Financial Services Future Regulatory Framework Review:

BSA response to HMT's Proposals for Reform

February 2022

Building Societies Association

Introduction

The BSA is pleased to respond to the proposals in the Treasury's latest Command Paper, as we did to the Phase 1 and 2 consultations on the Future Regulatory Framework (FRF). We remain fully supportive both of the broad direction of travel, and, in general, of these specific proposals. Our comments in this response either suggest modest improvements to the Treasury's own proposals, or draw attention to areas which fall just outside the scope of the main FRF project but nevertheless very much form part of the overall picture of the regulation of financial services. Comments are set out in the same order as the Command Paper text, and we have concentrated on those topics of greatest interest or concern to our members. We also welcome the insights and contributions coming from other financial services trade associations and stakeholders, several of which we have drawn on in the suggestions below. No-one has a monopoly of wisdom.

We agree with the Economic Secretary's statement that *"the FRF Review provides a once-in-a-generation opportunity to ensure that, having left the EU, the government maintains a coherent, agile, and internationally-respected approach to financial services regulation that is right for the UK"* and that is why some of these other matters should not be overlooked. The BSA is ready to assist the Treasury with further engagement as the project proceeds. We also welcome the Treasury's assessment that the FRF proposals are consistent with the Government's other great regulatory project – BEIS's reform of the Framework for Better Regulation, drawing in turn on the TIGRR report. And we welcome the Treasury's separate consultation on updating the Building Societies Act, to which we will also respond shortly.

Executive Summary

We support the Chancellor's vision for financial services;

We reaffirm support for the FSMA 2000 model for rule-making, rather than retained EU law;

We call on Treasury to reaffirm the existing principle of consumer responsibility;

All regulation should embody parity of esteem and treatment for mutuals alongside PLCs;

A new "fail-fast" mechanism is needed to deal with evident policy mistakes – the Treasury's review option is insufficient;

Consultation, scrutiny and engagement are needed before, not after, major regulatory frameworks are agreed internationally;

The Ombudsman framework needs re-examination, with a view to a proper appeal mechanism, and application of regulatory principles to the FOS;

Robust cost-benefit analysis is essential, and should draw on best practice within Government and internationally.

Vision

We support the Chancellor's vision for ***"an open, green, and technologically advanced financial services sector that is globally competitive and acts in the interests of communities and citizens, creating jobs, supporting businesses, and powering growth across all of the UK"***.

BSA members, building societies and large credit unions, are mostly headquartered well away from London and the South East, and contribute naturally to their own regions and communities - where they may be the, or one of the, largest locally-based financial services providers. As mutuals, moreover, they have no barriers or distractions to acting in the interests of the citizens who are their members, as they do not have to maximise profit extraction for the benefit of the owners of capital. While separate from the main FRF project, we continue to urge the Treasury to complete the legislative updating of both the Credit Unions Act, as well as the Building Societies Act on which HMT is now consulting, so that all our members can play the fullest possible role in realising the Chancellor's vision.

Overall approach, objectives and principles

The BSA reaffirms its strong support for the proposed move, or return, to a comprehensive model based on the UK's own Financial Services and Markets Act 2000 (FSMA) with the architecture well-described at paragraph 1.13. We have advocated this approach since late 2016, and are pleased that it now commands overwhelming support from other stakeholders too.

We agree that some modification of the statutory objectives and regulatory principles is needed, and we are content with what is proposed in **Measures 1 and 2** (So, answers to **Q1 – Yes ; Q2 –Yes).** Regarding sustainability and net zero, we think it is preferable for these to be an explicit part of an objective or principle, so that regulators are not forced into contortions having to maintain that desired actions by firms are justified purely on risk or consumer detriment grounds where this may not strictly be true, at least in the short term.

At the same time, we call on the Treasury to **re-affirm the importance of the existing principle of consumer responsibility**[1], which some members think is at risk of being undermined and eroded by current discourses around duty of care, vulnerability and also by egregious outcomes from the Ombudsman mechanism.

The existing duty[2] on both PRA and FCA to take account of **differences between PLCs and mutuals** – added to FSMA as part of a main regulatory principle at the BSA's instigation through the Bank of England & Financial Services Act 2016 - has been a valuable check on the

[1] *the general principle that consumers should take responsibility for their decisions* - FSMA section 3B (1) (e)

[2] see FSMA section 3B (1) (f) : *the desirability where appropriate of each regulator exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (including different kinds of person such as mutual societies and other kinds of business organisation) subject to requirements imposed by or under this Act;*

unquestioning PLC-based assumptions that might otherwise hold sway in policy space. But this approach should be enhanced in two ways. First, strengthened to say that PRA or FCA rulemaking should afford and embody **parity of esteem and treatment** to mutual/cooperative models alongside PLCs and not be exclusively built on a PLC mind set with mutuals as a tick-box afterthought. Second, its scope should be widened. In particular it should apply to the Bank of England in certain other capacities, such as that of Resolution Authority, as it already does in its manifestation as the PRA.

Retained EU law

We support the repeal of most retained EU law in favour of FSMA rules. One useful by-product of this is that the resulting **FSMA rules are capable of waiver or modification** (always subject to the strict safeguards in FSMA section 138A) when circumstances so demand – which was not possible with EU law. We are content with the additional areas of rule-making competence now required by replacing some areas of retained EU law. And we recognise that a colossal task is involved, both for Treasury and PRA/FCA, and prioritisation will be needed.

We raise one small note of caution. Legislation, while inflexible, is (usually) precise and is to be interpreted independently by the courts. FCA rules (especially high level rules) are more broad-brush, and less precise, their interpretation (by FCA) less predictable. Moreover, they are subject to the over-arching principles which could (and have been in the past) used to "evolve" the requirements of the rules themselves - a form of "mission creep" if not outright revisionism. We need some sensible controls to check this tendency.

We have one other specific comment. Clearly, retained EU law took effect as at the point of exit, and does not reflect subsequent EU changes. Rightly, it is for the UK to decide whether or not to move in a similar, or different, direction. But there are a few areas where the EU has made small improvements, in the direction of proportionality for smaller, simpler firms, which have not been onshored. Regarding the CRR 2 changes for small and non-complex banks, these have generally been implemented separately by the PRA. But where the paper states[3] that *"the government would expect the regulators to initially replace the repealed provisions with rules that are similar to those which are currently in place"* we would encourage a presumption in favour of adopting (at the same time) any **sensible subsequent improvements to EU law** especially where these might **reduce or simplify obligations or burdens for smaller firms**. This would help avoid inadvertent outcomes where small UK firms remain under the same more burdensome obligations that were onshored, while EU firms get the benefit of these subsequent improvements.

Turning to the question of which areas of retained EU law to prioritise, we have one suggestion: where the subject matter is due for imminent policy change anyway, we can see merit in only having one set of changes – from the current retained EU law straight to the new/updated PRA rules including the policy changes. To illustrate, much of the text of retained CRR and CRD will need to be changed anyway to implement Basel 4. It is at least for consideration whether this would be more efficient for both PRA and firms if done as a single exercise rather than two successive sets of text changes.

[3] Executive Summary, paragraph 18 on page 7.

Accountability, scrutiny and engagement

We agree that existing mechanisms, but with suitable enhancements, remain broadly the right ones, and we are content with the Treasury's proposals, including on **Measures 3 and 4** , so far as they go. With these powers, statute will still give the regulators adequate and appropriate independence from Treasury, and avoid the pitfalls now identified in Germany[4] over the Wirecard scandal and the BaFin. But Measure 4, while desirable, on its own is not sufficient : we call also for a new **"fail-fast"** mechanism that can be triggered not by Treasury but by suitable bodies representing firms – analogous to the "super-complaint" procedure in other contexts. This mechanism would be for use in exceptional situations (only), where a rule or rules, having been made, has turned out not to work at all as expected or intended, but instead is producing harmful or perverse outcomes, and needs urgent amendment. We welcome insights on this matter from the other financial sector trade bodies.

We illustrate the need for such a mechanism with experience hitherto on certain aspects of EU regulation, which once passed, could not be amended even when proven to be ill-advised and counterproductive. Firms had to endure many years of bad outcomes until in some cases legislation was finally corrected by the EU as part of its ReFIT programme. But in the meantime the damage was done and set in stone. Examples might include application of COREP and FINREP to the UK; original application of much reporting and disclosure obligations to small and non-complex banks under CRR / CRD (now reversed by CRR 2); and applying the derivatives clearing and trading obligations under EMIR and MiFIR to small financial counterparties.

Regarding accountability to Parliament, and given the broader scope of regulatory activity now that major areas of EU competence gave been returned to the UK, we suggest that a specific new arrangement focused on FSMA regulation – possibly a joint committee of both Houses – might be best to examine the regulators' use of their FSMA powers, and the discharge of their FSMA responsibilities, separately from wider questions around financial services. Again, we welcome others' insights on this matter.

We draw attention to one specific area in which the mechanisms need to be made more effective, by ensuring that accountability, scrutiny and engagement all take place at an earlier stage of the policy process where **major regulatory frameworks are agreed at international fora such as the Basel Committee**. In several places in the text, the Government's commitment to international standards is mentioned, and we support this in general provided due account is taken of what is proportionate and appropriate for smaller, simpler, domestic firms.

The text speaks of the UK helping to shape and develop, keeping pace with, and promoting, international standards, and of the regulators conforming to, and aligning with those same standards. But these standards are not a given, rather they arise – as in the case of the Basel framework- by negotiation and eventual agreement among prudential authorities and central banks. Paragraph 25 stresses, quite correctly, that "*Any policymaking process risks being deficient if it does not draw sufficiently on the views, experience and expertise of those who may be impacted by regulation.*" But this cannot always be ensured by consulting on draft rules for the UK at the implementation stage. The example of "Basel 4" illustrates the problem.

What is generally referred to as Basel 4 was the final completion of the prudential repair exercise necessitated by the previous financial crisis, started as Basel 3. The Basel 4 framework was consulted on at high level by the Basel Committee, and the final result published in 2017. We are now expecting independent implementation by the UK, rather than having this

[4] ESMA identifies deficiencies in German supervision of Wirecard's financial reporting

mediated through EU law. But the UK appears to have committed itself *a priori* to full implementation of the Basel framework – so any subsequent consultation can only be effective on second order detailed matters where national regulators have some discretion. The substance of Basel 4 is not open to any meaningful consultation because the main outcome has been pre-decided.

In advancing this point, the BSA is not criticising the content of Basel 4 per se – some elements are advantageous to many of our members, and the process is anyway too far advanced. But there is a question of principle around its legitimacy which should be addressed ahead of any future or similar situations. The question is whether the accountability, scrutiny and engagement obligations under FSMA can be met, as it were, at one remove by the Basel Committee's processes – which is doubtful – or whether the PRA should be obligated to consult on its policy positions, with CBA, before sitting down in that Committee and making collective decisions that are then regarded as binding on the UK and not subject to further substantive consultation. Otherwise the Basel process appears to circumvent the FSMA safeguards as the key decisions are pushed upwards, behind closed doors, and above challenge, and subsequent "consultations" risk becoming a mere procedural exercise.

Statutory Panels

The BSA has made a significant commitment to the success of both existing sets of Panels, by nominating diverse and experienced practitioners when invited to do so. Most recently, the last deputy chair of the PRA's Practitioner Panel, and the retiring chair of the FCA's Small Business Practitioner Panel, have both been from BSA members. We continue to support the Panels concept and are content with the proposed measures.

Scope: Ombudsmen as quasi-regulators

(We have drawn this matter to the Treasury's attention separately and, while recognising that it is not a consequential of the move away from EU law, it is part of the FSMA architecture and so we include it here for completeness.)

The Financial Ombudsman Service (FOS), though established and designed as a mechanism for alternative dispute resolution (ADR), has come to function -through interaction with other conduct regulation- as a quasi-regulator in its own right, but without the necessary safeguards.

During the passage of FSMA in 1998-2000, one of the difficult issues was whether, and how, to make Ombudsman decisions final and binding on the firm, (though not binding on the complainant), and at the same time to exclude the jurisdiction of the courts (again, asymmetrically -as the complainant's recourse to the courts is unaffected – only the firm is denied recourse), so giving rise to a potential problem under the European Convention on Human Rights (ECHR).

Subsequent experience underlines two points as regards the FOS. Firstly the rubric that it makes decisions on a fair and reasonable basis can serve as an attempted justification for applying requirements retrospectively. The question is what, if anything can/should be done to ameliorate that? The second is the requirement contained in DISP that firms learn from FOS decisions. Denying firms any ability to challenge the decisions runs especially contrary to natural justice since those decisions can in turn give rise to a binding quasi-precedent applicable to a range of circumstances. The inability to challenge and appeal the effect of those decisions is striking when compared with the situation that applies under court jurisdiction. Perhaps this mechanism is in fact incompatible with Article 6 ECHR after all.

Twenty years on, it is timely to re-examine whether this situation remains appropriate (if indeed it ever was), whether a proper appeal mechanism should be introduced, and whether – given the quasi-regulatory effect Ombudsman rulings can develop – the FOS should also be, for instance, subject to the regulatory principles, including – explicitly – the principle of consumer responsibility.

Cost benefit analysis

We also fervently welcome and support the greater emphasis on cost benefit analysis, and transparency. And we would urge that the regulators' practice should be (and perhaps be required to be) informed by, and consistent with, evolving best practice on CBA across Government. CBA is not a static discipline – it is steadily evolving. We draw attention specifically to two existing general frameworks that can help (*mutatis mutandis*) drive best practice by both PRA and FCA. First, the Treasury's own Green Book[5]. Second, the (next stage of the) Better Regulation Framework[6] that is currently being enhanced by BEIS following on from the TIGRR[7] report. Both contain valuable ideas and tools that can be used or adapted – no need to re-invent the wheel!

We welcome the proposal for a statutory CBA Panel. We recognise the practical difficulties of giving this Panel a pre-publication role, and agree that this should only be adopted for substantial pieces of policy, where there is no immediate urgency. An example might be the long term policy changes brought in under successive Basel frameworks, which each have long gestation periods that could accommodate the Panel's involvement. Another might be the FCA's latest proposals on the consumer duty, where measures estimated to cost several £ billion have so far been justified without any quantification of the expected benefits.

We raise one technical point on the application of CBA in relation to the form and substance of regulatory outputs. Early in its separate existence, the PRA introduced the concept of the "supervisory statement" which appeared intended to fall outside the FSMA safeguards on rules and guidance on rules. This may also have had the intention of allowing PRA to express views on matters covered by EU Law (CRR) without appearing to infringe EU competence. But it also appeared to circumvent FSMA. This may not have been by design, and in fairness, recent practice by PRA has been to consult and do proper CBA on its proposed SS. But we think it should be clarified that any material regulatory outputs intended to have ongoing effect and with which firms are expected to comply are covered by the same obligations as in FSMA sections 138I and J and 139A, regardless of their formal presentation.

Touching on the public frameworks that the regulators will be called upon to publish and maintain, we also commend the use as appropriate of a well-established methodology - the Table of Eleven - to help better target regulatory interventions by assessing what form the optimal intervention should take; and the complex interactions between regulation, knowledge/awareness, incentives and enforcement; and by understanding that the required outcome is a particular set of circumstances or modified behaviours, not the creation of a new regulation per se. The Table of Eleven will particularly help with two related bugbears: extending or creating new regulation instead of addressing compliance with and enforcement of existing regulation; and "performative regulation" – regulation that is hailed as "making a statement" or "sending a message" but often with little focus on actual compliance or enforcement. The proliferation of performative regulation with little compliance or enforcement risks undermining the status of and effectiveness of good regulation as all regulation is thereby brought into disrepute.

[5] The Green Book: appraisal and evaluation in central government
[6] Reforming the framework for better regulation
[7] Taskforce on Innovation, Growth and Regulatory Reform

The Table of Eleven (T-11) is an analysis tool developed by the Ministry of Justice in the Netherlands in the 1990s to aid effective policy making and regulatory compliance. It was later cited by the OECD as widely influential across advanced economies in improving regulatory effectiveness. The distinctive insight of T-11 is the breakdown of the intermediate behavioural steps between the input (a piece of regulation) and the outcome constituted by a defined target state of affairs. Wider use of T-11 would reduce the temptation towards "performative regulation".

Activity specific regulatory principles

We can see the possible need for these but would again caution against too much proliferation of such principles, which can get in the way of clarity of purpose.

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £435 billion, and account for 23% of the UK mortgage market and 17% of the UK savings market.