That depends, Minister

Paul Wallace examines the government's plans to rewrite financial regulation post-Brexit and questions whether eroding financial regulators' independence is a good idea

Free of the constraints of EU membership, the government is starting to rewrite the rule-books that govern the City. The idea is that so-called cumbersome legislation drafted in Brussels can be revised to better fit the distinctive features of the UK financial system. Those include London's longstanding role as a global banking hub. Ministers are keen to seize the opportunity. But are they neglecting the painful lessons of recent history in using regulation as a tool to boost the City?

In 2008, the global financial crisis nearly toppled the British banking system. That experience led to much tougher regulation. Caution became the watchword for supervisors who had learned through bitter experience that unfettered markets and meretricious innovations can undermine financial stability. The coalition government led by David Cameron overhauled the regulatory regime, abolishing the Financial Services Authority (FSA) and replacing it with two regulators. The Bank of England's Prudential Regulation Authority (PRA) was put in charge of supervising banks and insurers. The Financial Conduct Authority (FCA) was set up to oversee markets more generally, with around 50,000 firms now subject to its strictures.

These two authorities lie at the heart of the government's proposals for regulatory reforms, although the Bank of England is also involved because of its oversight of clearing houses. Ministers plan to shift a vast array of rules inherited from the EU off the statute book. They are to be spring-cleaned by regulators – reducing their complexity where possible and tailoring them better for financial firms operating in the UK. Or so the thinking goes.

Sliding doors

A year ago, Rishi Sunak, the then chancellor, set out the direction of travel he wanted for the City in his Mansion House speech. "We will pursue high quality regulation because it leads to better markets and will strongly resist its politicisation," he declared. That "high quality" is rooted in the independence of UK regulators, making the British approach "internationally respected", according to John Glen, the then City Minister and Treasury Economic Secretary.

But even as Sunak and Glen insisted that the UK would strive to retain high standards and regulatory independence, they have pressed for changes that may take the nation in the opposite direction. In a recent report, MPs on the Treasury Select Committee sounded the alarm. "The Treasury should respect the principle of regulatory independence and must not pressure the regulators to weaken or water down regulatory standards," they said in June.

At present, the PRA's overarching objective is that the 1,500 firms it supervises are safe and sound. A further goal with respect to insurers is to secure the protection of policyholders. The PRA also has a secondary aim – to encourage competition among the firms under its watch.

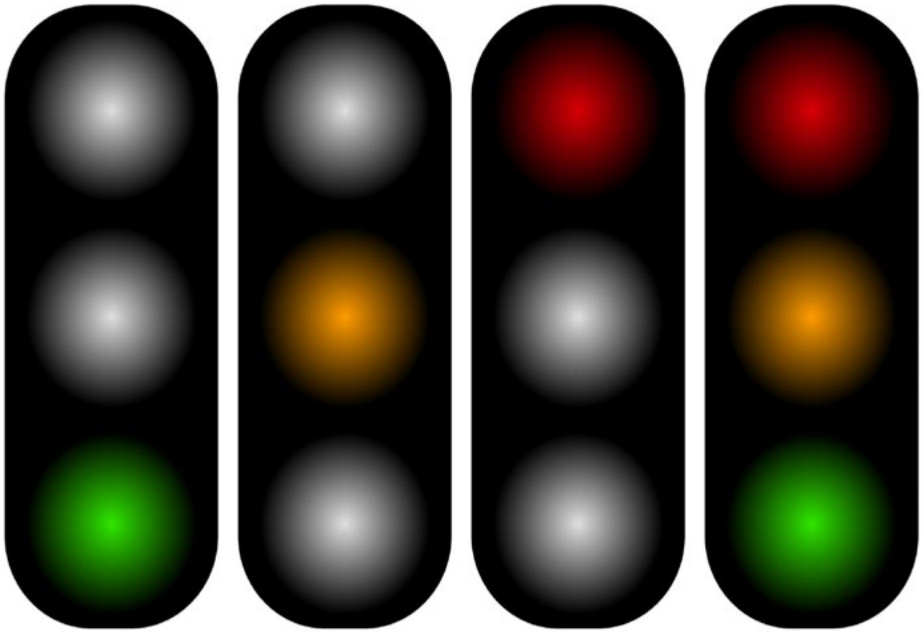
> *There are concerns that the changes will strengthen the hand of financial firms pressing for laxer rules*

The FCA's strategic objective is to ensure that the markets it oversees function well. Its operational aims are threefold: ensuring appropriate protection of consumers; promoting competition in the interest of consumers; and protecting the integrity of the UK financial system.

The two regulators will now be set a secondary objective, of supporting the growth and international competitiveness of the financial sector, as well as the broader economy. Adding bite to the new goal, they will have to report every year on their performance against it. The Treasury claims this can be done in a way that "does not detract" from their current main objectives, which prioritise prudence and the protection of consumers.

That may be the intention but the additional objective will strengthen the hand of financial firms pressing for laxer rules. Charles Randell, who stepped down in May as chair of the FCA (a year early in his five-year term), told MPs on the Treasury Select Committee in December there was a risk that the regulator would get "a large amount of lobbying input saying, 'This rule does not exist in this country, that country or the other country and, therefore, you should not do it'."

He added pointedly: "We are not regulating for consumers in Zurich or Singapore. We are regulating for consumers in Totnes or Tottenham."



The shadow of the FSA hangs over this decision to make competitiveness a goal. Under the Financial Services and Markets Act 2000, the new 'super-regulator' (already in operation since 1997) was given four objectives: market confidence, public awareness, protection of consumers and reduction of financial crime. There were seven principles to which it should "have regard", one of which was "the international character of financial services and markets and the desirability of maintaining the competitive position of the United Kingdom". In practice, that particular "have regard" opened the door for bankers to push for the light-touch regulation that contributed to the severity of the financial crisis in the UK.

> *There is always the risk that 'exceptional circumstances' turn out to be suprisingly frequent*

Milking the cash cow

Then, as now, the political background mattered. For Tony Blair's Labour government, the City was a cash cow, yielding rich revenues to finance higher spending on public services. In his Mansion House speech last year, Sunak said "we need this industry to succeed". The then chancellor acknowledged: "You contribute £76bn in tax a year – enough to pay for our entire police force and our entire state schools' system."

But now, unlike then, we know that you can have too much of a good thing in encouraging financial firms. As Adair Turner pointed out after becoming chairman of the beleaguered FSA in September 2008, days after the collapse of Lehman Brothers brought the financial crisis to a head, some of the innovation on Wall Street and in the City was "socially useless". In fact, it was worse than useless because the crisis inflicted enduring harm on the UK economy by impairing investment in boosting productivity.

Left to themselves, the two regulators would doubtless heed that painful history but their vaunted independence is being eroded. When consulting on the reforms, the government said it had "a justifiable interest in the policymaking that informs the regulators' rules".

The role of Parliament

Until now, it has been largely up to regulators whether they choose to review their rules, but the Treasury is seeking a new 'public interest' power to intervene. It claims this will offer "a new avenue for challenge of the regulators' rulemaking while still maintaining the operational independence of the regulators". It says the power would be used only in "exceptional circumstances". In a parting shot, Randell warned in May, "there is always the risk that 'exceptional circumstances' turn out to be surprisingly frequent, or that the mere existence of the power could bring pressure to bear on the FCA to change its priorities".

While this and other measures aim "to strengthen the regulators' relationship with HM Treasury", the missing piece of accountability is in Parliament. The Treasury Select Committee lacks the resources and the time to keep tabs on what regulators are doing in a complex, technical and detailed field where it is vital to understand the fine print. What is required is a new parliamentary committee, drawn from experts in the House of Lords, as well as MPs, which is properly staffed and able to challenge regulatory proposals, not least by comparing them with rules in other jurisdictions. Without such a punchy body, the risk is that the Treasury bypasses effective parliamentary scrutiny by exerting pressure on the FCA and PRA to do its bidding.

The scramble to unscramble

Even before the new regulatory framework comes into shape, there has been a rush to take advantage of Brexit in easing rules. Some of the ideas make sense. The Solvency II rule-book inherited from the EU imposes unnecessarily onerous capital requirements on insurers. Planned reforms will lighten these, making it easier for them to invest in riskier assets in the real economy, such as offshore wind farms, rather than holding safer bonds. The EU is itself moving in a similar direction.

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There may also be a case for getting rid of overly prescriptive rules for trading in the wholesale capital markets. One example is the EU's double volume cap, which limits the amount of 'dark' trading in equities (where orders are not publicly disclosed before trades are done). There is no such restriction in the US and it has, in any case, been suspended by the FCA since early 2021 without adverse effects on price discovery.

Spacs

More questionable has been the move to encourage Spacs – special purpose acquisition companies. A Spac raises money from investors through an IPO with the aim of purchasing an operating business. Despite worries about 'what is really going on here?', these 'blank cheque' companies boomed on Wall Street in 2020 and 2021.

The push to support Spacs in the City followed a hastily conducted review for the Treasury by Jonathan Hill, a Conservative peer, of the stock market's rules on listing. Reporting in March 2021, Lord Hill noted "a number of reservations being expressed about Spacs, such as the allocation of 'promote' shares to Spac sponsors as well as their performance over time." But he seemed more concerned about London missing out on the business – "the bottom line from a competitive point of view"– and recommended regulatory changes to facilitate the launch of such companies in the UK. Even as the rules have been duly relaxed, they are being tightened in the US where the Spacs boom has turned sour, with many investors licking their wounds.

Crypto

Even more dubious for some people is the Treasury's embrace of crypto. This is a sector where the two regulators have been extremely wary. Speaking at the Cambridge International Symposium on Economic Crime in September 2021, Randell highlighted the FCA's concern about the risks of investing in cryptocurrencies. Andrew Bailey, Bank of England governor, has also noted the link between crypto and criminality.

Nevertheless, Sunak declared in early April his "ambition to make the UK a global hub for crypto asset technology". For his part, Glen said he wanted the UK to be "the very best place in the world to start and scale crypto-companies". The timing of the Treasury's plan for 'UK Crypto' was, to put it mildly, unfortunate. Soon afterwards, cryptocurrencies nosedived and one hyped 'stablecoin' (TerraUSD), which was purportedly pegged to the dollar, became worthless.

Rushed, headline-driven, short-term initiatives are no way to reshape complicated financial rules. That is one of the crucial reasons why regulators should be genuinely independent of the political cycle. Brexit does present an opportunity to simplify and to improve regulations. But some see it also as a chance for vote-chasing politicians to jeopardise what should remain the overriding goal: avoiding another financial boom and bust. ■

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