its sense of wider purpose – that it has become more effective at extracting wealth for the benefit of financial intermediaries than at generating wealth for wider society.

These sorts of metrics can act as a 'canary in the mine', warning us that things are going badly wrong and that the system has become self-serving or self-perpetuating. But they tell us little about whether things are going right: about whether the finance system is truly fulfilling its social purpose. In particular, they do not touch on how well the system is serving its ultimate purpose.

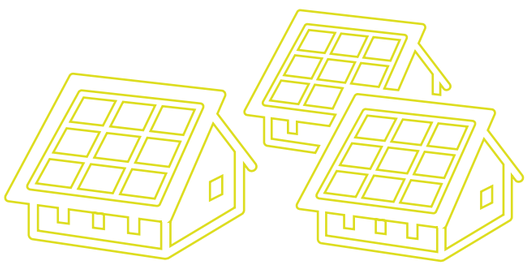


3.2.2. ULTIMATE PURPOSE: DELIVERING FOR SOCIETY

The financial system should be judged not only on how efficient it is at turning money into more money, but also on the social, economic and environmental impacts of that money.

This means looking 'under the bonnet' at where money is flowing in the finance system – and where it is not. It means asking who is included in the system and who is excluded. It means asking whether capital is being invested in a way that genuinely creates sustainable, equitable wealth, or whether it is fuelling destabilising speculation or planetary destruction.

Consider the finance system's function of channelling capital into productive, sustainable activity in the real economy. As a number of recent reports have noted, capital markets appear to be increasingly focused on trading existing assets in more or less speculative ways, rather than on financing new investments.[24] Similar problems have been highlighted in the banking sector, where as little as 3% of lending goes to productive activity[25] – with only a fraction of this going to small businesses, and even this fraction being highly skewed geographically (around a third in London and the south east, and just 3% in the north east).[26] There is a danger that much financial system activity serves primarily to inflate asset price bubbles – such as the pre-crisis explosion of sub-prime mortgages – and exacerbate financial instability, rather than fulfilling its essential role in the productive economy.



MEASURING FINANCIAL SYSTEM SUCCESS

A number of recent initiatives have sought to identify a broader set of metrics which can give us a truer picture of how the financial system is delivering on its purpose. For example:

The **Citizen's Dashboard of Finance project,** led by Finance Watch, has assembled a range of indicators across key domains including measures of economic contribution (such as the proportion of real economy lending, the length of holding periods and the level of churn in investment portfolios); social contribution (such as measures of financial inclusion and exclusion); and environmental contribution (such as the size of the renewable energy finance gap). It also measures the level of 'rent' the sector extracts for performing these functions, represented by the ratio of finance sector profits to corporate profits.[27]

The New Economics Foundation's **Financial System Resilience Index,** while less focused on the ultimate purpose of finance, is also designed to encourage regulators to look at a broader range of metrics. It measures a range of factors known to affect system resilience, including the size of the financial system relative to the economy, levels of interconnectedness, proliferation of complex financial instruments, and the proportion of risky assets or funding sources on banks' balance sheets.[28]

There is also growing interest in the development of non-financial metrics at the individual company level, allowing investors and other stakeholders to understand the contribution of financial services firms to the economy, society and the environment. For example:

The Global Alliance for Banking on Values' **'Sustainable Banking Scorecard'** measures quantitative factors (such as the percentage of banks' balance sheets allocated to real economy lending and to 'triple bottom line' lending), alongside qualitative factors (such as transparency and management systems).[29]

The Banking Standards Board is developing a **Consumer Outcomes Framework** to identify, communicate and measure what the outcomes of a good banking culture look like to individuals and micro-businesses.[30]

Meteos' **BankingFutures** report on long-term value proposes innovative ways to measure seemingly intangible things such as bank culture – for instance, through employee views, incentive systems and bank risk appetites – as well as suggesting a greater focus on measuring customer outcomes in a way that enables comparison between banks and divisions and over time.[31]

3.3. WHAT MIGHT THIS MEAN FOR REGULATION?

"Regulatory reform has tended to progress crisis by crisis, market failure by market failure, regulatory standard by regulatory standard."

– Aikman et al., 2018[32]

All of this suggests that if we want to reorient financial regulation around a clearer sense of purpose, regulators will need to develop and adopt their own broader metrics of financial system success. These will need to be subject to some form of democratic debate or policy direction in order to identify the critical domains that need to be measured.

In this report, we argue for a new **regulatory compass:** a broad framework which could guide the regulatory system, including the kind of information which regulators ask individual firms to disclose, the way regulators assess the riskiness of new products or businesses, and the criteria they use to select businesses for positive support or incubation. We introduce the components of the framework in section 5 and discuss some of the more granular implications for government and regulators in section 6.

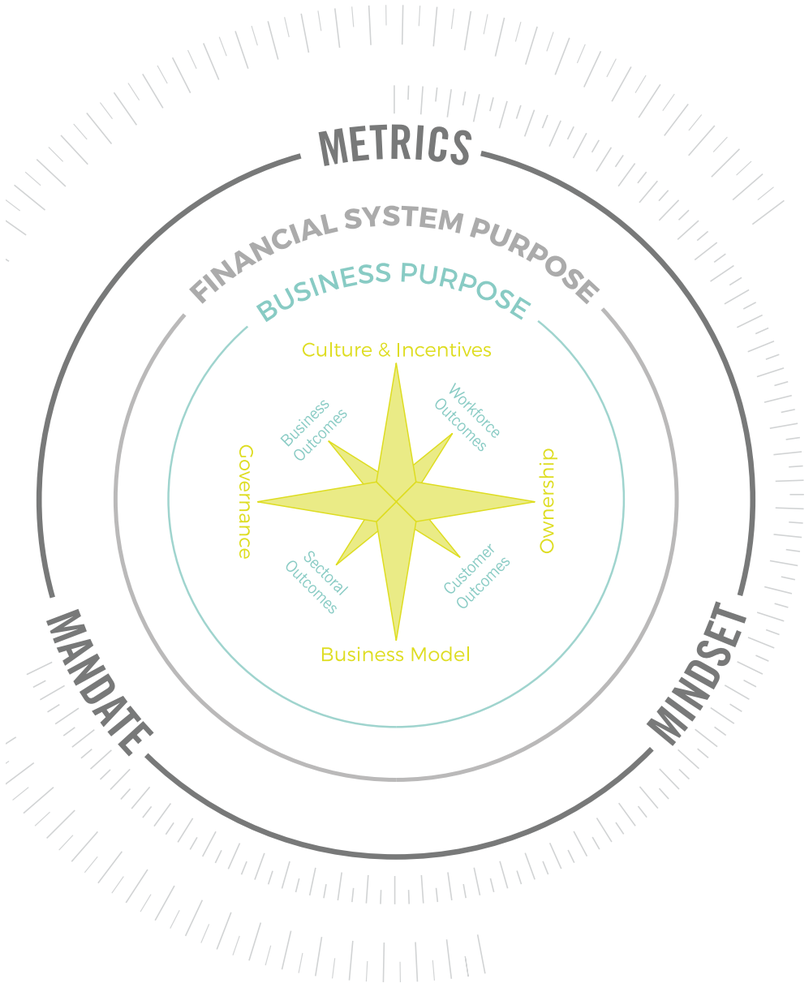
It is worth noting that this is not simply about metrics, but about mindset. It is vital that regulators take a holistic and systemic view of the outcomes of finance, informed by a clearer stance on the system's purpose. Without this, a focus on individual regulatory issues and interventions is too often reduced to a game of 'regulatory whackamole'. This might be successful in fighting the most egregious individual instances of bad practice, but risks leaving untouched the systemic dynamics that might be causing harm on a mass scale.

This term was conceived by David Pitt-Watson, Executive Fellow at London Business School.

We recognise that this has implications for regulators' mandates and we explore the implications of this in 5.3. At its heart, this is a question of political and social priorities, decisions and leadership.

WHY A COMPASS?

The compass framework draws together the key shifts we need to see if regulation is to incorporate an understanding of social purpose. A compass is a navigation guide: it sets out a direction, rather than charting a course in detail. This report does not provide a roadmap for financial regulation, but instead offers key considerations for purpose-driven regulation in a rapidly changing landscape, buffeted by the forces of fintech and the uncertainties of Brexit. Rather than telling us if we're following the route we originally planned, the regulatory compass helps us check that we're heading in the right direction now.



CASE STUDY:

THE DUTCH PENSION SYSTEM

What is the purpose of the pension system? Answers could include giving people a predictable and reliable income; enabling them to live a dignified life in old age; sharing risks, such as longevity; and providing a social safety net to support people who don't have a large amount of assets. Where pensions are provided through the capital markets, the money invested can also fulfil a wider purpose: channelling people's money into productive, sustainable investments which both give them a return and contribute to a healthy economy, society and environment for them to retire into.

There is a growing consensus that the UK pensions system is increasingly not fulfilling these purposes. The shift to Defined Contribution (DC) pensions means that risk is increasingly being transferred to individuals and is not being shared. It could even be argued that a DC pension is more a savings plan than a pension, since it does not provide a predictable income (but rather a lump sum that can be used to purchase an annuity).

Most people are not saving enough to provide an adequate income in old age; fees and charges are comparatively high and are eating significantly into these savings pots; annuities are expensive and sometimes unreliable; while 'pension freedom' reforms do not seem to be improving this situation and could even be making it worse.[33] Meanwhile, there are growing concerns that the way pension capital is invested is not supporting the productive economy – and therefore pension savers – to the extent it should be.

The Dutch pensions system (and to some extent the Danish system, which shares some similar features) offer an approach which is delivering objectively better outcomes for savers. A recent report by the Pensions Insurance Corporation argued that moving to a Dutch style system could boost British savers' pensions by as much as 30-40%.[34]

At the heart of the Dutch approach is a model known as 'Collective Defined Contribution' (CDC). This is essentially a hybrid of the Defined Benefit (DB) and DC pension types present in the UK. The system is based on relatively large-scale schemes which serve an entire industry or sector (e.g. taxi drivers), unlike the UK system where pensions are the responsibility of individual employers.

Unlike DC pensions, the schemes pool beneficiaries' savings rather than delineating individual investment pots – making it easier for them to invest in long-term assets, such as infrastructure, and to pool risks. Unlike DB pensions, the level of payouts is not guaranteed. There is a target level of pension which employees can expect, but schemes have the discretion to cut the payout rate if necessary to restore their finances. These decisions are made on an annual basis by a group of actuaries, who can also adjust payouts between different age cohorts to cross-subsidise and share risk between generations.

Advocates of the Dutch approach argue that it facilitates the economies of scale, risk-sharing, and long-term productive investment that are needed for a healthy pension system.[35] Crucially, it is also dominated by trust-based governance models that are legally accountable to the savers whose money they manage – a declining feature of the UK pensions system, with more and more employers opting for 'contract-based' pensions provided by shareholder-owned insurance companies.

Although it does not offer the certainty of DB, the level of stability and predictability – and the absolute level of average retirement incomes – goes far beyond that offered by DC. In response to the 2008 crisis, Dutch pensions fell by only 2%, compared to a fall of over 50% in annuity rates for British savers over the preceding 10 years.[36]

Some sceptics argue that the Dutch system depends on particular features of Dutch society, such as high savings rates and sectoral co-operation, which could not be replicated in the UK. While there are clear differences between the Dutch context and the UK context, it is still significant that the current UK regulatory architecture (which theoretically exists to protect savers) makes Dutch-style CDC pensions impossible to introduce. If we consider the wider economic role of pensions – channelling long-term investment into the productive economy – even bigger questions emerge about the effectiveness of the UK pensions system in fulfilling its ultimate purpose.

More than anything, this case study demonstrates that looking at regulation from the perspective of purpose and outcomes leads to a whole new set of questions – and a new set of policy options. It also demands a willingness to rethink deep structural features of the UK landscape if the evidence suggests they are not fit for purpose.

4. THE FIRM-LEVEL CHALLENGE: ALIGNING BUSINESS MODELS WITH SOCIAL PURPOSE

4.1 FIRM-LEVEL PURPOSE AND CONFLICTS OF INTEREST

"An industry of the scale and importance of finance needs social capital as well as economic capital in order to operate, innovate and grow. To maintain social capital, finance ultimately needs to be seen as a vocation, an activity with high ethical standards, which in turn conveys certain responsibilities."

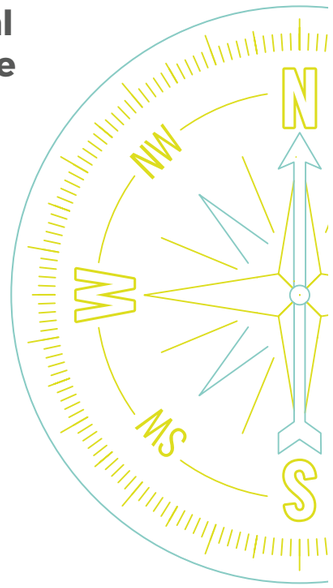
– Carney, 2018 [37]

"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."

– Fink, 2018 [38]

If we want a financial system that meets its social purpose, we need to take much more of an interest in the purpose of individual businesses within that system. Financial services firms only exist because they have a social license to operate: they depend on some degree of social consent for their power to discharge their functions. So it is not unreasonable to expect them to have a purpose that goes beyond serving themselves or generating profit for their shareholders.

This may sound like a radical departure from the 'goose that lays the golden eggs' approach to the financial sector, but it is no longer heresy to ask financial providers to live up to their social responsibilities as the words of the Governor of the Bank of England and the CEO of BlackRock (above) attest.



For better or worse, the purpose which firms pursue – and the incentive structures, governance, ownership and business models which flow from this – have fundamental impacts on their ability to fulfil the wider social purposes.

Where a firm's primary purpose is badly misaligned with its social role, there are severe limits to what 'regulatory whackamole' can achieve. Regulators cannot force a square peg into a round hole.

The UK's banking landscape is uniquely dominated by large, shareholder-owned banks whose primary purpose is, or is perceived to be, generating returns for shareholders.[39] This has fundamental implications for the way the UK system behaves in comparison to those of other countries.[40] In contrast, research by the New Economics Foundation has found that stakeholder banks across 65 countries – including cooperative banks, credit unions and public interest savings banks – have a greater focus on customer needs and long-term lending, a greater positive impact on underserved customers, SMEs and the local economy, and a positive impact on financial stability.[41]

If shareholder expectations of return on equity are incompatible with meeting the needs of other stakeholders, this will inevitably have a major influence on senior manager objectives and the overall conduct of the business.[42] **Likewise, the intense commercial pressures on fintech start-ups can often lead to a race to capture market share or deliver a speedy, profitable exit for investors – with inevitable implications for the priorities of the business and its leadership.**

Recent years have seen growing concern about the need to extend fiduciary duties through the pensions and investment chain, to consider the social and environmental impacts and risks of investments.[43] But the overriding duty to shareholders owed by major insurance companies and asset management companies, for example, means that conflicts of interest are unavoidably baked into the heart of their model. As ShareAction argue in a 2011 report, if there is an irreconcilable conflict between dominant business models and fiduciary duties, *"[we] need to countenance the possibility that it is the business models and not the fiduciary duties which must be changed".*[44]

More recently the Financial Services Consumer Panel has called for the Financial Conduct Authority (FCA) to extend a Duty of Care to customers to all financial services firms.[45] The FCA has responded to this call by announcing its intention to publish a discussion paper on Duty of Care, as part of its full post-Brexit review of its Handbook of rules and guidance.[46] The potential for conflicts of interest mean that it will be vital to ensure the Duty of Care is applied not just in individual engagements with customers, but also at the level of overall firm strategy, culture and operations.

4.2 PURPOSE AS A REGULATORY LENS: WHAT ENDS ARE BUSINESSES PURSUING?

If regulation is primarily designed to police firms' behaviour within dominant models that systematically generate bad outcomes – such as excessive risk-taking, mass mis-selling or high fees and charges – it is likely both to fail and to inadvertently stifle the emergence of different and potentially better models. Purpose-driven regulation would look at business and governance models themselves, seeking to nurture those with the greatest potential to deliver positive social value and align the financial system with its social purpose.

There is evidence that the FCA is taking steps in this direction (see 5.2), with its new mission acknowledging its role in ensuring that financial markets add public value – *"the collective value that an organisation contributes to society"*[47] – and with an increasing use of market studies and thematic work to understand how market structure is affecting consumer outcomes.[48]

Two recent interventions highlight the value of this approach:

1 The FCA's ongoing review of business models in the current account market[49] follows the 2016 review by the Competition and Markets Authority (CMA).[50] This found millions of account holders were paying over the odds, but the CMA's recommendations still put the onus on customers to switch banks, rather than challenging the business models generating these outcomes. The FCA's explicit focus on business models, particularly the much-criticised 'free-if-in-credit' model, could help to fill this gap.

'Free-if-in-credit' models have been criticised for disguising the cost of banking, using overdraft charges to subsidise better-off customers, and creating barriers to entry.

2 In July 2016, the Credit Card Market Study published by the FCA identified serious and extensive issues of persistent and expensive credit card debt in the UK and set out a proposed package of remedies to reduce the number of customers with problem credit card debt,[51] with new rules finalised in February 2018.[52] The reforms aim to support and incentivise both consumers and firms to avoid and to address persistent debt, with firms ultimately encouraged to use forbearance, up to and including writing off debts in some intractable cases. The FCA acknowledged that there will be a significant cost to firms due to lost interest, although the benefit to consumers is estimated to be around 10 times greater than this cost to firms.[53] The FCA argues that the new rules are compatible with its regulatory duties and principles, as they tackle a market failure whereby consumers suffer the economic, social and personal cost of high debt servicing payments, while firms have no incentive to intervene.

As both examples illustrate, **a pure competition lens is often insufficient** to address problems in financial services provision – particularly where consumers technically have a choice of providers, but all these providers share the same problematic business model. In these circumstances, regulators need to look not just at competition in the narrow sense of how many players are in the market and their relative market share, but at the broader concept of diversity: how many different *types* of players are in the market, and whether they are genuinely offering people a range of different ways to get what they need. They may also need to look at wider questions of fairness and on the social impact of some sectors on particular groups, such as vulnerable customers.

4.3 THE EXPERIENCE OF SOCIAL PURPOSE BUSINESSES

We sometimes talk about 'purpose-driven' businesses as if they are a special case. But all businesses have a purpose which is reflected in their governance and ownership structures. For this reason, in this report we use the term 'social-purpose businesses' to refer to those whose stated purpose extends beyond profit maximisation and encompasses the achievement of some kind of positive social outcome.

It is precisely because our approach to finance is often blind to this question of purpose that dominant corporate forms focused on profit maximisation are seen as 'purpose-neutral' – when of course they are not.

This matters, because regulation is often designed around the large incumbent firms who dominate the market, and therefore tailored to their governance models and the purpose embedded within them. Such regulation can often be inappropriate for businesses which do not share this purpose, reinforcing the existing system dynamics that perpetuate the dominant position of incumbents and make it hard for new models to break through. Worse, we can be blind to the implicit bias in this approach, simply treating incumbent models as the default and seeing firms that do have an explicit social or environmental purpose as aberrations.

In the remainder of this section we explore these issues through the prism of three different sectors in which social-purpose institutions face specific regulatory challenges. We include case studies and examples based on the experiences of members of the Lab's community.

4.3.1 SOCIAL-PURPOSE BANKS AND BUILDING SOCIETIES

THE PROBLEM: The aftermath of the financial crisis saw a raft of new regulation designed to tackle the excessive risk-taking of large universal banks. Throughout the drafting process, this regulation became more and more complex as banks lobbied for exemptions and caveats. This regulation has proved extremely challenging for smaller, social-purpose banks to comply with, since they do not have the same economies of scale or large compliance and lobbying teams. These banks are often simply not engaging in the risky business models that precipitated the crisis, and thus the regulation, in the first place.

For example, in January 2017 Airdrie Savings Bank, the last independent savings bank in the UK, announced that it was to close its doors – citing as one reason the challenge of complying with the increased volume and complexity of regulation.[54] Airdrie was a trustee savings bank run by a board with an overriding duty to customers. Its demise has further reduced the diversity of the UK's already unusually homogenous banking system.

CASE STUDY:
AIRDRIE SAVINGS BANK

Airdrie Savings Bank, established in 1835, was until recently Britain's only independent Savings Bank. As a mutual with no external shareholders, Airdrie was dedicated to furthering its members' interests; it made much of its money through deposits with other banks and in government bonds.

In 2008, with the economy relatively stable, the Bank was in a strong position and planning for expansion. It had succeeded by concentrating on its distinctive model and had been cited by The Economist[55] as a model for the future of financial services – small, retail deposit-funded and focussed on serving the community. Yet as the global financial crisis took hold, the policy response to the crisis inadvertently created barriers to Airdrie's success.

The first significant impact was felt through the dropping of interest rates to 0.5%, aiming to stimulate the economy and bring stability to the financial system. With two thirds of its lending placed in other banks and government gilts, Airdrie found its margins severely weakened, with negative impacts for its capital base, operational resources, product development and growth plans. The unintended consequence of a policy aiming to restore resilience to the financial system was that it ultimately threatened diversity in that same system.

At the same time, regulatory scrutiny began to increase. In the wake of the crash, regulators began to ask for significantly more information from Airdrie, seeking to interrogate its business model and challenge its strategy. Airdrie invested significant resources to meet new regulatory requirements, with its compliance team growing from two in 2012 (who also covered general service standards) to five compliance and risk specialists by 2017, in additional to outsourced compliance services and internal audit consultants.

By 2012, Airdrie was making operational losses and had been forced to sell some of its assets. In 2013, Rod Ashley joined as CEO and he soon identified fundamental strategic issues for the bank, exacerbated by the low interest rate environment and regulatory demands. There was increasing tension between the trustees, management team and regulators, with the board feeling that the regulatory burden was disproportionate for Airdrie's size and risk. New regulatory regimes were continuing to come into force, including liquidity rules and more complex capital requirements, and a uniform approach to regulation meant that Airdrie faced the same regulatory requirements as large institutions, but without the equivalent resources to deal with them.

A new governance structure and business strategy was implemented, with some branches closed, uneconomic business areas cut, and lending expanded into new markets. Within 18 months, lending had increased by 25%, but it also became clear that the bank would struggle to grow in the future. Airdrie needed to grow its capital base to enable it to expand to a more sustainable size – generating sufficient profits to re-invest and to be able to withstand economic shocks – but was hindered by its squeezed margins and legal barriers.

Limitations placed on the Bank through the 1819 Savings Bank (Scotland) Act made it impossible, in the Bank of England's view, for Airdrie to raise external capital. This Act could have been changed through another Act of Parliament, via a Private Member's Bill, but any opportunity to do this was lost when political attention was diverted by Brexit. The Treasury appeared to have little awareness of Airdrie's existence, or the need to ensure that changes in UK regulation had regard to Airdrie's model. It seemed that the distinctiveness of Airdrie's model meant that it suffered from a lack of attention and support within policymaking – yet it was precisely this 'outlier' status that could bring greater diversity to the financial system.

Faced with this set of complex challenges to its sustainability, Airdrie's board initiated a comprehensive strategic review of all future options. This review ultimately concluded that it was not in the interest of Airdrie's savers – its owners – to continue operating and thereby reducing the capital that belonged to them. In January 2017, Airdrie announced its decision to wind down. At this point, the FCA moved from managing its relationship with Airdrie through a call centre, with infrequent contact from a pool of supervisors, to intensive individual supervision.

Airdrie formally closed in March 2018, making it the first retail bank that has wound down in an orderly fashion since the financial crisis. Its journey continued to expose gaps in regulation – for example, there is no home for dormant accounts where the organisation is no longer in existence. In Airdrie's case, these deposit accounts have been taken on by the Wesleyan Bank, who are in part motivated by the need to support other small banks. The orderly wind-down of Airdrie would also have been considerably more difficult without the support of TSB, who acquired Airdrie's lending assets and assisted in moving customers to new banking facilities, in recognition of its shared history within the savings bank movement.

Ultimately, Airdrie wound down for three core reasons: the long-term low interest rate environment, which reduced the window of opportunity to shift its business model; the regulatory restrictions of the 1819 Act and lack of policy support to address these; and a major increase in the regulatory burden for the bank's size, both in terms of information requests and compliance with new rules. A more proportionate approach to regulation for local and community banks, combined with proactive support for models that increase diversity in banking, would go some way to addressing this, as would greater analysis of the secondary impacts of macroeconomic policy on the diversity and resilience of the financial system.

Capital requirements – the 'buffers' which banks are required to have to protect them against losses – are a particularly good example of how well-intentioned regulation designed around large incumbent banks can have unintended consequences for others. These requirements are based on assessments of 'risk-weighted assets', so the amount of capital which banks must hold depends on the type of assets they hold, and how risky these assets are deemed to be. Both the complexity and the calibration of these requirements pose challenges for smaller and social-purpose banks. For example, social-purpose banks are more likely to engage in 'non-standard' lending activities which are treated as higher risk even if the 'real world' activities in question may be relatively low risk. Banks with a specialist social or environmental mission may also be perceived as less diversified than large universal banks, because their risk exposure is more concentrated in one sector or geography, and therefore seen as riskier by regulators. Combined with their relatively smaller compliance resources, this leaves the deck stacked against them.

There is a risk that measures intended to reduce risk at a micro-prudential level (looking purely at the likelihood of individual bank failure), actually increase risk at the macro-prudential level (looking at the system as a whole). There is good evidence that highly homogenous and top-heavy banking systems are at greater risk of systemic collapse – and that the presence of a diverse range of 'stakeholder banks', focused on serving a mission beyond profit maximisation, is associated with stronger, more patient and less volatile real economy lending.[56] By disadvantaging smaller and social-purpose banks, prudential regulation therefore risks having unintended consequences for the ability of the system as a whole to fulfil its social purpose.

SOLUTIONS: There are two possible approaches to rethinking capital requirements to address these problems. One is to recalibrate risk weightings to actively incentivise socially useful and environmentally sustainable real economy lending, or at the very least to ensure that it is not disincentivised – for instance, by reducing the capital weighting applied to assets such as onshore renewables. This is the approach being advocated at an EU level by the *New Pathways to Sustainable Finance initiative,*[57] alongside penalising factors for loans to unsustainable activities.

As part of this approach, regulators could also establish a 'two tier' system or sliding scale of regulation to make compliance less burdensome for small banks. Arguably, a 'two tier' system already exists, but in the opposite direction – since large banks are allowed to use the 'internal ratings-based' approach to calculate their own risk-weighted assets, potentially placing them at a further advantage relative to their smaller competitors.

The second approach is a more radical overhaul of prudential regulation, abandoning altogether the attempt to calibrate capital requirements based on the perceived riskiness of different assets, and instead adopting a simple leverage ratio as the key metric for bank capital. There is a danger that simple leverage ratios would simply encourage banks to hold riskier assets in pursuit of higher returns. However, as the Chief Economist of the Bank of England has pointed out, simple leverage ratios perform much better than complex risk-weighted capital ratios as a predictor of bank failure.[58] Arguably, attempting to match the complexity of regulation to the complexity of the system serves only to benefit the biggest players, without necessarily being more effective at predicting inherently uncertain outcomes.

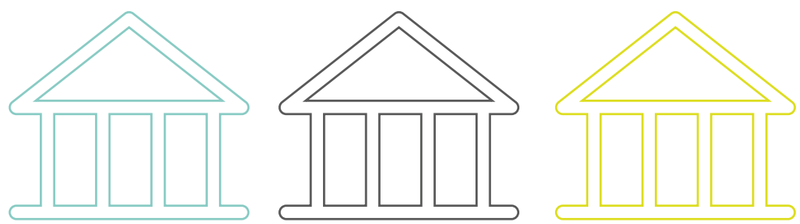
Regulators and policymakers could also **offer positive support to small banks with distinctive social-purpose business models,** particularly those deemed to be under-represented in the UK, or which evidence suggests can deliver better social and environmental outcomes, making it an explicit policy objective to nurture a more diverse banking ecosystem.

The FCA's current strategic review of retail banking business models should explicitly consider the regulatory challenges such new business models will face and the FCA's Innovation Hub could proactively prioritise these models for receiving support. The FCA should also consider launching a standalone 'Diversity Hub' to complement its existing efforts, with an explicit policy objective to nurture a more diverse banking ecosystem.

Likewise, the Prudential Regulation Authority (PRA) could offer additional support to firms bringing diversity to the banking sector. A sandbox could be established for new community and stakeholder banks to test their products and demonstrate the robustness of their approach. Those seeking to lend to customers deemed atypical or high-risk (such as those with variable income) could also access a sandbox in which they could prove the viability of their business models, while offering the PRA an insight into future systemic issues (such as the rise of the gig economy).

We are aware that much of the regulation in question here ultimately derives from the international Basel Agreements, and so could not be changed unilaterally by UK regulators except in an extreme Brexit scenario. Nonetheless, both of these ideas illustrate changes of approach which could make regulation work better for smaller, social-purpose banks – and potentially drive better outcomes at a system level.

This is not to say that UK regulators could not advocate such changes at the international level..



4.3.2 SOCIAL INVESTMENT AND THE REGULATION OF ADVICE

THE PROBLEM: Surveys consistently show that a significant proportion of people (67%, in a representative UK survey)[59] want their money to do good in the world as well as making a return. Demand is strongest among young people,[60] with 46% of millennials wanting their bank, pension or savings provider to offer a fossil-free option,[61] and a recent campaign by Friends of the Earth Scotland mobilised large numbers of savers to persuade NEST to drop fossil fuel investments from their ethical fund.[62] This evidence – which is corroborated by studies at the European level[63] – suggests that there is a critical mass of savers for whom objectives beyond the purely financial are important, including many who are willing to forego maximum financial returns in order to achieve social or environmental impact.[64]

In some respects the UK is an acknowledged pioneer in the supply of social impact investment, with government-backed initiatives including Big Society Capital, the Social Impact Taskforce and National Advisory Board, and the Global Impact Investment Steering Group.[65] But the sector continues to express frustration at a lack of dealflow and perceived regulatory barriers to its growth.

In June 2018, the government published its response to the recommendations, in which it pledged to work with industry and regulators to increase support for social impact investing.

In 2017 a UK Government Advisory Group[66] published a comprehensive set of recommendations designed to help the UK market realise its full potential, including a call for regulators to build capability on social impact considerations and to embed social impact in regulatory frameworks and understanding. The recommendations of the Green Finance Taskforce's 2018 report also include a call for both government and regulators to drive demand and supply for green lending products.[67]

Despite the FCA's stated view that *"regulation does not prevent the social investment market from developing,"* [68] the experience of the Lab's community suggests the regulation of investment advice (for example, the guidance on client suitability) and product marketing (for example, the Financial Promotions regime) are still relatively poor at recognising social and environmental investment objectives. While the FCA has an obligation in law to have a broad concept of motivation, **in practice regulation tends only to recognise financial objectives.**

In turn, financial advisors rarely raise these issues with clients proactively, and when they do the quality of advice is often poor – to the extent that having a financial adviser makes people less likely to have knowledge of or prior engagement with social impact investment.[69] Advisors appear particularly nervous about stepping into unfamiliar territory and concerned about liability if clients forego maximum financial return in exchange for social impacts which then fail to materialise. This is despite the fact that, as with any kind of financial advice, advisors' obligation is only to present a truthful picture, and not to guarantee the outcomes of the investment.

CASE STUDY:

SOLIDARITY INVESTMENT FUNDS IN FRANCE

'Solidary investment funds' emerged in France in the 1980s and were established in law in 2001. They are defined as comprising 5-10% investments in the social or solidarity economy (for example, in social enterprises) and 90-95% investments in regular listed securities, which are positively screened as 'best in class' for socially responsible investment.

Since 2010, it has been mandatory for all French employers with a corporate savings plan to offer their employees the option to put some of their savings into a solidarity investment fund. This regulation has helped to drive a significant expansion of the solidarity investment market, from 200 million in 2002 to over 6 billion in 2013. Over one million people in France now invest at least some of their money in the solidarity economy. The law also appears to have driven growing engagement and expertise in social investment among asset managers themselves.

The performance of solidarity investment funds has so far appeared to match that of traditional French stocks, with some suggesting they were also more resilient to the impacts of the financial crisis.[70]

The FCA has stated very clearly that there is nothing in international or UK rules that prevents financial advisors from recommending social investments to their clients.[71] But vitally important documents such as the FCA's Conduct of Business Sourcebook (COBS) often include no mention or examples of social, environmental or ethical elements that might form a part of clients' investment objectives. There is also a huge amount of inertia in a financial sector which has little experience of considering non-financial goals and factors. In this context, failure to include clear and explicit explanations and examples of why and how firms and advisors should consider these factors perpetuates an unbalanced approach.

Perhaps partly for these reasons, the market for social-purpose investments remains fairly marginal, despite widespread consumer interest. A 2015 survey by Barclays found that 56% of retail and affluent investors were interested in social investment, but only 9% were acting on this.[72] A 2016 survey for Good Money Week found that 54% of the UK public is unaware that sustainable and ethical financial products exist.[73]

"For decades, finance has lived by the principle of 'know your customer'. Yet too often this has not included the environmental and social preferences of Europe's households, businesses, municipalities or national governments. This needs to change."

– High-Level Expert Group on Sustainable Finance, 2018 [74]

THE SHIFT TO AUTOMATION COULD EXACERBATE THESE PROBLEMS: Mark Carney's 2017 speech on fintech praised the advent of AI-driven 'robo-advice' and its potential to more efficiently match customers with the 'best' rates from across the market.[75] But how well will these robo-advisors fare if their customers care about more than just getting the 'best' rates?

Just as the shift from relationship banking to centralised credit-scoring algorithms makes it more difficult for lenders to assimilate 'soft' information about borrowers' creditworthiness, so the advent of robo-advice may make it even harder for customers to access affordable advice on 'softer' concerns, such as the social and environmental impact of their money.

CASE STUDY:

UK ROBO-ADVISOR MARKET

Of the 16 'best' robo-advisors profiled by thisismoney.co.uk in March 2018,[76] only one (EQ Investors) proactively offers portfolios aligned to social or environmental goals ('Positive Impact Portfolios'). This not only highlights the 'robo-advice gap' for the majority of investors who want to consider these factors; it also points to a future lack of data on the social and environmental investment practices of customers. The bias already demonstrated in robo-advice provision today could lead to even greater bias against social and environmental investment goals in the future.

The algorithms that enable AI are not neutral: they are designed with a specific purpose and encode a set of values and preferences. If the human providers of financial advice are blind to the importance of social and environmental factors, then the AI that aims to replace their advice could be even more so. Moreover, machine learning techniques that use historical data to learn from past experience could lead to the reproduction of historical biases and prejudices that no longer reflect society's views. If regulators apply the same approach to robo-advice as they currently adopt for in-person advice, the chances of both scenarios increase. In this way, the blind spots of the current system could become further entrenched, along with the implicit values bias this entails.

SOLUTIONS: This example reveals another dimension to the question of purpose – the need for a truer understanding of the purposes being pursued by customers themselves. There is a danger that regulatory approaches based on an idealised, theoretical model of the utility-maximising consumer inadvertently privilege a particular set of values: the pursuit of maximum financial return to the exclusion of all other objectives. They do not serve the best interests of real-life customers who do not fit into this mould.

How would regulation look if it started from a human perspective rather than a product perspective? What if our core question focussed on what a given customer actually wants to achieve, and whether what they are being offered is meeting those needs? Would this help us to move beyond a 'box ticking' approach of simply ensuring that a particular sales process is duly followed, or that certain pieces of boiler-plate information are provided?

A number of specific suggestions have been made by the socially responsible investment community for ensuring that the market better reflects people's real priorities. For example, one recurring proposal is that the concept of investment 'suitability' be reformed to better account for the range of objectives that might make an investment 'suitable' or otherwise for a customer's purposes.

In 2016 the FCA considered and rejected a specific proposal to relax suitability rules in relation to social investment.[77] It based this assessment largely on the concern that customers might not be sufficiently financially literate to accurately weigh the social benefits against the financial risks of a given investment, and that the onus should therefore be on advisors to determine whether an investment is 'suitable'.

But evidence suggests the converse is also true: savers who care deeply about the non-financial impacts of their money may not realise it is being invested in activities they find abhorrent, or that positive alternatives are available. Over half of UK investors do not know which companies or industries are included in their investment funds or pension,[78] yet 69% of the British public would be unhappy if they found out their money was being used for unethical activities,[79] suggesting a significant number of investors are unknowingly investing in areas that conflict with their values. **Again, this could be regarded as a form of status quo bias – a position which appears to be value-neutral but in fact skews the system towards certain objectives and away from others.**

There is a danger that this merely intensifies conservatism among advisors who feel it is safer simply not to offer their clients social or ethical options, even if they might be the best fit for their objectives. Either way, there remains the broader question of whether the concept of suitability is fit for purpose or needs to be clarified – not least because neither the 2011 *Assessing Suitability Guidance,*[80] nor the 2017 *Assessing Suitability Review,*[81] contain any mention of non-financial motivations.

Better guidance could also be provided to investment advisors on discovering and reflecting their clients' non-financial motivations in their advice, including an explicit statement that clients' social and environmental motivations should be taken into account. They could be encouraged to focus more on helping people to achieve their positive overall savings objectives – both financial and non-financial – rather than simply on avoiding liability or preventing harm. If customers are being prevented from realising these objectives by inadequate advice, this should also be regarded as a form of consumer detriment.

The FCA is a leading voice in understanding the role of behavioural factors in finance. This work demonstrates very clearly the fact that behaviour change needs to be supported not only by the content of regulations, but by signals and framing and incentives which 'nudge' people sufficiently to change existing habits and decision-making patterns.[82] It is important that this type of analysis and understanding is applied not only with respect to the behaviour of consumers, but also regarding the behaviour and role of financial professionals, including financial advisors, for whom incentives and experience are often a barrier to change.

To encourage and support a shift to more even-handed inclusion of a range of motivations for saving and investment, these elements should be included clearly and frequently in rules, and advisors should be supported to develop new skills and use new tools to support clients' decision-making in this way. There are signs of progress in the EU's recent *Financing Sustainable Growth Action Plan,*[83] which proposes to amend European legislation to ensure that sustainability preferences are taken into account in suitability assessment. We now need to see this type of positive approach embedded in a post-Brexit UK financial advice industry.

The issue of consumer detriment also needs to be applied to investors' desires to avoid investing in certain sectors, and the risk of them doing so without being made aware of this. UKSIF have suggested a new requirement on financial advisors to specifically ask customers whether they would like to exclude specific sectors or companies, and to help customers understand the implications of this decision.[84] Conversely, investment products which do not exclude certain sectors – those that a large percentage of investors have expressed a desire to avoid – should be required to display a warning to this effect. In the same way that financial promotions must currently state that the value of investments can go down as well as up, it should be essential to disclose the risks of your money flowing to companies or industries that you do not support.

In different ways, these proposals all turn the 'default' position on its head. They start from the perspective of a customer who cares about non-financial outcomes and wants to be provided with options, rather than from the perspective of one who is only interested in financial return. This is fully human-centred regulation.

In the same way that auto-enrolment has sought to shift the default option from 'not saving' to 'saving', small nudges could have big impacts on the outcomes the financial system promotes. They also highlight the fact that the status quo – the assumption that concepts like risk, investment objectives and interests are purely financial in nature – is not morally neutral, but effectively nudges the system in the opposite direction.

4.3.3 SOCIAL-PURPOSE INNOVATORS – GETTING OFF THE GROUND

THE PROBLEM: Regulators are increasingly recognising the importance of nurturing innovation, as well as the ways in which regulation designed around incumbents can often fail to do this. For instance, Mark Carney recently highlighted the risk that existing authorisation processes *"unnecessarily block new business models and approaches"*, adding: *"this is why in the UK, the PRA and FCA now work closely with all firms seeking new authorisation as banks."*[85]

This aspiration is to be applauded. But the experiences of our community of social-purpose innovators suggest that more needs to be done if it is to be fully realised. The fact that this statement appeared in a speech on fintech also suggests a tendency to see innovation primarily in technological terms. **Less attention has been paid to the social dimension of innovation and, in particular, to the needs of new businesses who challenge the status quo not just through technology but also through new business models centred on social or environmental purpose.**

The authorisation process can be especially challenging for these types of business for a number of reasons. One reason is simply the length of the process, which can often take two years or more. For social-purpose businesses with limited access to upfront capital, whose initial backers may be foundations and donors rather than venture capitalists, this can be a particular challenge. Start-ups are then left in a Catch-22 situation where they need to start proving impact in order to attract financial support, but require financial support in order to gain the necessary authorisation to start achieving impact.

Another reason is the lack of understanding or even suspicion that can surround unusual business models – particularly models that are not straightforwardly commercial. Where regulators focus solely on the processes being followed by new entrants without first understanding the outcomes they are seeking to achieve, time-consuming misunderstandings can arise.

The very presence of a social mission, and the small scale that often accompanies this, can be seen as an inherent 'risk' by regulators. While the authorisation process is in theory 'neutral' towards a firm's purpose, if regulators do not consider a firm's social mission or see this as a risk to the finances of a new businesses, they are not neutral. **The unique risks of social-purpose business models are being given weight, but the unique benefits are not.**

This can be exacerbated by the impersonal and process-driven nature of the regulatory process. We are aware of authorisation processes that have not involved one in-person visit to the company, or one conversation with customers or staff. When all communications are conducted by email and focus on the detail of procedures, it seems extremely difficult for regulators to understand a firm's purpose, culture and ethos – and thus to regulate them effectively.

The FCA's Innovation Hub was designed to help overcome some of the broader issues facing innovators, to support them to experiment, and to help them navigate the authorisation process. But while Innovation Hub personnel can develop a deep understanding of businesses, it is critical that this understanding is also developed within authorisation teams – otherwise there is a risk of inconsistent treatment. As we discuss below, the Innovation Hub itself could also do more to take account of social purpose in its approach to supporting innovators.

CASE STUDY:

ABUNDANCE INVESTMENT

Abundance is an investment platform that allows people with as little as £5 to invest in projects that benefit the environment and society. Abundance was launched in 2012 and initially specialised in lending for green energy projects. Its investments now include energy efficiency and housing projects, with products including an Abundance ISA and an Abundance Pension (a Self-Administered Personal Pension). Abundance's groundbreaking proposition for retail investors – small, long-term investments that support the transition to a more sustainable economy – reflects its organisational purpose: to help the public invest in things they truly care about.

Founded in 2008, Abundance began the process of applying for authorisation to the Financial Services Authority (FSA – the precursor of the FCA and PRA). Despite the centrality of Abundance's social mission in its work, the Abundance team found that the FSA did not consider the way in which the mission influenced all aspects of its strategy and operations; instead, it focussed on systems and controls, considering these in isolation from Abundance's purpose.

The FSA was only able to judge Abundance on the basis of its 'regulatory business plan': how appropriate its products were for retail investors and whether sufficient consumer protections were provided. It did not consider the unique value of Abundance's ethical investment proposition for retail investors, or the wider environmental benefits of the investment process Abundance enables, despite these being important solutions to significant market failures and supportive of government objectives.

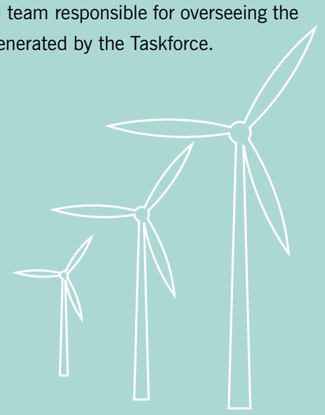
At the time, the FSA was acting within its remit to ignore wider issues of choice and competition, and instead focus wholly on consumer protection issues. The FCA now has an additional remit to promote effective competition in the interests of consumers, which (in theory) should enable it to acknowledge the contribution of a business's unique mission to consumer choice.

Today, Abundance has permissions for a range of regulated activities, but these are not well-designed for Abundance's unusual product offering and are very complex for a small business to navigate. In some cases, regulations prove prohibitively costly for Abundance, limiting the services they can provide. For instance, Abundance would like to support a secondary market – enabling investors to buy and sell existing investments – but offering anything beyond a basic list of investment opportunities would involve becoming a 'Multilateral Trading Facility', requiring levels of regulatory capital which they see as disproportionate to the risks involved, as well as further permissions.

Abundance saw the FCA's regulatory sandbox as an important new mechanism to enable new businesses and innovations to demonstrate their ability to produce good outcomes for customers within the regulatory framework. However, in 2014, Abundance's application to the sandbox was not selected, because it was an existing authorised business with an idea that wasn't sufficiently 'new' or 'different'. Most of the sandbox participants to date have been fintech propositions (either from start-ups or established institutions) and none of the 60 projects in the first three sandbox cohorts have an explicit focus on environmental benefit.

To a large extent, the FCA is doing all it can within its statutory objectives. The lack of collective goals across government departments acts as a barrier to the regulatory reform required to enable more financial solutions for climate mitigation and resilience. The UK Government has a carbon reduction target, which the Department for Business, Energy & Industrial Strategy is responsible for achieving through their management of the Carbon Budget, but the Treasury does not have any climate-related targets. This means that climate risks are not yet integrated into the work of the FCA.

For the FCA's mandate to change, of course, requires action at the parliamentary level, and we argue in 5.3 that politicians must give regulators clear direction on the need to consider social and environmental purpose. We are beginning to see progress in this direction with the work of the Green Finance Taskforce, which acknowledges the central role of finance in enabling the shift to a low carbon economy, and the creation of a cross-departmental team responsible for overseeing the legacy of policy ideas generated by the Taskforce.



SOLUTIONS: In order to fully address these issues, we need a new concept of innovation and how it relates to the social purpose of finance. This is becoming particularly urgent as the pace of technological innovation creates whole new business models and markets, leaving regulators scrambling to catch up.

Regulators recognise that **innovation is not necessarily a good in its own right:** as Mark Carney says, *"the challenge for policymakers is to ensure that fintech develops in a way that maximises the opportunities and minimises the risks for society".* They also recognise that innovation can be either incremental or transformative: it can either enable us to do things better, or to do better things.

In order to really make use of these insights, regulators need a framework for thinking about the societal challenges we want innovation to solve, and thus the kinds of innovation we want to support – which may require combinations of social and technological innovation. In the absence of a clear sense of this, regulation too often defaults to a simple competition lens.

For instance, the criteria for new products and businesses being given support via the FCA's Innovation Hub and regulatory sandbox do not explicitly include the potential social value of these innovations. Although applicants to the regulatory sandbox are required to demonstrate that their innovation has the potential to benefit consumers, this 'benefit' can be indirect, through heightened competition – and thus need not have anything to do with the impact of the innovation itself. There is no mention of potential benefits to stakeholders other than consumers, such as communities, wider society or the environment.[86]

The Lab's own approach to selecting innovators to support through our flagship Fellowship programme is relevant here. We distinguish between three types or levels of innovation:

1. Innovation that increases efficiency but doesn't alter the fundamentals of what is being done or how, such as new customer interfaces ('status quo innovation')
2. Innovation that changes the relationship between customer and provider, e.g. crowdfunding ('disruptive innovation')
3. Innovation that changes the relationship between the finance system and wider society, including values-driven lenders and investment platforms ('transformative innovation').[87]

It is important to note here that 'innovation' can relate to governance, business model and purpose as well as technological innovation.

There is no reason in principle why regulators could not take a similar approach to selecting participants in initiatives like the regulatory sandbox: social purpose could be included as a specific criterion or positive attribute for businesses seeking support. This would align with the FCA's recent statement of the importance of 'public value' in its overall approach (see 5.2) and could be combined with landscape analyses to identify specific priority areas or challenges where innovation is needed and applications encouraged.

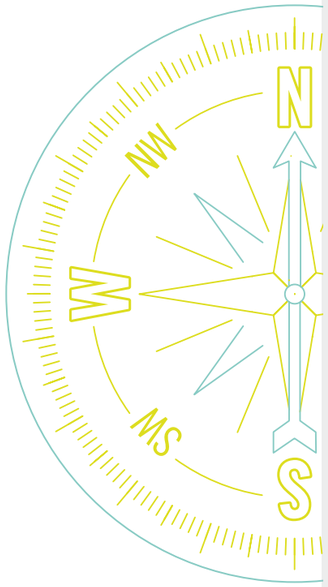
5. THE REGULATORY CHALLENGE: IMPLICATIONS AND RECOMMENDATIONS

In each of the problems identified above, we identify some specific steps that could be taken now to improve the experience of social-purpose businesses and the effectiveness of regulation. But these experiences are not accidents or anomalies. They also reflect wider limitations in the dominant approach to regulation. If we want to build a genuinely purpose-driven financial and regulatory system, some of the assumptions underpinning this approach will need to be rethought.

In this section, we draw out some of the broader implications of the discussion so far for financial regulation. We also make some general recommendations which could help to ensure the regulatory system enables, rather than hinders, solutions to the problems we have identified. Our recommendations are summarised the concept of the regulatory compass introduced in 3.3.

As we have seen, for better or worse, the financial system is changing – and regulation must change with it. Regulators will need to see clarity and leadership from policymakers and government in order to adapt to this shifting context.

Whether it is the rise of fintech or the impacts of Brexit, the coming disruption presents policymakers and regulators with a choice. Do we 'bake in' the shortcomings of the current approach, or do we seize the opportunity to return to first principles, and reorient regulation more explicitly around the social purpose of finance?



5.1 THREE REGULATORY FALLACIES

Our discussions and case studies have highlighted three false assumptions that prevent our current regulatory approach from aligning the system with its social purpose:

1 **The fallacy of composition:** This is the assumption that 'if every unit in the system works, then the system works'. Since the financial crisis, prudential regulators increasingly recognise that complex systems are more than the sum of their parts.[88] But, notwithstanding the establishment of the Bank of England's Financial Policy Committee (FPC) and its remit to address systemic risk, this has yet to fully translate into new approaches to regulation. Regulation which focuses purely on minimising risk at the level of individual institutions (or even individual consumers) may neglect or even unintentionally worsen outcomes at the level of the system as a whole. This is illustrated by the example of bank capital requirements which focus solely on individual bank risk rather than on desirable systemic outcomes, such as diversity or sustainability, and by the example of the pensions industry, where detailed regulation of individual investment institutions is failing to prevent a worrying slide in retirement outcomes for UK savers.

2 **The fallacy of neutrality:** It is often assumed that status-quo regulation is value-neutral, and that the kinds of changes discussed in this report would amount to regulators taking an unjustifiable moral or political stance. But there is no such thing as value-free regulation: there are only values blind spots. Regulation designed around dominant profit-maximising business models often inadvertently disadvantages other business models – as we have seen with both established businesses (such as social-purpose banks) and would-be challengers (such as social-purpose innovators). Focussing on allegedly value-free outcomes such as competition or innovation does not prevent regulation from having value-laden outcomes – it merely disguises them.

And regulation premised on the theoretical utility-maximising consumer inadvertently short-changes people with objectives beyond financial return.

3 **The fallacy of market efficiency:** It is also increasingly apparent that competition and market integrity are not adequate proxies for the outcomes we want the financial system to serve – be they financial health for individuals or sustainable wealth creation for society at large. Focussing regulation on these outcomes does not guarantee good social outcomes and may even inadvertently undermine them. David Pitt-Watson[89] draws an analogy with medieval medicine: improving competition in the market for leeches would not have improved outcomes for patients. There was a more fundamental problem of whether the remedies on offer were actually achieving the right things.

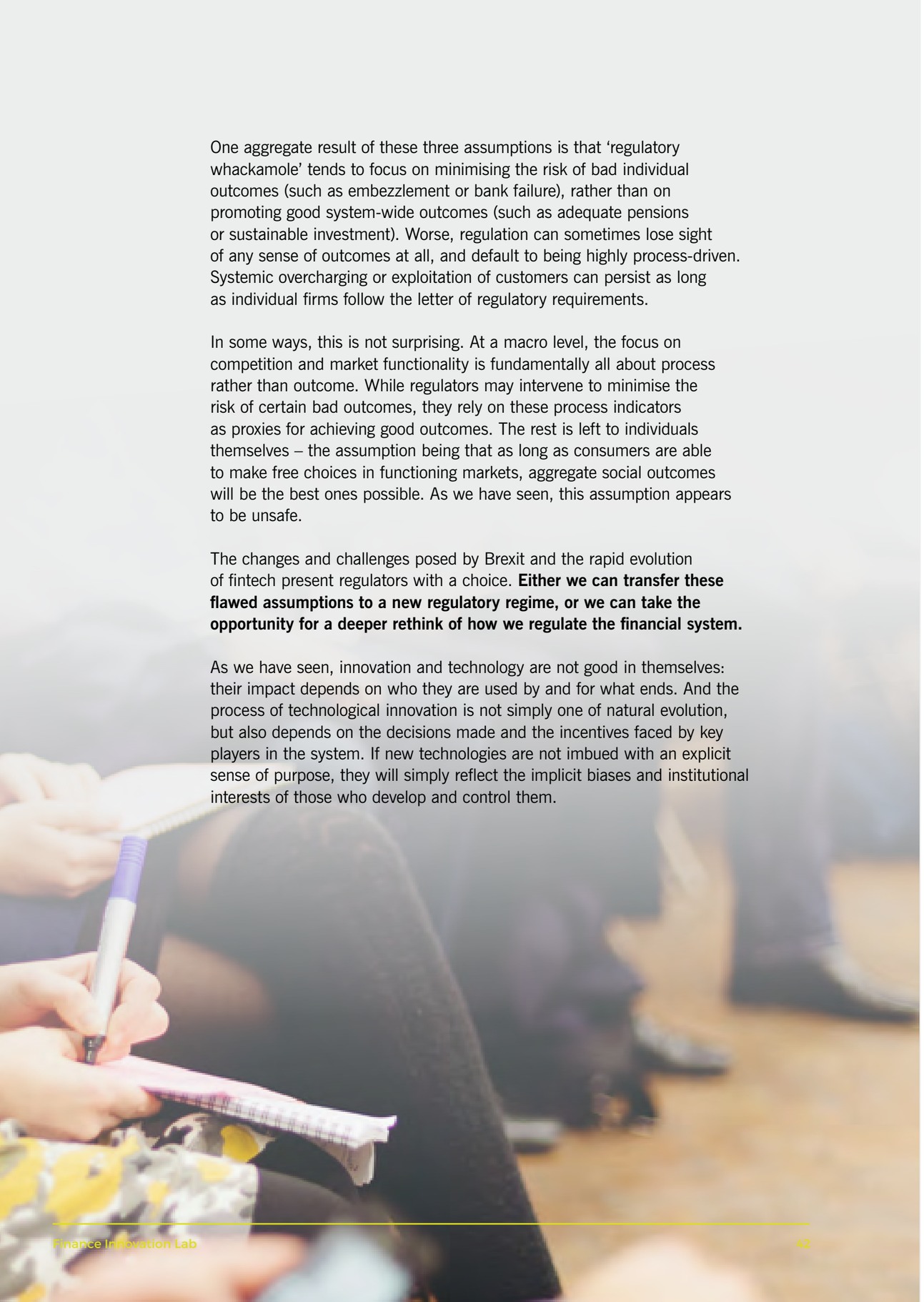
If customers technically have a wide choice of banks or pension providers, but all the options on offer are similar and none are genuinely meeting their needs, something is wrong. Indeed, the evidence linking competition to better social outcomes in these sectors is extremely thin. A competition lens is no substitute for focussing directly on ensuring the system is delivering good outcomes for people.

One aggregate result of these three assumptions is that 'regulatory whackamole' tends to focus on minimising the risk of bad individual outcomes (such as embezzlement or bank failure), rather than on promoting good system-wide outcomes (such as adequate pensions or sustainable investment). Worse, regulation can sometimes lose sight of any sense of outcomes at all, and default to being highly process-driven. Systemic overcharging or exploitation of customers can persist as long as individual firms follow the letter of regulatory requirements.

In some ways, this is not surprising. At a macro level, the focus on competition and market functionality is fundamentally all about process rather than outcome. While regulators may intervene to minimise the risk of certain bad outcomes, they rely on these process indicators as proxies for achieving good outcomes. The rest is left to individuals themselves – the assumption being that as long as consumers are able to make free choices in functioning markets, aggregate social outcomes will be the best ones possible. As we have seen, this assumption appears to be unsafe.

The changes and challenges posed by Brexit and the rapid evolution of fintech present regulators with a choice. **Either we can transfer these flawed assumptions to a new regulatory regime, or we can take the opportunity for a deeper rethink of how we regulate the financial system.**

As we have seen, innovation and technology are not good in themselves: their impact depends on who they are used by and for what ends. And the process of technological innovation is not simply one of natural evolution, but also depends on the decisions made and the incentives faced by key players in the system. If new technologies are not imbued with an explicit sense of purpose, they will simply reflect the implicit biases and institutional interests of those who develop and control them.



5.2 TIME FOR A NEW APPROACH

If we want to ensure the financial system delivers on its purposes and serves the economy, society and the environment, there is no escaping from the need to explicitly orient regulation towards these purposes. And if we want the process of innovation to create a new financial system that better serves its purpose, we need to actively shape it towards those ends. This means having regulatory objectives that go beyond market efficiency or a narrow concept of consumer detriment. It also means paying explicit attention to the purpose of regulated entities – and treating the presence of a wider social purpose as an asset to be nurtured rather than an anomaly to be treated with caution.

We are seeing promising early signs of this new approach. The FCA's recent restatement of its mission includes the concept of 'public value' as part of its objective:

"Public value is the collective value that an organisation contributes to society. This is in contrast to private or market value, which is the value of a good or service to an individual customer and provider. Our aim is to add public value by improving how financial markets operate, to benefit individuals, businesses and the UK economy." [90]

Prudential regulators are also increasingly aware that the social and environmental impacts of finance cannot be assumed to be outside the scope of regulation, at least in as much as issues such as climate change impact on financial stability.[91] The Bank of England has taken a leading role in clarifying the roles and responsibilities of regulators and financial institutions in relation to climate change:

"While the mitigation of climate change has traditionally been seen as the remit of government policy, there is growing recognition of the role of participants within the financial system, including central banks and financial regulators, to mitigate financial risks from climate-related factors."

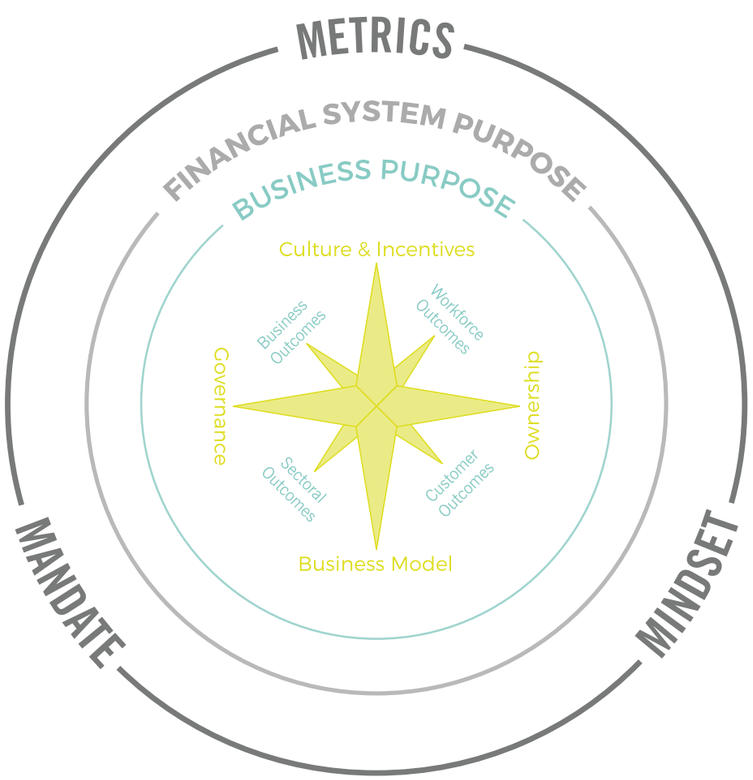
– Aikman et al., 2017[92]

There are also indications of an appreciation that financial organisations must serve a higher purpose:

“Purpose is what an organisation stands for; why it does what it does; and what it should be trusted to deliver. Purpose is always broader than a simple bottom line.”

– Carney, 2018[93]

These are welcome developments, but we need to go further. UK regulators – and the policymakers who instruct them – need to develop a more explicit, rounded and substantive concept of what social purpose (or ‘public value’) means in the context of financial services. This should then act as a compass which guides regulation at every level. An understanding of the purpose of the system as a whole should then translate into an understanding of the purpose of each organisation within the financial system, and how that shapes and is shaped by its ownership, governance, business model, culture and incentives. Only then can regulatory bodies meaningfully measure how well the system and each firm is delivering its key outcomes.

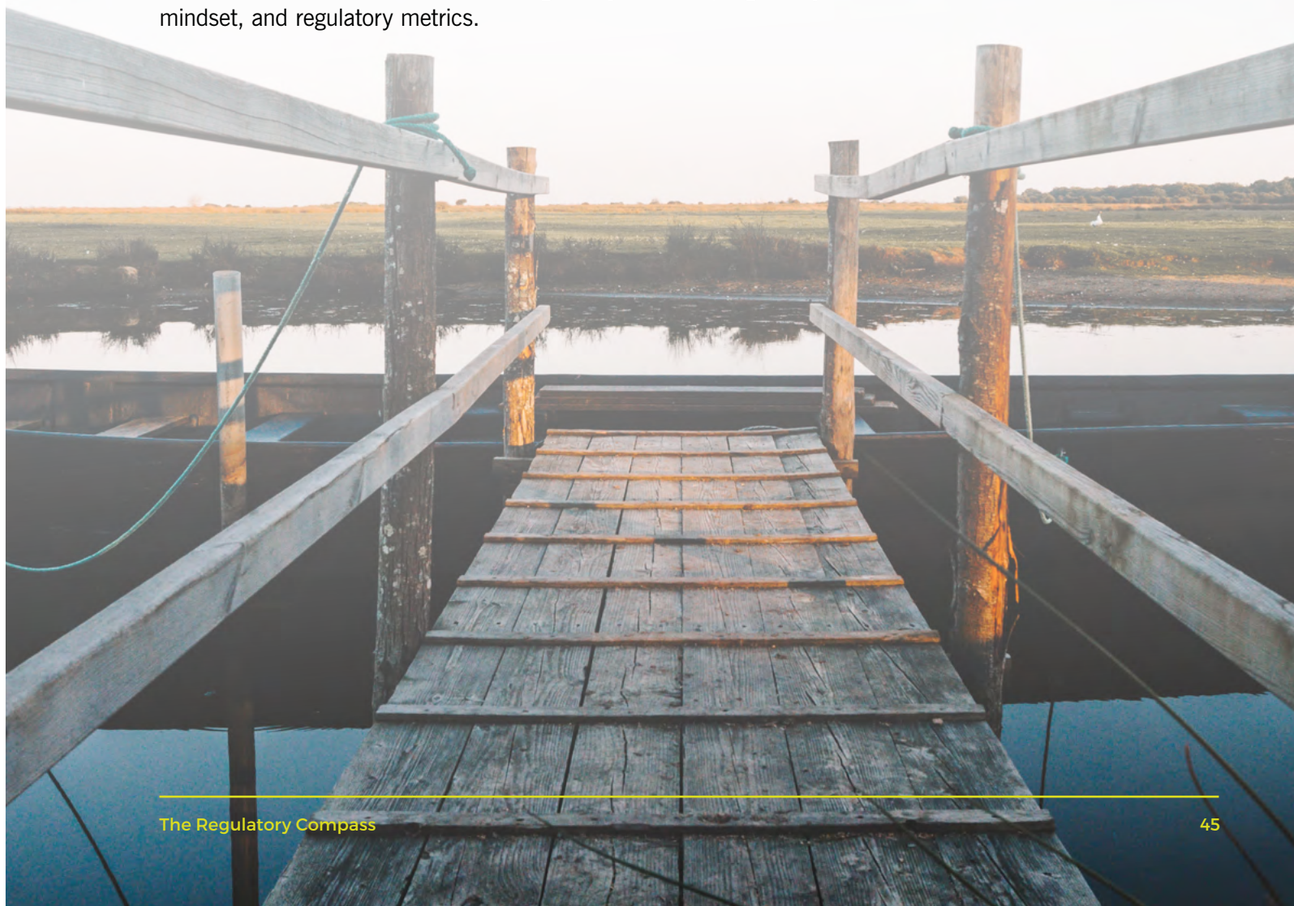


This shift demands democratic discussion. Regulators might reasonably respond that it is not their job to pass judgement on the purposes of the businesses they regulate. But it is the job of politicians to ensure that regulation is promoting the social outcomes we want to see, and it is the prerogative of politicians to change the parameters within which regulation operates.

This does not mean that positive steps cannot be taken within existing regulatory mandates, including some of the recommendations made below and throughout this report.

The need for democratic consensus on the purpose of finance and financial regulation is also an opportunity to enhance genuine democratic accountability. If regulation remains focused on ever more complex and technical rule-making, it will inevitably be difficult or impossible for the average person – or the civil society organisations that represent them – to engage with it. This leaves the regulatory conversation dominated by regulated firms and ever more divorced from those it is supposed to support and protect. But **once we begin to ask about the purpose of finance, we can start a meaningful conversation with the users of finance about the outcomes they want the system to achieve.** This enables true democratic dialogue, and ultimately a healthier regulatory system.

In the remainder of this section, we delve deeper into what this new regulatory approach might look like in practice and make some recommendations for the kinds of changes which could help to enable it. These are needed at three levels: regulatory mandate, regulatory mindset, and regulatory metrics.



5.3 REGULATORY MANDATES: CHANGING WHAT WE ASK OF REGULATORS

Assuming that we can agree that the financial system ought to serve a certain set of purposes, such as those outlined in 3.1, the question becomes: who is accountable for defending and promoting these purposes? We need to revisit regulatory mandates to ensure that politicians are giving regulators clear direction about their role in this.

Changes to the regulatory ecosystem and to regulatory mandates were made after the 2008 crisis, to address the problem of issues 'falling between the cracks' of different regulatory remits. But the overarching aim of holding **the financial system to its overall purpose may still be falling between those cracks.** The distinction between prudential regulation (overseen by the FPC and PRA) and consumer regulation (overseen by the FCA and the CMA) leaves a grey area when it comes to the wider social and environmental outcomes of finance – such as support for the productive economy or compatibility with the UK's obligations under international climate agreements.

These methods can be designed to give particular priority to the voices of groups who are traditionally marginalised – such as the financially excluded or future generations.

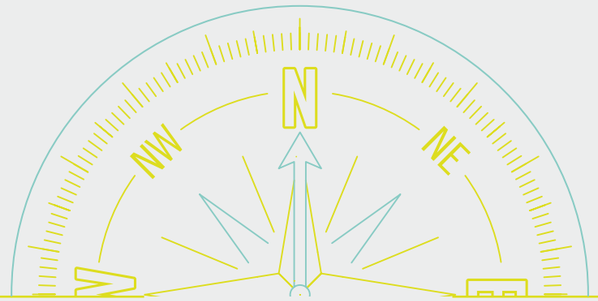
We propose that this work should be taken to its logical conclusion via a thorough review of the purpose of finance and how this is reflected in regulatory mandates. **This should involve full democratic consultation, including through participatory methods such as citizens' juries, to ensure that the voices of ordinary users of finance – and others affected by its activities – are heard.**

The work of the RSA's pioneering Citizens' Economic Council demonstrates the importance and viability of engaging citizens from all sections of society in genuinely democratic deliberations about national economic policymaking.[94] We are delighted to see that the Bank of England has now adopted in full the RSA's recommendation to use citizens' juries and believe that this can serve as a template for the wider consultation we propose.[95]

The government could then be required to report to parliament on a regular basis on how these objectives are being achieved, with the Treasury Select Committee tasked to hold the government and regulators accountable for this.

We do not want to pre-empt this process, but opposite we summarise the current mandates of the key financial regulators and make some suggestions for what a purpose-oriented alternative could look like.

REGULATORY BODY	CURRENT OBJECTIVES	ILLUSTRATIVE NEW OBJECTIVES
Financial Conduct Authority (FCA)	**Strategic objective:** > To ensure that relevant markets function well. **Operational objectives:** > To secure appropriate protection for consumers > To protect and enhance the integrity of the UK financial system > To promote effective competition in consumers' interests.	> To promote the financial health and wellbeing of individuals using the finance system. > To ensure that the financial system helps individuals to meet their needs and improve their wellbeing, both financial and non-financial. > To protect individuals using the finance system from damage to their needs and wellbeing, both financial and non-financial. > To promote a diverse financial system that works in the interests of its users.
Prudential Regulation Authority (PRA)	**Primary objectives:** > To promote the safety and soundness of the firms it regulates. > To contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders. **Secondary objective:** > To facilitate effective competition.	**Primary objectives:** > To maximise the contribution of regulated firms to the stability and resilience of the UK financial system. > To promote the contribution of regulated firms to sustainable and equitable wealth creation. **Secondary objective:** > To promote a diverse financial system.
Financial Policy Committee (FPC)	**Primary objective:** > Identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. **Secondary objective:** > To support the economic policy of the government.	> Identifying, monitoring and taking action to improve the UK financial system's performance in relation to: ▸▸ financing the productive economy of the UK and its regions ▸▸ impact on social equity ▸▸ impact on ecological sustainability ▸▸ the resilience of the economy and financial system. > Identifying, monitoring and taking action to remove or reduce systemic risks to the above outcomes.



5.4 REGULATORY METRICS: EMBEDDING PURPOSE AT EVERY LEVEL

This approach demands new regulatory metrics to assess how well the system is serving its purposes. Regulators would monitor their success and be held to account based on the performance of the overall system against its purpose. This might affect the priorities of systemic regulation – for instance, incorporating environmental sustainability factors into bank capital requirements.

Whole-system metrics could be set at a macro or sectoral level, for example:

- Key measures of systemic risk such as leverage ratios, asset and risk concentration, system complexity, system resilience, and volatility
- Diversity of ownership, funding and business models for financial sector firms and the wider economy
- Proportion of money creation and lending allocated to the productive economy and to SMEs
- Adequacy of capital allocation/funding provision to key social and environmental priorities, such as clean technology and renewable energy, food and agriculture, or transport and infrastructure – as well as over-allocations to unsustainable sectors such as coal extraction
- Adequacy of outcomes in priority areas such as sufficient retirement income, reduction in the carbon intensity of energy production and consumption, reduction in levels of unsustainable debt (at the individual, household, institutional and system-wide level).

These metrics could draw on the forthcoming unified EU classification of sustainable activities announced in the EU's Action Plan on Financing Sustainable Growth.

These metrics would then 'cascade' down through every level of regulation, for instance being reflected in the information that regulators require firms to disclose. Regulators cannot gain a full and accurate picture of how well the system is serving its purpose unless and until firms are required to disclose meaningful information about their performance against these measures.

Regulators would need to take efforts to understand, measure performance against, and advocate for better practice around:

- **The purpose of individual businesses within the system:** This means understanding and supporting governance, ownership and business models that evidence suggests are best aligned with the fulfilment of the activity's social purpose, rather than simply policing those that are not. It also means understanding and responding to the range of different social-purpose business models, and positively valuing them as an important part of an ecosystem that is fulfilling its social purpose. Finally, it means examining any implicit or unintended biases in regulation towards dominant business models and their purposes, and seeking to correct these where possible.

- **The corporate culture and employee incentives within these businesses:** Regulators should seek to ensure that corporate culture supports organisational purpose and that incentives are aligned with this, from the objectives and remuneration packages of senior management to the sales targets of junior staff. This will reduce the need for costly 'regulatory whackamole' to deal with the consequences of flawed incentives, such as mass mis-selling or excessive risk-taking. We recognise that the FCA places a high priority on culture and would argue that this must be assessed within the context of an organisation's purpose, governance and ownership, as do many authors in its recent Discussion Paper Transforming Culture in Financial Services.[96]

"Practically, this means a whole-system approach to culture with alignment between the formal (purpose processes, structures, systems) and informal aspects (beliefs, norms and unspoken rules) and a focus on every individual in the system (organisation)." – FCA, 2018[97]

- **The purposes of individual users of the financial system:** Rather than assuming that concepts like 'consumer detriment' or 'suitability' can be understood solely through the prism of the theoretical utility-maximising consumer or minimising the risk of relative financial detriment, regulators should actively seek to understand the purposes and goals being pursued by the real people using the financial system. In this context the relevant question becomes not just 'did this provider deliver the product they said they would?' but 'did this person achieve the outcomes they were looking for?' This means recognising that finance is always a means to an end, and engaging systematically with other regulators, policymakers, academics and civil society organisations in spheres like education and health, to understand whether finance is helping or hindering people to flourish in these spheres, and what regulators could do to improve outcomes.
- **The impact of the business on key sectors of the productive economy:** Regulators should seek to understand the contribution of financial firms to the sectors of the economy they seek to serve. This might include: proportion of lending to SMEs and to social enterprises; availability and affordability of consumer credit to vulnerable and low-income groups in society; aggregate cost of financial intermediation to pension assets and incomes; availability and cost of financing for service provision in key sectors such as (renewable) energy and water.

Although it is not a regulator, the Banking Standards Board (BSB) plays an increasingly important role in addressing business purpose, corporate culture, and individual behaviour in the banking sector. It considers general characteristics associated with fair and good banking, such as trust, respect, openness, competence and shared purpose, and it assesses the degree to which the expressed corporate purpose and values are reflected in the way business is actually done. We would urge the BSB to extend its assessment and thought leadership work to include banks' wider role in society, and the benefits and risks they pose to citizens. Ultimately, there is no value-free interpretation of good behaviour or ethics in banking[98] – these only have meaning in the context of a clearly defined social purpose.

5.5 REGULATORY MINDSET: HUMAN-CENTRED REGULATION

The principle of engaging with the users of finance as human beings rather than as theoretical 'consumers' has wider applicability as part of a new, purpose-driven regulatory approach. For a long time, it has been assumed that maintaining efficient markets or mathematical risk models could substitute for the exercise of human judgement and human values in the pursuit of good social outcomes. It's time to try a new approach.

This could be linked to a more participatory regulatory approach, seeking to consult and involve those whom regulation exists to protect as fully as possible, including through use of public dialogue workshops.

At a consumer level, this means engaging with users directly, understanding and responding to the things they want the financial system to do for them. These include the ultimate life goals they want financial products to help them achieve, such as a secure retirement or a decent education, and the values they want to see reflected in the use of their money, such as wanting to avoid financing certain activities or positively support others (see 4.3.2). Guidance for customer-facing activities, such as the provision of financial advice, should also encourage this holistic, human-centred approach.

A good example to build upon might be the FCA's work on vulnerability. As the authors note, *"financial services need to be able to adapt to the changing circumstances that real life throws at people, rather than being designed for the mythical perfect customer who never experiences difficulty"*.[99] Conversely, they also note that the ways in which financial services can cause detriment go far beyond traditional notions of financial loss – to encompass, for example, the stress and anxiety that go with spiralling financial insecurity or being forced to continuously re-explain traumatic circumstances. This work helps to point the way towards a much more rounded regulatory approach that seeks to serve the whole person, not the abstract 'consumer'.

It's worth noting that this is distinct from the growing use of behavioural economics in regulation – understanding people better in order to 'nudge' them into making decisions that are deemed to be rationally in their best interests, such as saving more or switching accounts. In some senses, it is the opposite: genuinely listening and making regulation itself accountable to the lived experiences and needs of the people participating in the system – and recognising that often, it is the system, not individuals' behaviour, that is at fault.

Human-centred regulation can be applied not just to regulators' interaction with users, but also with regulated firms. With the potential of regtech to dramatically reduce the burden of routine compliance activities, there is an opportunity to refocus the time and attention of human regulators on the things that humans do best. This means more personal contact with regulated firms, both during the authorisation and supervisory process, using site visits and meetings to gain a deep understanding of their culture and business model.

Since the financial crisis, there has been much talk about 'culture change' and the role of regulation in promoting this. But, as the BankingFutures report notes, culture is *"only truly understood by spending long periods of time inside the organisation and with senior leadership"*.[100] If regulators are serious about promoting culture change to better align the financial system with its purpose, they need to invest in the human relationships and experiences that can help them to grasp and intervene in these dynamics. Likewise, if regulators are serious about promoting socially useful innovation and ensuring that innovators are not inadvertently stifled by regulation designed for incumbents, they must focus the authorisation process on gaining a deep understanding of new entrants' culture and business models – one which goes far beyond procedural box-ticking.

The rise of fintech makes this human-centred approach more important rather than less. If finance is ultimately a social system which rests on trust and judgement, how does such a system function in an increasingly digitised and automated world? The trend towards replacing human relationships and decisions with automated processes and data analysis has potentially profound implications, whether in high-frequency trading, credit scoring algorithms or robo-advice.

The financial crisis gave us a glimpse of this, by exposing the dangers of outsourcing judgements about risk to models which are ultimately as fallible as their human designers.

Technology necessarily reflects the biases, interests, values and blind spots of those who create and control it. And if, as Mark Carney hopes, we are to *"ensure that fintech develops in a way that maximises the opportunities and minimises the risks for society"*, [101] technology must remain squarely accountable to the achievement of social purpose. For regulators like the FCA, this means embedding a sense of social purpose much more directly into programmes designed to nurture innovation. For regulators like the Bank of England, it means embedding this perspective firmly into the analysis of systemic trends, risks and opportunities.

We must respond to fintech not with a kind of technology fetishism but with an ever more human-centred approach to regulation – seeking to understand the inherent value judgements and the human consequences of technological innovations. Only this way can we build and sustain a financial system that is truly oriented to its social purpose.

CASE STUDY:

WEAPONS OF MATH DESTRUCTION

Data scientist Cathy O'Neil left a career in academia to work in finance. Her experience of working in a hedge fund around the time of the financial crisis led her to rename certain algorithms 'Weapons of Math Destruction' (WMDs) – harmful models which *"encoded human prejudice, misunderstanding, and bias into the software systems that increasingly managed our lives… Their verdicts, even when wrong or harmful, were beyond dispute or appeal. And they tended to punish the poor and the oppressed in our society, while making the rich richer"*.[102]

O'Neil identifies three key characteristics of WMDs:

Opacity – the true purpose of data collection and the uses of data are hidden, often behind the justification of 'intellectual property'

Scale – feedback loops help to create the environments that justify their assumptions, making the model more and more unfair, and establishing norms that affect our whole lives

Damage – these algorithms may not be universally damaging, but many people suffer as a result of them, often with no opportunity to appeal.

She singles out credit scoring and insurance as using particularly opaque, far-reaching and damaging models, but recognises that there are many potential WMDs across the financial system.

O'Neil is clear: algorithmic models, *"despite their reputation for impartiality, reflect goals and ideology… Our own values and desires influence our choices, from the data we choose to collect to the questions we ask. Models are opinions embedded in mathematics"*. Purpose is critical to the nature of these models – if businesses are motivated solely by short-term profit, *"the money pouring in seems to prove that their models are working"*. If we want the financial system to fulfil its ultimate purpose in the economy, society and the environment, can we afford not to consider this purpose in the way we regulate automation?

CASE STUDY:

GROWING A CULTURE OF SOCIAL IMPACT INVESTING IN THE UK

In autumn 2017, an industry-led Advisory Group appointed by UK Government published a report arguing that social impact investment can play a vital role in creating a society that works for everyone, with private finance making a direct contribution to the public good. Social impact investment is currently a very small part of a very large universe of business and finance, but it can be seen as an indicator of growing interest in the wider social purpose of finance.

The report assesses the potential to grow the social impact investing market in the UK and offers a range of recommendations for government, regulators, and firms,[103] many of which relate to the metrics and mindset categories described above. While the report does not directly address the question of mandate, it makes a clear statement about social purpose in finance and proposes changes in government policy, regulatory approach and industry leadership. We would argue that a number of its recommendations require a shift in the mandate of regulators to ensure that progress goes beyond incremental change.

Recommendations to industry and regulators include:

- Regulators (including the FCA and PRA) should build capacity in relation to social impact considerations and should embed social impact in 'business as usual' frameworks and understanding
- The FCA and the Financial Ombudsman Service should ensure a joined-up approach is communicated to the adviser community, clarifying how social impact elements of investments will be treated
- The FCA should consider whether the Know Your Customer requirements should be interpreted to include information about an individual's values and whether these might influence investment decision-making
- The FCA should promote its regulatory sandbox and Innovation Hub to encourage testing of more potential social impact investment products
- The PRA should develop a framework for social impact investing, exploring how social returns might interact with expected risk-adjusted financial returns, including when determining risk weights under Solvency II
- The financial services industry, professional bodies and educational institutions should provide educational support and continuous professional development to help advisers and others understand and include social impact investments in products and portfolios.

6. IN CONCLUSION

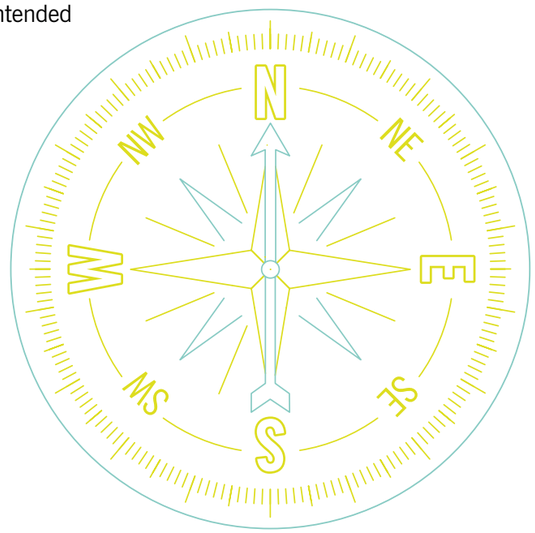
Our financial system operates in a world characterised by economic, political, technological and social upheavals. Much is uncertain, but it is clear that there is significant political and public demand for change in finance – both to address the problems of the past and to meet the challenges of the future.

We believe we can use this moment as an opportunity to articulate a clearer vision for the ultimate purpose of finance and for the kind of regulatory system that will best support that purpose. This means a regulatory system that is able not only to avert crises and crashes, but also able to ensure that finance supports the productive economy, serves its all citizens, and helps us to address the major social and environmental challenges we face.

To navigate the risks and seize the opportunities, we need to focus regulatory analysis and action on the social purpose of finance. The regulatory compass provides a way to visualise this terrain at a range of levels. It offers a direction for regulatory mandates, metrics and mindsets that are aligned with what our economy, society and environment really need.

We recognise that our recommendations are ambitious – necessarily so if we are to address the scale of the changes ahead of us. Some of these steps might not be achievable immediately; many require further exploration and experimentation. But many could also begin now, within the scope of existing mandates and in support of existing policy and business priorities.

As with past transformations in the regulatory regime, such as the introduction of ringfencing or the Basel III rules, an orderly and gradual transition can be implemented in a way that enables financial services providers to plan for and respond positively to the new regulatory approach.
We acknowledge that there is also a risk of generating unintended consequences – for example, from reducing capital risk weightings for certain industries – and ongoing monitoring for both anticipated and unanticipated effects of the new regulatory approach is essential.



In the long term, these changes will be beneficial both for the financial sector and the wider economy: restoring trust in the financial sector, encouraging new entrants and more meaningful competition and choice, providing greater financial support across non-financial sectors, and supporting the transition to a sustainable economy.

Most importantly, these changes will help to ensure our financial system enables us to achieve our goals, as individuals, as communities and as a society. The need could not be clearer – now is the time for action.

RECOMMENDATIONS FOR GOVERNMENT:

1 Government, led by HM Treasury, should conduct a review to develop an agreed set of purposes for the financial system, to assess the extent to which it is serving those aims, and to identify key structural and cultural features of a system capable of meeting those aims. This should be based on full democratic consultation with stakeholders affected by the finance system and should have clear terms of reference that balance financial sector input with that from other groups.

2 The results should be used to update the mandates of the Bank of England (including the PRA and FPC) and the FCA – for example, to allocate clear responsibility for ensuring that the financial system serves the productive economy, is compatible with ecological sustainability, and helps individual users to achieve their life goals.

3 The legislation enacting this should also require the government to report to Parliament on a regular basis on how these objectives are being achieved, with the Treasury Select Committee tasked to hold the government and regulators accountable for this.

RECOMMENDATIONS FOR REGULATORS:

1. Financial regulators should adopt a new set of metrics against which to measure their success, which should capture the performance of the financial system in serving its purpose. This could include, for example, percentage of productive economy lending (PRA), size of the climate finance gap (FPC), or adequacy of retirement incomes (FCA).

2. Regulators should seek to embed these purposes in their approach to assessing and managing systemic risks – for example, the Bank of England could advocate at the European level for the adjustment of capital weighting rules to better align with environmental sustainability.

3. Regulators should undertake sectoral and structural analysis to identify and support the governance, ownership and business models which can best align the financial system with its social purpose – for example, the FCA could work with government to restrict the ability of providers with inherent conflicts of interest to offer pension products under auto-enrolment.

4. Regulators should develop a mindset that sees 'consumers' as whole human beings with a range of motivations, seeks to understand their needs and values, and ensures that guidance for customer-facing activities does the same. For example, the FCA could reform suitability rules and guidance for financial advisors to better reflect people's non-financial objectives.

5. Regulators should embed an explicit understanding of social purpose into their approach to encouraging innovation and to regulating new markets. For example, the FCA's Innovation Hub should include social purpose (or potential to create public value) as a criterion for deciding which innovations to support, or it could proactively solicit applications from innovators addressing particular social and environmental challenges.

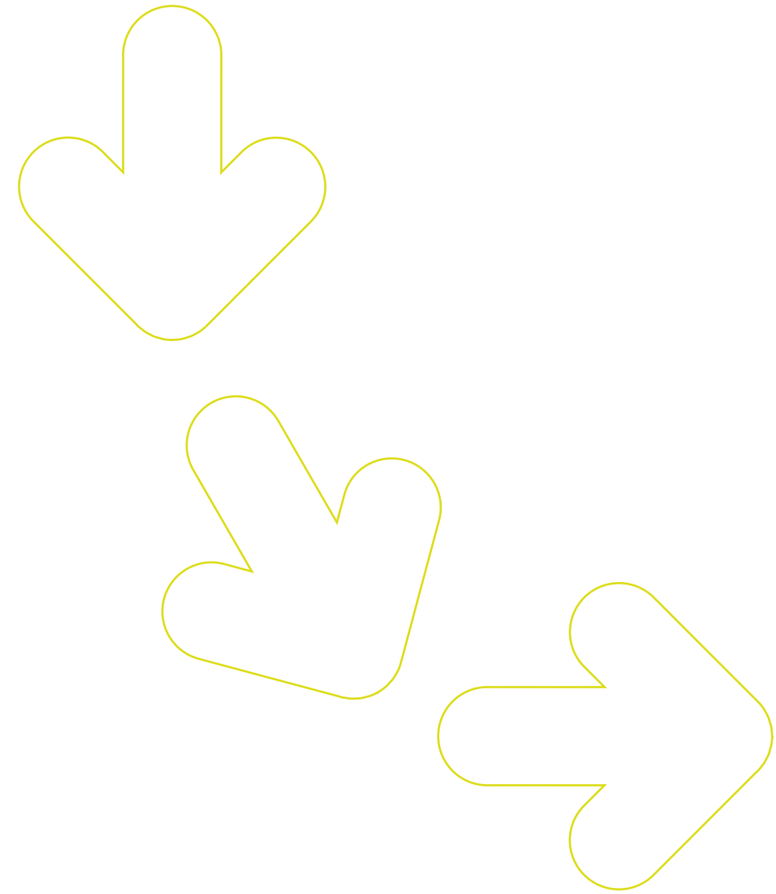
6. An understanding of the value of diversity (as opposed to or in addition to competition) should be embedded into the authorisation and supervision processes, with a new Diversity Hub established to enable firms with atypical governance and business models to demonstrate the viability of their approach. Consideration of diversity should be incorporated into the approach of the CMA, as well as the FCA and PRA.

7. Regulators should monitor and hold firms to account for the individual and collective human outcomes of new technological developments. It cannot be assumed that technological innovation automatically drives public good.

8. Regulators should take advantage of regtech to refocus the time and energies of human regulators on face-to-face interaction, aiming to build a deep understanding of firms' culture and business practices – for example, by building more site visits and consultation with employees or customers into the authorisation process.

"The hard bit is what happens next."

– Aikman et al., 2018[104]



7. GLOSSARY

Capital adequacy requirements – The 'buffer' of assets that banks are required to hold to protect them against potential losses.

CMA – Competition and Markets Authority, responsible for regulation to ensure markets work well for consumers, business and the economy.

FCA – Financial Conduct Authority, responsible for the regulation of financial institutions' conduct, financial markets, and market infrastructure.

FCA Handbook and Code of Business Sourcebook (COBS) – The Handbook sets out the rules and guidelines of the FCA. Within that, the COBS sets out the day-to-day rules that apply to the business of financial firms.

Fiduciary duty – The legal duty of someone who is responsible for assets (owned by someone else) to protect them and manage them in their owner's best interests.

Financial Promotions regime (FCA) – Sets out the rules for promotions and advertising to ensure they treat customers fairly.

Financial Stability Board – International body that monitors the financial system and promotes financial stability, including coordinating financial authorities and standard-setters. Key functions include setting guidelines on bank and insurer capitalisation.

Fintech – A portmanteau of 'financial technology' referring to the collection of technologies changing finance, including smart phones, Application Programme Interfaces (APIs), Artificial Intelligence (AI) and blockchain.

Free if in credit – The provision of current accounts and related banking services free of charge to customers whose accounts are in credit.

Leverage ratio – The ratio of assets (equity) to debt (capital) on a bank's balance sheet. A specific measure of this (relating to 'Tier 1' capital) is used by regulators to determine capital adequacy.

Macro-prudential risk – The risk of loss or failure across the financial or banking system.

Micro-prudential risk – The risk of loss or failure for an individual bank.

PRA – Prudential Regulation Authority, responsible for promoting the safety and soundness of banks and insurers, including securing an appropriate degree of protection for insurance policyholders.

Productive economy – Refers to the parts of the economy that support the production of goods and services that are sustainable and socially useful, in contrast to the parts of the economy concerned only with transactions in financial markets.

Regulatory equivalence – The EU may acknowledge that the legal, regulatory and/or supervisory arrangements of a jurisdiction are equivalent to its own in terms of outcomes.

Regulatory sandbox – A 'safe space' in which businesses can test innovative products, services, business models and delivery mechanisms, without immediately incurring all the normal regulatory consequences.

Risk weighting – The assessment of the riskiness of assets to determine how much capital banks must hold against them.

Stakeholder bank – A bank which aims to achieve the greatest benefit for its stakeholders (e.g. local people and business, SMEs, or green enterprises), rather than seeking to maximise profits and returns to shareholders.

Suitability assessment (FCA) – The rules and process by which firms should determine whether a financial transaction or product is suitable, based (for example) on the risks and types of transactions involved and the impact they have on an investor's portfolio.

Universal bank – A bank combining retail, wholesale and investment banking activities in a single firm.

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At the beginning of 2017, Finance Innovation Lab held a series of three workshops to explore how policy and regulation can recognise and support financial business models that focus on social or environmental purpose. The workshops were designed and hosted by Chris Hewett, formerly Head of Advocate at the Lab. Participants were drawn from within the financial services sector, academia, civil society, consumer groups and policymakers.

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ABOUT THE FINANCE INNOVATION LAB

The Finance Innovation Lab incubates the people and the ideas that can change the financial system for the better. Our vision is a financial system that serves people and planet – one that's democratic, responsible and fair.

We work with innovators creating new, purpose-led models in finance, intrapreneurs seeking to change their organisations from the inside out, and regulators and policymakers shaping the rules of the game. Our work is rooted in an understanding of finance as a complex system: a network of relationships with a specific purpose, worldview and set of values. Our fundamental belief is that because humans created the financial system, humans can change it.

We were founded in 2009 as a joint project of WWF-UK and ICAEW (Institute of Chartered Accountants in England and Wales), and we are now a Registered Charity (number 1165269) and Company Limited by Guarantee (number 09380418).

For more information about our work, please visit **www.financeinnovationlab.org**.

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