

FUTURE OF FINANCIAL SERVICES

SUBMISSION TO THE TREASURY SELECT COMMITTEE

FINANCE INNOVATION LAB, FEBRUARY 2021

The [Finance Innovation Lab](#) is a UK-based charity working to build a financial system that serves people and planet – one that’s democratic, sustainable, just and resilient. We welcome this inquiry, and have structured our submission to deal with several, but not all of the substantial issues raised by the Inquiry, focussing on issues we feel are centrally important for regulating financial services in the wake of Brexit.

1. The objectives of regulators

1. We believe that it is fundamentally important for the statutory objectives of the regulators to be updated to emphasise the social and environmental purpose of regulation. This is the key opportunity for the UK to be a true global leader. As our major 2018 report, *The Regulatory Compass*,¹ sets out, the current system tends to focus on minimising the risk of bad individual outcomes, such as consumer detriment or bank failure, rather than on promoting good system-wide outcomes, such as adequate financial provision for aging populations, or meeting key commitments such as the sustainable development goals.
2. Regulation can, as a result, be too narrowly focussed and pay insufficient attention to many of the most important outcomes that the financial system should be geared towards. This is not surprising as the current regulatory focus on system stability, market functioning and competition, integrity and consumer protection is quite narrow. As the climate crisis proves, for example, this narrow focus does not guarantee good overall outcomes for the economy, society and environment. A requirement for regulators to align regulation with net-zero emissions and the goals of the Paris Agreement would do this. The same argument can be made for other key social priorities such as financial exclusion, ending poverty or rebalancing the economy.
3. The global financial crisis of 2007-8 resulted in one welcome shift in this direction by recognising the importance of overall financial stability as a key objective for regulation. This inquiry provides an opportunity to push for the next logical steps to properly incorporate social and environmental purpose into the mandate of regulators to ensure they are guided by the outcomes the system is intended to produce, in the same way that they have responsibility for reducing systemic risk.
4. This shift to a system of regulation oriented to social and environmental purpose should be seen as an acceleration of existing trends and best practices. A recent study of the mandates of 135 central banks found that 12% already have explicit

¹ The Finance Innovation Lab, ‘The Regulatory Compass. Towards a Purpose-Driven Approach to Financial Regulation’ (London, 2018), <https://financeinnovationlab.org/wp-content/uploads/2018/06/Regulatory-Compass.pdf>.

sustainability mandates, and an additional 40% have a mandate to support government policy priorities, including sustainability goals.²

Division of responsibilities

6. The government's [proposed](#) delegation of “a very substantial level of policy responsibility” to regulators requires significant strengthening of the mechanisms by which regulators are held to account for meeting the purposes of regulation. The proposal that the regulators should only explain how they ‘have regard to’ these purposes is, we believe, too weak, particularly given the incomplete scope of their current overall objectives highlighted above.
7. The Financial Services Bill, as the first legislative example of the new approach, suggests some weaknesses with regards to how framework legislation treats social and environmental issues. For example, the main focus of the bill – a new prudential regime for investment firms – gives a very limited list of public policy issues that the FCA must ‘have regard to’ including the UK’s global share of the market.³ Social and environmental issues are not mentioned, nor are implications for the stability of the system as a whole.
8. We strongly believe that any suggestion that regulators should have an objective – even a secondary objective – relating to⁴ growth of the finance industry or its global ‘competitiveness’ should be rejected. Such proposals would introduce the dangerous idea that the growth of the financial sector should be seen as an end in itself, which would undermine the role it needs to play in contributing to the real economy and supporting social and environmental outcomes. Learning the lessons from the global financial crisis led to competitiveness being removed from the list of things that regulators should have regard to in 2012.
9. This is particularly important given the evidence that excessive growth of the financial sector is bad for the real economy.^{5,6} One estimate is that the financial sector reaches its optimal size when credit to the private sector is equivalent to around 90-100% of GDP,⁷ significantly lower than the UK average. The reasons for this are varied, but include the drain of skilled workers into the financial sector which can harm research and development,⁸ and the reduction in focus on the sector’s main aim of providing finance to support the sustainable development of the real economy. One estimate, for

² Simon Dikau and Ulrich Volz, ‘Central Bank Mandates, Sustainability Objectives and the Promotion of Green Finance’, *SOAS Department of Economics Working Paper*, no. No. 232 (January 2020): 1.

³ “the likely effect of the rules on the relative standing of the United Kingdom as a place for internationally active investment firms to be based or to carry on activities” - <https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162.pdf>

⁴ The Financial Markets and Services Act 2000 required the FSA to ‘have regard to’ “the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom.” This duty was not passed on to the FSA’s successors by the 2012 Financial Services Act.

⁵ Stephen G Cecchetti and Enisse Kharroubi, ‘Why Does Financial Sector Growth Crowd out Real Economic Growth?’, n.d., 31.

⁶ Jean-Louis Arcand, Enrico Berkes, and Ugo Panizza, ‘Too Much Finance?’ IMF Working Paper, no. WP 12/161 (2012), <https://www.imf.org/external/pubs/ft/wp/2012/wp12161.pdf>.

⁷ Arcand, Berkes, and Panizza.

⁸ Cecchetti and Kharroubi, ‘Why Does Financial Sector Growth Crowd out Real Economic Growth?’

example, is that bank lending to non-financial businesses is only 18% of total lending, and only 12% if the real estate sector is excluded.⁹

2. Regulating Purpose-driven institutions

10. We believe it is time to consider alternative models for regulating truly purpose-driven institutions, to recognise that they will require a different regulatory framework to allow these institutions to thrive and the diversity, resilience and competition within the system to improve. Purpose-driven financial institutions are those which embed social and environmental purpose into their mission, supported through their ownership, governance, culture and leadership. Unlike many other leading economies, where such organisations are a bedrock of the financial system, the UK's ecosystem of purpose-driven financial institutions is currently small.¹⁰
11. This would recognise that the mission, incentives and culture that are built into such institutions are a very powerful way of ensuring that regulatory objectives are met – often more powerful than direct regulation itself. For example, the mission of the nascent network of Mutual Banks is to serve and create value in the different regions and localities of the UK in a sustainable way, based on the German Sparkasse model, where their stability and prudence are underpinned by mutual supervision and joint liability. Another example are credit unions, which work not for profit, but for the interests of their members.¹¹

3. Accountability, Scrutiny and Public Engagement

Transparency

12. Central to all improvements to accountability, scrutiny and stakeholder participation will be improvements in transparency. Previous FCA research has examined the benefits of regulators demanding transparency by regulated entities,¹² but the focus should also be on the transparency of the regulators themselves. The main transparency principle – which is the rationale for UK freedom of information legislation – is that people have a right to know about the activities of public authorities, unless there is a good reason for them not to.

⁹ <https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/are-firms-underinvesting-and-if-so-why.pdf?la=en&hash=96588BB2D1AEEA1C13C0E2E159962B2B3E505DD4>

¹⁰ Gemma Bone-Dodds, 'Barriers to Growing the Purpose-Driven Banking Sector in the UK' (Finance Innovation Lab, 2020), <https://financeinnovationlab.org/wp-content/uploads/2020/12/Purpose-Driven-Finance-Finance-Innovation-Lab.pdf>.

¹¹ C. V. J. Simpson, *The German Sparkassen (Savings Banks): A Commentary and a Case Study* (London: Civitas, 2013).

¹² <https://www.fca.org.uk/publication/research/oxera-transparency-report.pdf>

13. Procedural transparency means ensuring that the process by which key decisions are made – on the design of new regulatory standards for example – should be transparent to the public. This means disseminating information which facilitates informed participation by interested stakeholders in decision-making in a timely fashion, and in a manner that ensures that those affected and interested stakeholders can effectively access and understand it.
14. The key to effective transparency of information is shifting to a presumption of disclosure. We agree with the Committee for Standards in Public Life that the regulators need to balance “the demands of their role and protecting sensitive information whilst also seeking to be as transparent as possible by not withholding information from the public.”¹³ A presumption of disclosure, which has been adopted as best practice by organisations including the World Bank,¹⁴ means that public institutions assume that they should publish information and documents about their activities, policies and practices and only withhold information under a limited regime of exceptions. The point is not that all information should be publicly available, but rather that there should be no assumption that it should be kept secret.

Stakeholder participation and public engagement

15. Effective accountability and legitimacy depend on stakeholder participation and public engagement. A recent thorough review of the evidence designed to provide a ‘Field guide’¹⁵ for regulators concluded that there were five key principles that regulators should follow to ensure effective engagement:
- *Engage and inform the public early and often.*
 - *Practice procedural fairness and neutrality in every public interaction.*
 - *Strive towards diversity of viewpoints and experience.*
 - *Choose methods that fit the purpose.* For example, to gain input and understanding of broader issues and affected citizens, deliberative approaches such as stakeholder groups, citizens panels and juries can be most effective.
 - *Embrace an ethic of experimentalism and evaluation.*
16. This is an area where the UK could show real leadership, particularly given the well documented problems at EU level. One key study of several thousand EU agency consultations found that the large majority of submissions received in public consultations come from regulated industries, and in 85% of cases non-business interests represent less than 10% of submissions.¹⁶
17. Providing resources for civil society groups representing citizens and social and environmental concerns to engage will be important. Public interest groups face issues

¹³ Great Britain and Committee on Standards in Public Life, *Striking the Balance: Upholding the Seven Principles of Public Life in Regulation Report.*, 2016, vii.

¹⁴ The World Bank, ‘Towards Greater Transparency Through Access to Information. The World Bank’s Disclosure Policy’ (Washington D.C.: World Bank Group, 2009), <http://documents1.worldbank.org/curated/en/241111468161347673/pdf/511890BR0REVIS101Official0Use0only1.pdf>.

¹⁵ Nash and Walters, ‘Public Engagement and Transparency in Regulation: A Field Guide to Regulatory Excellence’.

¹⁶ Beyers and Arras, ‘Who Feeds Information to Regulators?’

of capacity which can undermine their ability to participate. It is critical here to consider carefully how marginalised and under-represented groups can be supported to participate. This is particularly important given the evidence of how the financial system discriminates against people of colour, for example.¹⁷

18. As noted above, deliberative approaches such as stakeholder groups, citizens panels and juries are important for gaining understanding of broader social and environmental impacts of regulation. UK regulators are experimenting with these approaches, for example through the Bank of England's citizen's panels, and the FCA's Financial Services Consumer Panel. We welcome these moves and believe that they should be significantly expanded and improved. We note that the FCA's statutory panels are largely mechanisms for gaining input from industry, with only the Financial Services Consumer Panel (FSCP) for consumers, with limited powers.
19. One sensible proposal is that participation mechanisms such as stakeholder groups should be a maximum of 50% industry representatives and at least 50% representatives of citizens and public interests including social and environmental groups. This protects against the very real issue that stakeholder groups can end up merely replicating the views of the industry lobby.¹⁸ For example, only 13 out of 30 representatives in the EU's Securities and Markets Stakeholder Group are financial market participants.¹⁹
20. We believe the time is ripe for an independent external scrutiny function to be introduced, such as the proposal that there should be a Supervisory Board, to monitor the functioning of the regulators, consisting of stakeholders with no direct links to the regulators themselves or the firms they regulate.²⁰

Strengthening the Integrity Framework

We believe there is a need for a significant strengthening of the integrity framework which would include the following key areas:

Strengthened whistleblower protection

21. A 2016 report found that, while 93% of financial sector whistleblowers raised concerns with their employer in the first instance, 70% "were either victimised, dismissed or felt resignation was the only option open to them" and 33% of concerns were ignored.²¹ Recent evidence from the financial sector whistleblowing support

¹⁷ Omar Khan, 'The Colour of Money Report. How Racial Inequalities Obstruct a Fair and Resilient Economy' (Runnymede, 2020), <https://www.runnymedetrust.org/uploads/publications/pdfs/2020%20reports/The%20Colour%20of%20Money%20Report.pdf>.

¹⁸ Finance Watch, 'Finance Watch Blueprint on the European System of Financial Supervision', 2018, <https://www.finance-watch.org/wp-content/uploads/2018/08/blueprint-esfs-feb2018.pdf>.

¹⁹ <https://www.esma.europa.eu/about-esma/governance/smsg>

²⁰ See Lord Sikka's proposed amendment (no 120) to the Financial Services Bill for details on the role and mandate of such a board: <https://publications.parliament.uk/pa/bills/lbill/58-01/162/5801162-I.pdf>

²¹ Protect, 'Silence in the City 2', 2020, <https://s3-eu-west-1.amazonaws.com/public-concern-at-work/wp-content/uploads/images/2020/06/19125704/Protect-SILENCE-IN-THE-CITY-2-2020.pdf>.

organisation, Bank Confidential, suggests that the current system does not work in the way intended and actually puts whistleblowers at risk.²² Issues raised include: banks and the FCA interpreting confidentiality in a way which does not protect the whistleblowers' anonymity, putting them at risk or reprisals; a lack of support for whistleblowers from the FCA until very late in the process, and an underestimation of the number of whistleblowers and the difficulties they face.

An updating of the whistleblower framework - and its implementation - would be a key way to ensure the integrity of regulators and the system as a whole. This would mean closing the gap between best practice in institutional arrangements and the very poor experience of whistleblowers who use the system, by placing the anonymity and safety of whistleblowers as paramount. A whistleblowing organisation that is independent of the regulators could be established, to prevent any conflicts of interest and signal the importance given to supporting whistleblowers.²³

Effective 'revolving door' policies

The 'revolving door' is the practice of regulatory officials leaving their posts and being employed in the industries they regulate. An academic study of the relationship between US regulators and the investment banks they regulate found that it "generates inequality of influence between financial firms and creates economic distortions" and particularly benefited Goldman Sachs.²⁴ As the Committee on Standards in Public Life has said, "if not properly managed with adequate safeguards, the revolving door can be a serious threat to the regulator's essential integrity and independence."²⁵

The Committee found that policies in this area have tended to be unclear or insufficient. Among their recommendations are the need for "explicit prohibitions on disclosing confidential information, [and] restrictions on contact with the regulator."²⁶ In addition, expanding the 'cooling off' period between leaving a regulator and joining a regulated industry to at least one year would be an important step, if accompanied by effective enforcement mechanisms.

Proper lobbying policies

Given the need to understand the industries they are regulating, it is, of course, important for regulators to meet with industry representatives, but there are real dangers inherent if regulators and regulated firms develop very close relationships. It will be important to make sure that regulators consistently meet a broader range of stakeholders, not just industry representatives. The civil society groups we work with report that it can be difficult to get a meeting with relevant staff in regulators on issues that are critically important to their causes.

²² Bank Confidential, 'Whistleblowing Risks in Financial Services in the UK. Effectiveness of the Current Regime and the Role', 2020, <https://bankconfidential.com/wp-content/uploads/2020/06/BC-WB-REPORT.pdf>.

²³ Bank Confidential, 'Whistleblowing Risks in Financial Services in the UK. Effectiveness of the Current Regime and the Role'.

²⁴ Elise Brezis and Joël Cariolle, 'Financial Sector Regulation and the Revolving Door in US Commercial Banks', 2016, 53–76, https://doi.org/10.1007/978-3-319-44582-3_3.

²⁵ Great Britain and Committee on Standards in Public Life, *Striking the Balance*, v.

²⁶ Great Britain and Committee on Standards in Public Life, vi.

Lobbying transparency policies are an important part of this agenda, ensuring that the public is aware of who is meeting and influencing regulators and that the content of such meetings is publicly available. The UK's lobbying register currently only includes consultant lobbyists, not in-house lobbyists, meaning that a mere fraction of the lobbying that takes place is captured. For example, research in 2015 from Transparency International UK found 96 professional lobbying firms on the register, representing 360 clients, but 2,735 lobbyists meeting with UK Ministers in one quarter alone.²⁷ No changes have been made to lobbying legislation since then. This is notably out of step with other major Western democracies, including the US, Canada, and Ireland, and with other nations in the UK, such as Scotland.²⁸

Parliamentary scrutiny

The strengthening of parliamentary scrutiny over both the regulators and future changes in regulation will be important for the system to work effectively. This vital role that Parliament should play in providing democratic scrutiny will help to improve regulations and the work of regulators in maintaining and enforcing rules.

We support the proposal that a specialised Parliamentary committee be truly empowered to provide in depth scrutiny over financial services regulation and regulators. It will be vitally important for Parliament to ensure that this committee is not itself dominated by representatives with ties to the industry. Whether this is done by the existing Treasury Select Committee or through a new committee is obviously a decision for Parliament, but the crucial point we would like to emphasise is that such work requires significant resources, which will need to be provided if Parliamentary scrutiny is to work effectively.

²⁷ International Transparency, 'Accountable Influence. Bringing Lobbying out of the Shadows', 2015, https://www.transparency.org.uk/sites/default/files/pdf/publications/Accountable_Influence_Bringing_Lobbying_out_of_the_Shadows.pdf.

²⁸ See the US [Lobbying Disclosure Act Section 3\(7\) 1995](#), Canadian [Lobbying Act Section 7](#), Irish [Regulation of Lobbying Act Section 5\(2\)](#), and the [Lobbying \(Scotland\) Act 2016 Section 1](#) for more information.