The UK financial services framework of the future – the first proposals for reform

Almost a year after the Brexit transition period ended, the UK government is beginning to refine its thinking on how the financial services framework should evolve in a post-Brexit world in order to ensure it is fit for purpose and helps the UK regain its position as the world's leading international financial centre.

In his speech at Mansion House on 1 July 2021, the Chancellor built upon the vision originally announced in his statement to the House of Commons on the future of financial services back in November 2020 stating that:

> "We need a plan for our most global industry – financial services – which sharpens our competitive advantage while acting in the interests of our citizens and communities."

The Future Regulatory Framework (FRF) Review will play a critical role in delivering the vision articulated by the Chancellor and the consultation paper published on 9 November 2021 (the **Consultation**), makes a series of proposals to deliver the intended outcomes of the FRF Review, building on the strengths of the UK's existing framework.

Background

The FRF Review was announced by the then Chancellor of the Exchequer at Mansion House on 20 June 2019, with the objective of reviewing the UK's financial services regulatory framework to ensure it is fit for the future. The FRF Review represents an important opportunity, following Brexit, to ensure that the financial services regulatory framework reflects the UK's new position and supports delivery of the government's vision for the financial services sector.

In his speech at Mansion House on 1 July 2021, the Chancellor set out the government'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 across the UK. Published alongside the Chancellor's Mansion House speech was a policy document entitled "A new chapter for financial services". This explains that the government's vision is shaped around four key themes:

– an open and global financial hub;

– a sector at the forefront of technology and innovation;

– a world-leader in green finance; and

– a competitive marketplace promoting effective use of capital.

The FRF Review is a key pillar of delivering this vision, as it considers the UK's overall approach to financial services regulation. It also complements a number of further reviews and initiatives that are underway on specific areas of financial services regulation intended to support and encourage growth in the UK as a global financial services hub, whilst maintaining high regulatory standards. These include the government's reviews looking into the prudential regime for insurers, wholesale capital markets and the UK funds regime.

The government published an initial consultation looking at how to adapt the regulatory approach to meet the specific needs of the UK back in October 2020. The Consultation sets out the government's response to the feedback received on that previous consultation and sets out a series of proposals for how the government intends to take forward its approach to the FRF Review. The Consultation runs until February 2022.

Draft proposals

The Consultation sets out a series of proposals that the governments intends to take forward as part of the FRF Review, including:

– the changes needed to the regulators' statutory objectives and regulatory principles to ensure the government's priorities for the sector are fully reflected across the breadth of the regulators' responsibilities;

– the proposals for ensuring that accountability, scrutiny and engagement arrangements with HM Treasury, Parliament, and stakeholders are appropriate given the regulators' responsibilities; and

– the proposed approach to transferring responsibility for designing and implementing the direct requirements that apply to firms in certain areas of retained EU law to the regulators within a system established by government and Parliament.

We consider each of these in more detail below.

Objectives and principles

Each of the FCA and PRA has primary and secondary statutory objectives, and is subject to eight regulatory principles to which each must have regard when exercising their functions. The government considers that the regulators' current objectives are each important in helping to ensure that the financial services sector is delivering for businesses and consumers across the UK. Similarly, the government considers that the eight existing regulatory principles broadly capture the key considerations the regulators should take into account when carrying out their general functions. However, recognising that the financial services sector can help drive growth in the wider economy, the government intends to provide for a greater focus on growth and international competitiveness through the introduction of new secondary objectives for the PRA and the FCA to facilitate the long-term growth of the international competitiveness of the UK economy, including the financial services sector. The government will also require both regulators to report on their performance against their growth and competitiveness objective on an annual basis.

The new objectives have been widely flagged and are as expected, but are more symbolic than substantive. It is difficult to see in practice how they will meaningfully influence the behaviour of the regulators. Practical experience suggests that each regulator has plenty of cover from its primary objectives: political influence in regulation plays a greater role than secondary objectives.

In addition to the above, the government also considers there to be an opportunity to further strengthen the UK's regulatory regime relating to climate by embedding climate change into the regulatory principles. Alongside the new secondary objective to facilitate growth and international competitiveness, the government therefore proposes to amend the existing regulatory principles to be clear that such growth should occur in a sustainable way that is consistent with the government's commitment to achieve a net zero economy by 2050.

Whilst this climate change regulatory principle looks cutting-edge, it is very unclear from the paper what the regulators would be expected to do to deliver on it. One would hope for greater detail – the fear otherwise being that we see unpredictable measures that are not joined up with wider changes, and which could have damaging effects on markets or consumers (for example, if the FCA were to consider the principle required it to use regulation to direct investment away from non-green assets, which cause (or exacerbate) a 'green bubble'). The regulators' role here should be an integral part of a wider plan.

Relationship with HM Treasury

The government sets out proposals for strengthening the existing mechanisms underpinning the regulators' relationship with HM Treasury. The consultation sets out an overview of the responses provided to the previous consultation and outlines the considerations the government considers key in proposing changes to accountability – for example:

– through increasing the frequency of recommendation letters; and

– introducing a new power for HM Treasury to be able to require the regulators to review their rules where the government considers that it is in the public interest.

The government also considers that there is now a case for ensuring (through the introduction of a new accountability mechanism) that the regulators consider the potential impacts on deference arrangements and assess compliance with relevant trade agreements as a matter of course when making rules and when setting general approaches on supervision, where relevant and proportionate.

Accountability to Parliament

Chapter 5 sets out the role of Parliament in the scrutiny of the regulators under the UK's regulatory framework and the government's proposals to strengthen the existing mechanisms which Parliament uses to hold the regulators to account and scrutinise their work. The government's view is that the existing Parliamentary scrutiny mechanisms – including the targeted scrutiny provided by select committees – are appropriate and flexible and should continue to be the principal ways in which Parliament holds the regulators to account.

As a result, the government's proposals aim to ensure that select committees continue to have access to the information needed to best scrutinise the work of the regulators and set expectations for how the regulators must respond to any representations from Parliamentary committees. Two proposals are being consulted on, namely:

– a new statutory requirement for the PRA and the FCA to notify the relevant Parliamentary committee when they publish a consultation on any matter; and

– the introduction of a new statutory requirement for the regulators to respond in writing to formal responses to statutory consultations from Parliamentary committees

Stakeholder engagement and the policymaking process

The government recognises the importance of stakeholder engagement in the regulatory policymaking process and in trying to ensure this operates effectively, is focusing on addressing concerns about aspects of the operation of the regulators' statutory panels, a lack of clarity on the regulators' approach to reviewing their rules, and the rigour, scope, and external challenge of the regulators' cost benefit analysis (**CBA**) process.

In the context of strengthening the role of statutory panels, the government intends to:

– place the FCA's Listing Authority Advisory Panel and the PRA Practitioner Panel's insurance sub-committee on a statutory footing;

– introduce a new statutory requirement for the regulators to publish information on their engagement with the panels; and

– introduce a new statutory requirement for the regulators to maintain a statement on appointment processes for the panels.

A number of respondents to the consultation last year raised significant concerns around the CBA process including when and how regulators decide to conduct CBA. The government is therefore keen to increase transparency and improve consistency across the CBA process. In order to achieve this, two measures are proposed:

– the introduction of a new statutory requirement for the regulators to publish and maintain a public version of their framework for conducting CBA; and

– the creation of a new statutory panel to support the development of regulators' approach to CBA.

Whilst the proposals will be well received, many would acknowledge that CBA is almost inevitably an art that pretends to be a science. Whilst clearly the industry would welcome better (any) CBA, it is often a fool's errand trying to quantify indirect costs that arise from regulatory change.

The final piece on the policymaking process that the government is seeking to improve relates to the review of policy interventions following implementation to ensure they had the desired effect and remain fit for purpose. Whilst the regulators do review their regulatory policies and the FCA publishes its framework for ex post impact evaluation, there are no public frameworks outlining other forms of review, such as monitoring. The Consultation is therefore seeking view on a new statutory requirement for the PRA and the FCA to publish and maintain a framework for how they conduct rule reviews.

A comprehensive FSMA model

Chapter 7 of the consultation paper looks at changes that are deemed necessary to move to a "comprehensive" FSMA model of regulation in areas that are currently covered by retained EU law.

Revoking retained EU law

As has been widely publicised over the last few months, in order to move to a comprehensive FSMA model of financial services regulation, the government intends to ensure that the financial services regulators have the ability to determine the direct regulatory requirements which are currently set out in retained EU law. It will therefore be necessary to repeal a significant amount of retained EU law to achieve this transfer.

The Consultation is looking at the impact of introducing a power to repeal parts of retained EU law (including the direct regulatory requirements that apply to firms) and concurrently replacing it with the appropriate regulator rules to avoid any gap in regulation. At a minimum, the government proposes that the ability to repeal retained EU law should extend to:

– all EU Regulations and decisions related to financial services which are retained EU law by virtue of section three of the EUWA;

– all statutory instruments made under the European Union Communities Act 1972 (ECA) which are relevant to financial services, and statutory instruments made under other empowerments which implemented EU obligations relating to financial services;

– all EUWA statutory instruments relevant to financial services; and

– all instruments made under specific empowerments contained in legislation of the type specified above.

It is intended that this process will take place over a number of years. The consultation indicates that both HM Treasury and the regulators will be involved in the policy issues around the revocation of retained law, which seems rather counter to the principle that the regulators, not the government, are meant to decide what to do with it.

In addition to the above, the government is also looking at revoking and amending retained EU law for purposes other than regulator rulemaking, especially where such law has historically provided the wider "regulatory architecture" that establishes a particular regime. The government notes that in some instances, it will require the ability to amend retained EU law directly in order to bring it into alignment with the FSMA framework and ensure that it can be kept up to date. As referenced above, it is well understood that the process will be a significant undertaking, and will take a number of years. Following the delivery of the powers proposed in chapter 7, a subsequent programme of secondary legislation will be required to give effect to the changes thereby providing Parliament with the opportunity to scrutinise the legislation which enables these changes, and subsequently, the statutory instruments giving effect to these changes.

Designated Activities Regime (DAR)

Many activities covered by retained EU law are also regulated activities under the Financial Services and Markets Act (Regulated Activities) Order 2001 (RAO). This means that the full FSMA framework already applies, including a general rulemaking power for PRA and the FCA in relation to authorised persons, unless a firm is exempt. However, there are many pieces of retained EU law which set the rules for a kind of activity, product, or conduct which are not FSMA regulated activities, and which apply to a broader range of entities than FSMA authorised persons. As a result, the general rulemaking powers of the PRA and the FCA in relation to authorised persons does not currently apply – examples cited in the Consultation include the short selling regulation and margin rules.

To ensure that these activities can continue to be regulated in a proportionate manner that is consistent with the existing FSMA framework, the government proposes to create a new DAR. The DAR will be a mechanism to allow the regulation of certain activities outside the FSMA authorisation process. This will mirror the existing approach for the RAO (although the DAR would be subject to a more limited rulemaking power than the general rulemaking powers in relation to authorised persons). The government does not intend to restrict the DAR to retained EU law only. It is seeking powers to be able to designate, in the future, other activities where necessary.

Financial Market Infrastructure (FMI)

The government is keen to ensure that the regulators are given sufficient rulemaking powers to enable them to make rules replacing the direct regulatory requirements which currently apply to FMIs under retained EU law – for example, in relation to recognised investment exchanges (where the FCA already has specific rule-making powers and a recognition regime), the government will ensure that the FCA has the necessary additional powers to replace the direct regulatory requirements in retained EU law.

In relation to entities related to payments and e-money, the government states that where existing powers are not sufficient, it will ensure that they have the necessary additional powers to replace the direct regulatory requirements in retained EU law.

Central counterparties (CCPs) and central securities depositories (CSDs)

The government is also considering granting the BoE a general rulemaking power in relation to CCPs and CSDs so that it can set appropriate rules for these firms. Such a new power would be accompanied by appropriate enhancements or additions to the BoE's current framework of objectives and accountability in relation to the regulation and supervision of these entities.

Activity specific 'have regards' and obligations

The final proposal that the government is consulting on is the introduction of the ability for it to establish activity-specific 'have regards' and obligations which the regulators must consider when exercising their rules and rule-making powers in specific areas of regulation. In relation to the 'have regard' concept, we have already seen this in the context of the Financial Services Act 2021 and the consideration the PRA must 'have regard' to when making its rules to implement Basel standards.

Practical comment

The proposals set out in the consultation paper are largely as expected and mirror much of what the industry has been calling for. It is clearly crucial that the UK's regulatory system is agile and dynamic – whilst maintaining high standards – in order to facilitate the long-term growth and international competitiveness of the UK economy.

The on-the-ground question for firms is likely to be "what's going to change, when, and what do I need to do". The paper largely sets out how the framework will change, but fails to set out a roadmap for that process and the endpoint – particularly in terms of substantive policy change – remains unclear. The financial services industry continues to face of barrage a regulatory change flowing from G20 commitments, for example, in relation revised prudential standards and sustainability initiatives. Market participants are also trying to grapple with how they manage divergence between the UK and EU across entities that will be impacted by both regimes. The government should not underestimate the potential for even greater divergence from the original EU position (even if unintended) when the proposed reforms begin to apply and this will drive additional implementation challenges and system changes. For the UK financial services sector to be truly competitive and grow in the way envisaged by the government, careful (and transparent) management of the process and timetable for reform will be required.

Contacts

Bob Penn
Partner – London
Tel +44 20 3088 2582
bob.penn@allenovery.com

Damian Carolan
Partner – London
Tel +44 20 3088 2495
damian.carolan@allenovery.com

Nick Bradbury
Partner – London
Tel +44 20 3088 3279
nick.bradbury@allenovery.com

Kate Sumpter
Partner – London
Tel +44 20 3088 2054
kate.sumpter@allenovery.com

Ben Regnard-Weinrabe
Partner – London
Tel +44 20 3088 3207
ben.regnard-weinrabe@allenovery.com

Nikki Johnstone
Partner – London
Tel +44 20 3088 2325
nikki.johnstone@allenovery.com

Kirsty Taylor
PSL Counsel – London
Tel +44 20 3088 3246
kirsty.taylor@allenovery.com

Oonagh Harrison
PSL Counsel – London
Tel +44 20 3088 3255
oonagh.harrison@allenovery.com

UK
CS2111_CDD-66549_ADD-98343