Rebooting UK financial regulation for the post-Brexit world

Recognising the critical role that financial markets will play in the success of the UK's post-Brexit economy, the Treasury is now engaged in a review of the current financial regulatory framework. ***Anamika Ahir*** *and* ***Kevin R. James*** *propose that the Treasury pursue three key reforms to the current system: i) set regulators a new objective to "make markets effective"; ii) require regulators to collect and analyse the information the regime they implement demands; and iii) devise new accountability arrangements and international engagement practices to ensure that these changes happen.*

By permanently disrupting the UK's trading relationship with its largest trading partner, the immediate impact of Brexit was undoubtedly to reduce both the level and the growth rate of UK GDP. So, in order for Brexit to be an economic success, the government must exploit the legal and—just as importantly—the intellectual freedom that that follows from being free from the EU policymaking machine to devise new policies that will provide the foundation for a more dynamic, innovative, and prosperous economy going forward.

Recognising the critical role that financial markets will play in the success of the UK's post-Brexit economy, the Treasury is now engaged in a wide ranging review of the current financial regulatory framework. Inspired by this initiative and drawing upon the LSE's "Rebooting UK Financial Regulation for a Post-Brexit World" conference, we propose that the Treasury pursue three key reforms to the current system:

- First, set regulators a new objective, namely: make financial markets effective from the perspective of the real economy;
- Second, require regulators to implement an informationally consistent regime—that is: i) regulators must commit to collect and analyse the information that the regime they put into place demands; and ii) the regime must be designed to work effectively given the limited information that regulators can in practice collect and analyse; and
- Third, devise new accountability arrangements and international engagement practices to ensure that these changes materialise.

Consider each aspect of this reform program in turn.

Make financial markets effective

An extensive body of research undertaken over the last three decades finds that effective financial markets do significantly improve an economy's growth prospects (see here and here for surveys). Recent work also finds that effective financial markets can play an important macroprudential role by reducing crisis risk. Bringing about effective financial markets (while of course taking into account the costs of running those markets) should therefore be a principal objective of any financial regulatory regime.

Yet, no regulator in the UK has "make financial markets effective" as an objective.

The Financial Conduct Authority (FCA) interprets its "make markets work well" objective to (essentially) mean dealing with the risk of detriment that arises given markets *as they are*. So, the FCA's new Business Plan calls for putting into place data capabilities and policy mechanisms to deal with such risks "at pace". Yet, the plan does not create the research focus or analytical expertise required to identify and deal with the certain detriment that arises from the fact that markets as they are do not work as well *as they could* (which necessarily involves research-based counter-factual analysis).

The Bank of England, on the other hand, does have the research capabilities and analytical expertise that would make pursuing a market effectiveness objective feasible. However, its mandate to pursue financial stability is far too narrow to simply stretch it into a broader market effectiveness objective.

Consequently, just as there was a systemic risk underlap under the UK's pre-GFC regulatory arrangements in that no regulator was responsible for the stability of the financial system as a whole, we now have a market effectiveness underlap in which no regulator is responsible for the effectiveness of the financial system as a whole.

This market effectiveness underlap will not be easy to fix. The FCA could take on this task but doing so would require a massive change in organisational culture, capabilities, and approach. Alternatively, the Bank of England's mandate and powers could be expanded once again. However, the Bank is already an extremely powerful institution, and this change would make it more powerful still. Also, it would be challenging for the Bank's senior management to add yet another critical but conceptually very distinct task to their already very diverse portfolio of important responsibilities. Creating a new regulator to deal with market effectiveness (perhaps along the lines of the Financial Policy Committee with support) would solve some of these problems but would obviously raise coordination issues.

So, while the solution to this critical market effectiveness underlap problem is not yet clear, we urge the Treasury to identify market effectiveness as a key issue and to commit to exploring how to solve it.

An informationally consistent regime

The regime that a regulator puts into place must be informationally consistent to work properly. That is, the regulator must have the information it needs to know if possible polices are likely to work ex ante and if actual policies do work ex post. Otherwise, the regulator simply cannot choose between policy options rationally.

Astonishingly, as Peter Andrews' examination of conduct regulation shows, key parts of the UK's regime are not informationally consistent.

Consider conduct regulation. Poor conduct manifests itself in the form of investors purchasing unsuitable products and/or products with a poor price/performance relationship. Yet, the FCA does not now generally track either suitability or the price/performance characteristics of retail financial products (mortgages are a partial exception). Instead, the FCA tracks very indirect proxies of conduct, such as risks, compliance infractions by firms, and the state of firm systems and controls. While these indirect proxies are easy to measure, the repeated failures of the UK's conduct regime shows that this approach is not very effective.

We acknowledge that measuring suitability and the price/performance relationship of retail investment products is an extremely difficult and perhaps even an unfeasible task (at least till now). If this is the case, though, the right response is not to ignore its importance and carry on with an underperforming regime but to instead redesign the regime such that it works well with the information that the regulator can in practice collect and analyse. In the retail space, for example, that may mean building upon the Treasury's CAT Standards scheme to reduce the range and complexity of retail investment products (see a proposal along these lines here).

The FCA is now aiming to exploit advances in big data and analytics to put conduct regulation on a sounder foundation. But the fact that conduct regulation has not been on a sound foundation to date suggests that something has gone seriously wrong.

Of course, it is probably impossible and certainly undesirable for the Treasury to micro-manage the regulators in a manner that forces them to act in an informationally consistent manner. The question of whether regulators know what they need to know in order to operate their regimes successfully should arise in the context of ongoing discussions between the regulators and Treasury/Parliament (principally the Treasury Select Committee). The fact that we are where we are suggests that the government's current approach to regulatory accountability has not delivered in significant respects. A new approach is needed.

New accountability arrangements and international engagement practices

The Treasury's current approach to holding regulators to account consists of informal but regular consultation underpinned by a series of formal "have regards" that regulators must take into consideration when making policy. Mindful of the failures of the current approach, the Treasury aims to strengthen the accountability system by making consultation more formal (regulators will need to consult with the Treasury before making policy) and strengthening the "have regards". However, "more of the same" is unlikely to solve this accountability problem (as the Treasury Select Committee realises) for two reasons.

First, imposing "have regards" upon the regulators is an extremely ineffective way of trying to guide the regulators to do the right thing. Policymaking is complex, so—as Julia Black observes—accountability via "have regards" leads to a long list of confusing and possibly conflicting decision-making criteria. The PRA, for example, must "have regard" to over 20 different factors when making policy. This cannot be the foundation for a good policy process.

More importantly, both the "have regards" and the enhanced consultation requirements operate at the level of individual policies, but this is the wrong level for enforcing proper accountability. Any market outcome that matters for the real economy arises from a web of regulations, supervision, and guidance, rather than from any single policy. It can easily be the case that every single policy that affects an important market outcome can (kind of) make sense in isolation while the outcome of the ensemble is wholly unsatisfactory.

Accountability should therefore be at the market outcome level, which means that regulators should be required to account for their strategies to produce key market outcomes. To illustrate, take the core outcome of the FCA's consumer protection outcome, namely, investors should invest in suitable products. The Treasury could ask the FCA questions such as:

- What is your overall plan to ensure that investors invest in suitable products?
- What research/consumer trials have you undertaken to suggest that this plan will work?
- How will you measure suitability and track the proportion of investors with suitable products over time?
- How will you know if your plan is working (ex post reviews, etc.)?

Obviously, holding regulators to account in the substantive manner we envision here will not be a simple tick-box exercise, and the Treasury and the Treasury Select Committee will need to considerably enhance their ability to engage with the regulators to make this happen. This will undoubtedly be difficult to do. But the history of regulatory shortcomings shows that the regulatory system will not function properly unless the government can hold to account the regulators who exercise such vast delegated powers on its behalf.

A similar set of issues arises in connection with the Treasury's relationships with international regulatory bodies. As Niamh Moloney points out, organisations such as the International Organization of Security Commissions (IOSCO), the International Financial Reporting Standards Foundation, the Basel Committee, and the EU's regulatory bodies can play a crucial role in reducing frictions that could adversely affect the UK's ability to serve as an international financial hub. As owners of the UK's financial regulatory regime, the Treasury will need the expertise required to both advance the UK's approach to financial regulation on a strategic level and to hold the regulators to account for their international engagements on a technocratic level.

Conclusion

Absent economic reforms that exploit the legal and intellectual freedom that Brexit creates, Brexit will mean that the UK faces permanently diminished economic prospects. If there was ever a situation that called for "bold, persistent experimentation" to correct the faults in our economic system, this is it.

Our reading of the economic and legal evidence suggests that: i) a serious effort at financial regulatory reform along the lines we discuss above will significantly increase the effectiveness of UK financial markets; and that ii) this increase in financial market effectiveness will in turn lead to a substantial improvement in UK economic performance.

Of course, we could be wrong. That said, there is little downside to improving the effectiveness of financial regulation even if doing so is less beneficial than we expect. And, the cost of this regulatory reform moonshot amounts to little more than rounding error on the cost of other options that the government is considering to improve the UK's growth prospects. So, all in all, rolling the dice on financial market regulatory reform is just the sort of bold experimentation that Brexit demands.

But any reform effort will succeed only if it is indeed bold. We therefore urge the Treasury to take the bull by the horns and deliver the reforms the UK needs.

Who dares wins.

♣♣♣

Notes:

- *Authors' disclaimer: Views or opinions expressed in this blog are personal and do not represent those of people, institutions, or organizations that the authors may be associated with in a professional or personal capacity.*
- *This blog post expresses the views of its author(s), and do not necessarily represent those of LSE Business Review or the London School of Economics.*
-
- *When you leave a comment, you're agreeing to our Comment Policy*

Date originally posted: 2021-08-04

Permalink: https://blogs.lse.ac.uk/businessreview/2021/08/04/rebooting-uk-financial-regulation-for-the-post-brexit-world/

Blog homepage: https://blogs.lse.ac.uk/businessreview/