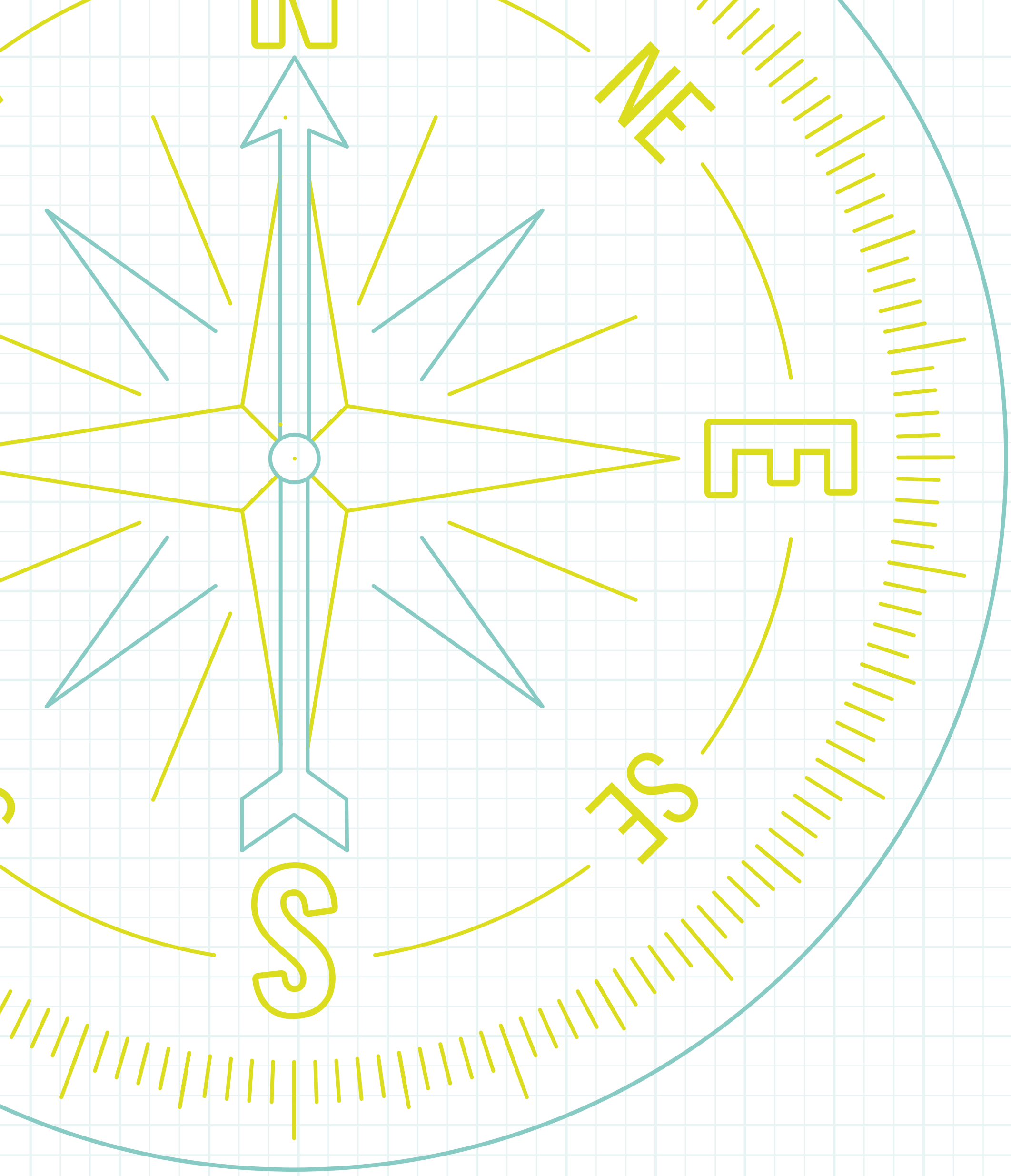


THE REGULATORY COMPASS

TOWARDS A PURPOSE-DRIVEN APPROACH TO FINANCIAL REGULATION

THE FINANCE INNOVATION LAB

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.

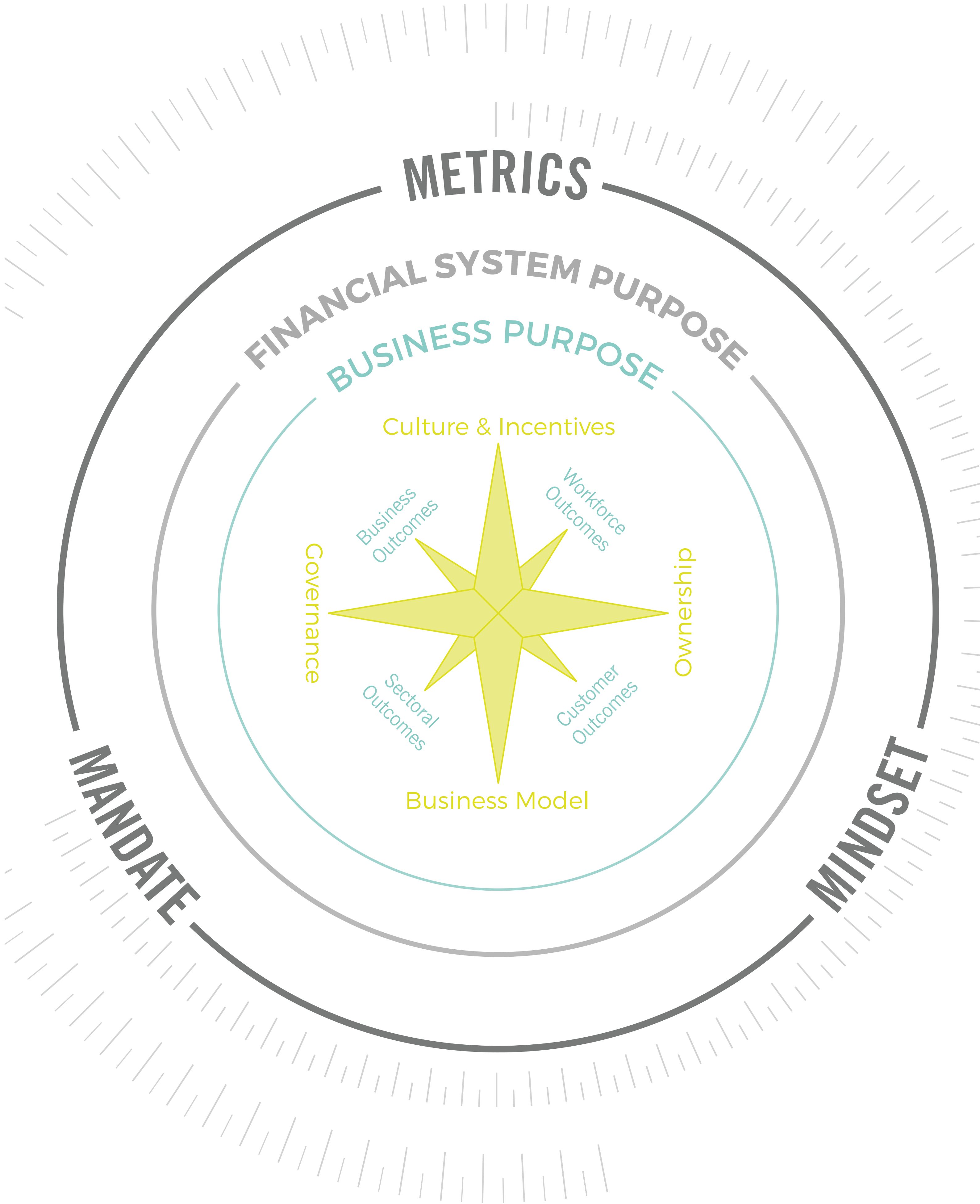
This shift demands democratic discussion. While regulators might reasonably argue that it is not their job to decide the purpose of the businesses they regulate, it *is* the job of politicians to ensure regulation is promoting the social outcomes that the public want to see.

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.


METRICS
FINANCIAL SYSTEM PURPOSE
BUSINESS PURPOSE
Culture & Incentives
Business Outcomes
Workforce Outcomes
Governance
Ownership
Sectoral Outcomes
Customer Outcomes
Business Model
MANDATE
MINDSET

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.

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**.