HM Treasury Financial Services Regulation: Measuring Success – Call for Proposals

https://www.gov.uk/government/consultations/financial-services-regulation-measuring-success-call-for-proposals

Response by the Transparency Task Force, 4th July 2023

Q1: Do you agree with the government's approach to the exercise of the power of direction in Clause 37 of the FSM Bill?

We believe it is better that the Treasury should have this power than that it should not do so, though we think it is important that the Treasury gives equal weight to applying such a right in respect of the regulators' existing objectives as it does to its application to the new competitiveness and growth one.

However in general terms we believe that the mechanism of requiring the regulators themselves to report on the matters referred to is suboptimal, whether in their annual reports, on the specific direction of the Treasury or otherwise, since it amounts to an expectation that regulators should mark their own homework, which is obviously a fundamentally flawed approach to any kind of stewardship, oversight or governance.

A better alternative would be to amend the FSM Act so such reporting exercises are undertaken by the National Audit Office, being a highly credible, independent statutory body accustomed to assessing the effectiveness of public institutions.

Q2: What are the key metrics that the FCA and the PRA should publish in relation to their new secondary growth and competitiveness objectives?

The consultation paper acknowledges widespread concerns that the proposed competitiveness and growth objective could conflict with or undermine the regulators' existing objectives. The management theorist Peter Drucker is credited with the aphorism that ‘only what gets measured gets managed.’ It is therefore essential that no measurement metrics for the new objective are published without first ensuring that corresponding ones are in place and operating effectively for the regulators’ existing goals, because introducing an asymmetry in the evaluation of regulatory performance risks privileging the well-measured objectives at the expense of those evaluated poorly or not at all.

Therefore, and because we are certain that the Treasury will receive a great many highly detailed and well thought-through submissions focusing on how the regulators’ performance against the competitiveness and growth objective can be evaluated, we have chosen to concentrate on how their success in executing their other objectives might be measured. Thereafter, we circle back to the original question and consider metrics for competitiveness and growth.

Existing objectives - PRA

Safety and soundness of PRA-authorised persons - this can be measured by the number and financial consequences (quantum of resulting losses) caused by (i) insolvencies of dual-authorised firms and (ii) ‘near misses’ - firms that require regulatory interventions to avoid insolvency.

Protection for insurance policyholders - similar to the above, prevalence and negative externalities of insolvencies and near misses.

Competition in relevant markets - if competition is effective, profits earned, over the medium and long term, do not significantly exceed a reasonable return on capital. Therefore, the effectiveness of a competition regulator can be judged by assessing whether excess returns are being earned on a sustained basis in any niche within the markets they regulate. Also, in a competitive market, levels of customer satisfaction are high, so these too should be measured.

It is important to stress that it is high *margins* that are a sign of an absence of adequate competition, not high *profits*. If value for money and customer satisfaction are both very good, levels of transaction will also be high, resulting in high profits.

Existing objectives - FCA

Consumer protection - the FCA is an omniregulator for solo-regulated firms, which constitute approximately 97 percent of the firms it oversees. For these, the FCA should be judged on the same 'safety and soundness' metrics as we have suggested that the PRA is tested against in respect of dual-regulated ones.

For all firms regulated by the FCA, and for unauthorised firms improperly conducting regulated activities, further tests are required in relation to the efficacy of the FCA's conduct regulation. We suggest these mirror those proposed for the PRA in respect of insurers, focusing on the prevalence and financial consequences of misconduct occurring within and straddling the regulatory perimeter.

The FCA is itself concerned at the number of and growth in consumer investment scams, a phenomenon it has so far failed to slow, let alone halt or reverse. We believe that ongoing, independent measurement and reporting, and case-by-case root cause analysis, is required in order to establish why this problem is not being resolved. External reports into two high-profile examples, London Capital & Finance plc and The Connaught Income Fund Series 1, both identified extensive regulatory failure.

We propose that such reviews should be commissioned after every such crystallised loss is identified, including the many as yet unresolved legacy cases that have occurred in recent years, and that follow-up exercises are required to establish whether 'lessons learned' translated into 'changes fully implemented.' We suspect that the pace of change is depressingly slow, if it is happening at all. Where regulatory failure has caused consumer detriment, we believe there is a need to provide appropriate financial redress, in the pursuit of natural justice, to rebuild consumer confidence in the sector and for reasons of transparency and alignment of economic interests (only when the negative externalities of a statutory body's shortcomings are charged back to that entity are they likely to be addressed with the necessary urgency).

Promotion of competition - the same tests recommended for the PRA should be applied. It is crucial that this takes a sectoral approach - even if, for example, margins earned in the industry as a whole are reasonable, it may be the case that those achieved in some sectors are excessive and thus indicative of an absence of effective competition. We cite asset management as an example of a regulated sector in which margins are anomalously high and retail banking as one where margins are modest but customer satisfaction is generally very low. Both are the results of a shortfall in competition - the former on price, the latter on service and innovation.

Integrity of the UK financial system - the Financial Services Act 2012 sets out five tests for this objective[1]:

(a) its soundness, stability and resilience,
(b) its not being used for a purpose connected with financial crime,

[1] though the use of the word 'includes' indicates they are not exhaustive

(c) its not being affected by behaviour that amounts to market abuse,
(d) the orderly operation of the financial markets, and
(e) the transparency of the price formation process in those markets

As with other tests, prevalence and financial impact of breaches of these goals should be measured and reported, and significant cases should result in independent reviews to establish causation, with follow-up to ensure that any regulatory shortcomings have been remedied.

Measuring performance against the competitiveness and growth objective

We believe it is self-evident that a well-regulated industry in which company failures and scandals are rare, products are of high quality, consumer detriment is minimised, and competition operates effectively to drive high value for money and customer satisfaction, is one that will grow and prosper. Domestic consumers and firms will be keen to transact with it, as will overseas consumers, firms and industry counterparties. Foreign governments and regulators will feel confident providing frictionless, equivalence-based market access.

For these reasons, it could be argued that separate metrics are not needed for the competitiveness and growth objective: if the existing regulatory objectives are being measured, and delivered, the Treasury can be confident that the new one is also being achieved.

However, if HMT still feels that standalone measurement criteria are needed, we suggest the following ideas:

- An annual survey of UK consumers' and non-financial firms' perceptions of the financial services industry. Questions might include ones such as:
    - Is it trusted?
    - Does it deliver good value for money?
    - Do they feel good about transacting with it?
    - Do they consider it honest?
    - Have they been badly treated by it?
    - What is the one word that best describes it?[2]
- Similar surveys of overseas consumers, firms, regulators, governments and financial services professionals
- Measurement of lending by banks to consumers (in particular, mortgage funding to first-time buyers with little or no deposit available, a proxy for the sector's success in

[2] Research findings by the Bank of England using that question are illuminating: https://www.bankofengland.co.uk/speech/2016/the-great-divide

enabling people with limited savings to become homeowners) and to firms (especially SMEs and high-growth businesses, where lending is typically not secured on tangible assets);
- The availability of equity investment for start-ups and early-stage businesses, especially in high-growth sectors;
- Use of social and online news media monitoring for positive and negative commentary about the UK financial services sector

It is important to note that society's interests are best served by aggregate GDP growth, a different measure than the growth of the financial sector (albeit that the latter contributes toward the future). Care should therefore be taken not to design metrics that prioritise the interests of the City, ahead of those of the wider economy. For example, increasing margins for banks and other financial services firms is likely to be to the detriment of households (hence consumption and demand) and other sectors.

We note that Chapter 3 of the consultation document indicates that there seems to be significant concern at the Treasury, perhaps reflecting lobbying by firms, about the time taken by regulators to process authorisation applications.

Reiterating Paul Drucker's observation about links between measurement and management focus, we counsel against measuring the wrong things. Any regulator can approve applications quickly, by not looking too closely at them; the reasonably foreseeable consequences are likely to include insolvencies and misconduct. These are far more likely to harm the reputation and standing of the UK financial services industry than is any minor inconvenience caused to firms from having to plan ahead somewhat in their business planning and resourcing decisions.

There is a risk that industry lobbying focused on reducing the time taken by regulators to authorise firms and individuals by creating additional emphasis on the measurement of the turnaround time in Authorisations may be driven by a desire to lower the bar for approval - something that may serve the interests of bad-actor firms, but which would harm the prospects of the honest majority in the industry, and the UK and its citizens as a whole.

Instead, there should be focus on increasing the speed and efficacy with which the regulators, the FCA in particular, investigate, prevent, curtail and punish wrongdoing in the sector, because it is this that materially harms the reputation and standing of the UK financial services sector and thus the propensity of domestic consumers and firms and overseas firms, regulators and governments to trust and transact with it.

While we were compiling this response document, we became aware that the FCA had known for at least three years about credible allegations of improper behaviour by Crispin

Odey toward young female employees, recent adverse publicity about which has led to a high-profile fund being gated as it could not honour redemption requests, while others were suspended. Shortly thereafter, the company announced plans to wind itself down.

A particularly sinister aspect of the case is that it is alleged that the FCA knew about various attempts by other executives at Odey Asset Management to hold Crispin Odey to account for his alleged behaviours, and also about moves by the latter to thwart them, and that it backed the wrongdoer over those trying to stop him.

Had the regulator instead acted as soon as possible, confidence in Odey Asset Management Limited and its funds might have been retained, the standing of the regulator and hence of the City would have been enhanced instead of traduced, the gating and subsequent 'fire sales' of illiquid positions and the destruction of enterprise value in the fund management firm would have been avoided. Instead, the FCA itself now faces investigation.

If, as we suspect, it emerges that the regulator was, yet again, at best slow and reluctant to act and at worst engaged in protecting a perpetrator, we stress that it is only the bad actors in the global financial industry that find such 'accommodating' behaviour attractive; the honest majority are reluctant to accept the guilt by association that results from domiciling in a country where financial regulators appear serially unwilling or unable to identify and remove 'bad apples'.

Who should do the analysis?

Not the regulators: they cannot be expected to mark their own homework objectively. We are concerned that the FCA in particular currently faces a compelling incentive to underplay instances of misconduct that could be construed as having been caused in part by regulatory failure, because of anxiety to avoid adding to longstanding stakeholder concerns about its performance. If our evidence-based suspicions are true, it may be trapped in a vicious circle of inaction and cover-up that can be broken only by the external imposition of sufficient transparency and accountability that its leadership team has more to gain from prompt, decisive and assertive action than it has from the opposite.

As with our answer to Q1, we believe that the National Audit Office is the appropriate body to undertake ongoing and ad hoc evaluation of the regulators' performance against their objectives - the NAO has the perfect set of capabilities to do so.

The commissioning, oversight and follow-up to reports triggered by cases of consumer detriment likewise should not be entrusted to the regulators themselves, as happens currently. We have proposed that a consumer oversight body be created to improve regulatory governance and transparency. Proposals to amend the FSM Bill to incorporate this measure have been opposed by Government in both the Commons and the Lords. If it is currently outside the Overton window, we suggest that responsibility for such reports be passed to the NAO. Its Investigation into the British Steel Pension Scheme was well received by stakeholders, and consumer representatives would be happy to work with it on similar exercises in the future.

Next steps

If you would like to discuss any of the ideas proposed in this document, please contact Andy Agathangelou, Founder of Transparency Task Force, at this address: andy.agathangelou@transparencytaskforce.org

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