Future Regulatory Framework (FRF) Review: Proposals for Reform

February 2022

Positive Money welcomes the opportunity to respond to the government's consultation on the Future Regulatory Framework.

We are a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

If you would like to discuss any aspects of this response please contact Simon Youel, Head of Policy & Advocacy at Positive Money: simon.youel@positivemoney.org.uk

Key Points

- New secondary objectives for growth and international competitiveness are not only contradictory, but are incompatible with the government's vision for a financial sector that acts in the interests of communities and citizens, creating jobs and supporting businesses.
- The evidence suggests that increasing the competitiveness and growth of the financial sector shifts investment away from the real economy and towards unproductive speculation, with severely negative impacts on the UK economy.
- The financial sector would better serve communities and citizens if regulators were instead given objectives relating to areas such as productive investment, employment, the net-zero transition, and sustainable house prices.
- The integration of net zero into the regulatory framework is welcome, but risks being undermined by the proposed objective for growth and competitiveness. The government should instead introduce a new statutory objective for Paris Agreement alignment.

Question 1: Do you agree with the government's approach to add new growth and international competitiveness secondary objectives for the PRA and the FCA?

1.1 **We strongly disagree with the government's approach to give regulators new growth and international competitiveness objectives. Such objectives are not only contradictory, but are incompatible with the government's vision for a financial sector that acts in the interests of communities and citizens, creating jobs and supporting businesses.**

1.2 A focus on competitiveness has been shown to encourage regulators to water-down standards, with disastrous effects for the UK economy. A pursuit of competitiveness by regulators has been recognised as contributing to the 2008 financial crisis, with Andrew Bailey, while chief executive of the FCA, pointing out that the "before the financial crisis, the Financial Services Authority (FSA) was required to consider the UK's competitiveness, and it didn't end well, for anyone including the FSA."[1] The FCA's incumbent chief executive Nikil Rathi has also spoken against a competitiveness objective, arguing that it is not necessary to have a strong, successful and dynamic financial sector.[2]

1.3 The government's starting assumption that the financial services sector is an "engine of growth for the wider economy" is not borne out by the empirical data, with a large body of research showing a negative relationship between the depth of financial sector activity and economic

[1] https://www.fca.org.uk/news/speeches/future-financial-conduct-regulation
[2] https://committees.parliament.uk/oralevidence/746/html/

growth.[3] The government's approach must reflect this evidence, and not encourage regulators to pursue finance-led growth at the expense of the real economy.

1.4 Previous attempts to increase the competitiveness of the financial sector in the UK and abroad have served to shift funding away from productive sectors and towards a majority of investment in unproductive assets.[4] For example, the removal of policies such as credit controls from the 1970s in the name of competitiveness squeezed out lending to businesses, as increased competition for deposits encouraged banks to pursue longer term assets such as mortgages. This shift in finance has not only inflated the price of assets such as property, but also damaged economic growth. A study of 46 economies in the period 1990-2011 found a negative relationship between economic growth and the stock of bank lending to domestic real estate, but positive income growth effects of credit flows to non-financial businesses.[5] These findings have been supported by studies focusing on a half-century of UK data since 1963.[6]

1.5 The government's implication that regulators will be required to facilitate the growth of the financial sector is particularly inconsistent with regulators supporting the long-term growth of the UK economy. It is estimated that the large size of the UK's financial sector may have cost the economy £4.5 trillion in lost growth between 1995 and 2015, due not only to the 2008 financial crisis, but also the misallocation of resources, skills and investment away from the productive real economy.[7]

1.6 Regulation aimed at increasing competitiveness will likely make the financial sector even less able to serve the needs of the UK economy. The government's vision for a financial sector which acts in the interests of communities and citizens, creating jobs and supporting businesses would be much better served with alternative measures, such as objectives for productive investment, employment, the net-zero transition, and sustainable house prices - all of which would help reduce the bias towards unproductive and speculative financial activity currently maintained by regulators.

Question 2: Do you agree that the regulatory principle for sustainable growth should be updated to reference climate change and a net zero economy?

2.1 We support the government's ambition to integrate Net Zero into the regulatory framework, but the current proposal to introduce a 'regulatory principle' is too weak, and risks being undermined by the stronger statutory objective for competitiveness. We recommend that the government introduce a statutory objective for alignment with the goals

---

[3] See for example: Cecchetti, S. G. and Kharroubi, E. (2012) *Reassessing the Impact of Finance on Growth*. BIS Working Paper No. 381. Bank for International Settlements;
Arcand, J. L., Berkes, E. and Panizza, U. (2015) 'Too Much Finance?', *Journal of Economic Growth*, 20, 105–148;
Rousseau, P. and Wachtel, P. (2017) 'Episodes of Financial Deepening: Credit Booms or Growth Generators? ', *Financial Systems and Economic Growth*, 52, 52-75.

[4] Bezemer, D., Ryan-Collins, J., van Lerven, F. and Zhang, L. (2021) 'Credit policy and the 'debt shift' in advanced economies', *Socio-Economic Review*, 1-42

[5] Bezemer, D., Zhang, L. and Grydaki, M. (2016) 'More Mortgages, Lower Growth? ', Economic Inquiry, 54, 652–674.

[6] Ryan-Collins, J., Werner, R. A. and Castle, J. (2016) 'A Half-Century Diversion of Monetary Policy? An Empirical Horse-Race to Identify the UK Variable Most Likely to Deliver the Desired Nominal GDP Growth Rate', *Journal of International Financial Markets, Institutions and Money*, 43, 158–176.

[7] http://speri.dept.shef.ac.uk/wp-content/uploads/2019/01/SPERI-The-UKs-Finance-Curse-Costs-and-Processes.pdf

of the Paris Agreement and emissions reduction targets outlined by the International Energy Agency pathway to net zero by 2050.

2.1 We agree with the government's assessment that the transition to Net Zero should be hardwired into the UK's regulatory regime. However, the current proposal for a regulatory principle for sustainable growth does not go far enough and risks being undermined by a stronger statutory objective to promote the international competitiveness of the industry. As the government's Future Regulatory Framework consultation document states, the regulators are "not required to act to advance their regulatory principles; instead they must take them into account when pursuing their statutory objectives".

2.2 Where regulatory changes involve a trade-off between supporting the net zero transition and promoting the international competitiveness of firms, the proposed approach will force regulators to choose the latter. As well as threatening the government's own emissions reduction targets, unregulated investment in fossil fuels[8] and ecological damage[9] would also expose the UK to serious financial stability risks. As the Bank of England recognises, climate change threatens to wipe $20tn off the value of assets by 2050.[10] [11] The International Renewable Energy Agency reported in 2019 that at least $11.8 trillion worth of assets worldwide were at risk of being stranded by climate change by 2050. UK banks are heavily exposed to these risks. Emissions from projects financed by the UK banking sector are greater than those of other European countries. Barclays and HSBC alone have poured more than £185 billion (US$255 billion) into fossil fuels since the signing of the Paris Agreement in November 2015,[12] more than three times the amount it would cost to power all UK homes with offshore wind by 2030,[13] despite International Energy Agency warnings that investment in new oil, gas and coal supply must stop this year if the world is to reach net zero by 2050.[14] In 2019, UK banks invested more than £258 billion in sectors which the government and scientists agree are primary drivers of biodiversity destruction.[15]

2.3 Climate-related risks are different from other financial risks. They are uniquely complex, involving tipping points and feedback loops, and cannot be 'efficiently' priced into market activities. To stop the financial system threatening the basic conditions for monetary and financial stability, the central bank must be empowered to adopt an active and 'precautionary' approach to managing these risks and fulfilling its new 'green' remit.[16][17]

---

[8] Rainforest Action Network, 'Banking on climate chaos: fossil fuel finance report 2021': https://www.ran.org/bankingonclimatechaos2021/

[9] Portfolio Earth, 'Bankrolling Extinction' report: https://portfolio.earth/

[10] Bank of England speech Sarah Breeden, 'Avoiding the storm: Climate change and the financial system', April 2019: https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/avoiding-the-storm-climate-change-and-the-financial-system-speech-by-sarah-breeden.pdf

[11] International Renewable Energy Agency (IRENA) report 2017: https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2017/Mar/Perspectives_for_the_Energy_Transition_2017.pdf

[12] Rainforest Action Network, 'Banking on climate chaos: fossil fuel finance report 2021': https://www.ran.org/bankingonclimatechaos2021/

[13] The Guardian, 'Powering all UK homes via offshore wind by 2030 'will need £50bn'', 6 Oct 2020: https://www.theguardian.com/environment/2020/oct/06/powering-all-uk-homes-via-offshore-wind-by-2030-would-cost-50bn

[14] International Energy Agency, 'Net Zero by 2050', May 2021: https://www.iea.org/reports/net-zero-by-2050

[15] https://portfolio.earth/wp-content/uploads/2021/01/Bankrolling-Extinction-Report.pdf

[16] UCL Institute for Innovation and Public Purpose, 'Climate-related financial policy in a world of radical uncertainty', December 2019: https://www.ucl.ac.uk/bartlett/public-purpose/publications/2019/dec/climate-related-financial-policy-world-radical-uncertainty

[17] Bank of England, 'MPC Remit statement and letter and FPC Remit letter', March 2021: https://www.bankofengland.co.uk/news/2021/march/mpc-remit-statement-and-letter-and-fpc-remit-letter

2.4 Delivering the government's new Net Zero Strategy, and keeping the Paris Agreement's 1.5C target alive, will require a rapid reallocation of public and private financial flows away from dirty sectors and towards clean ones. It is crucial that the new regulatory framework does not impede the decarbonisation of the financial system and wider economy.

Question 3: Do you agree that the proposed power for HM Treasury to require the regulators to review their rules offers an appropriate mechanism to review rules when necessary?

3.1 We do not agree that this proposed power is an appropriate mechanism, as we are concerned that this may become a channel for vested interests to lobby the government for rule changes. It is also unclear how it would be determined that publishing directions and reports is not in the public interest, and we are therefore concerned that this could be abused to avoid transparency.

Question 4: Do you agree with the proposed approach to resolve the interaction between the regulators' responsibilities under FSMA and the government's overseas arrangements and agreements?

4.1 We would support requirements for regulators to assess compliance with international agreements the government is party to. The Paris Agreement must be included among those considered by regulators.

Question 5: Do you agree that these measures require the regulators to provide the necessary information on a statutory basis for Parliament to conduct its scrutiny?

5.1 We support current proposals to introduce new statutory requirements for regulators to respond in writing to select committees, as well as to notify the relevant Parliamentary committee when they publish consultations, but we do not agree that the measures outlined are sufficient for Parliament to conduct its scrutiny.

We recommend that the government establishes a new Financial Services Joint Committee between the Commons and the Lords, with adequate time and resourcing to scrutinise the work of the regulators, debate new legislation, hold senior leadership of the regulators to account, and review the social, environmental and economic impacts of any regulatory changes.

5.2 Failing this, existing committees, in particular the Treasury Committee, should be given resources to perform these functions, such as additional committee specialists and analysis from the House of Commons Library.

5.3 Regulators need to be able to act swiftly to respond to emerging challenges, but the proposed increase in regulators' responsibilities and independence risks allowing regulation to be developed behind closed doors, making the system more vulnerable to lobbying and regulatory capture. The guiding principles for the new framework must give Parliament a role in defining the public purpose of regulation. Elected officials must have a role in overseeing and reviewing the regulators' performance against defined, measurable objectives at regular intervals.

Question 6: Do you agree with the proposals to strengthen the role of the panels in providing important and diverse stakeholder input into the development of policy and regulation?

6.1 We support the proposals to strengthen the role of stakeholder panels, provided there are robust processes in place to ensure the diversity of all panels, with specific provisions to include civil society representatives and consumer groups.

6.2 Positive Money considers a stronger role for stakeholders panels to be essential under the new regulatory framework the government has proposed. As the government recognises, panels that have diverse backgrounds, expertise and thought will be better placed to ensure regulators receive the most comprehensive appraisal of their policy. Genuinely diverse panels must include not just those who represent the financial services industry itself, but participants from a range of backgrounds and experiences. We therefore recommend that the FCA and PRA's new statutory panels consist of a maximum of 50% industry representatives and at least 50% consumers and civil society representatives.

6.3 In addition, resources should be provided by regulators to support public interest groups to participate constructively in the panels. Within this new requirement, the PRA should convene a new statutory panel to consult the public specifically (amending FSMA s136), bringing the PRA's public engagement in line with the FCA's.

Question 7: Do you agree that the proposed requirement for regulators to publish and maintain frameworks for CBA provides improved transparency to stakeholders?

7.1 We support adding a new requirement for regulators to publish and maintain frameworks for the CBA they conduct, which would improve transparency for stakeholders.

Question 8: Should the role of the new CBA Panel be to provide pre-publication comment on CBA, or to provide review of CBA post-publication?

8.1 We are not convinced that a statutory CBA panel would be beneficial: regulators are already conducting CBA with stakeholders voluntarily where they consider it to be appropriate. CBAs are naturally biased towards factors that are easier to quantify: the direct costs to firms of a rule change are generally easier to calculate using CBA models than benefits such as preventing consumer harm, or improving financial stability. As a result, CBA may neglect key public interest considerations.[18]

8.2 However, if the government decides to proceed and establish the new CBA panel, we strongly recommend the panel conduct reviews of CBA post-publication, to ensure transparency and enable stakeholders to provide evidence-based feedback, while allowing regulators to react quickly when needed.

8.3 Compelling regulators to conduct pre-publication CBA risks needlessly complicating the work of the regulators, and could easily serve to further promote the interests of large incumbent firms, who will be in a position to contest the fine details of regulatory changes. This risk would be compounded if the government introduces a secondary objective for competitiveness, which we expect industry to point to as justification for weakening regulatory protections, resulting in a CBA process that actively works against the best interests of consumers and the wider public.

8.4 We consider that providing post-publication review of CBA would introduce similar risks, but to a significantly lesser extent than pre-publication review, and would likely result in more constructive discussion. Periodically reviewing a number of CBA produced by the regulators would avoid the risk of delays to the policymaking process and ensure the influence of all stakeholders is publicly visible.

8.5 Additionally, the diversity of perspectives we have already called for across all panels must also be maintained on any new CBA panels, including the perspectives of consumer and civil society

[18] https://www.ft.com/content/db1ad3c7-db3d-4117-bf30-a76ea27f6001

groups. Again, we consider this to be essential for the future regulatory framework to be fit for purpose.

Question 9: Do you agree that the proposed requirement for regulators to publish and maintain frameworks for how the regulators review their rules provides improved transparency for stakeholders?

9.1 We support adding a new requirement for regulators to publish and maintain frameworks for how the regulators review their rules, which would improve transparency for stakeholders.

Question 10: Do you agree with the government's proposal to establish a new Designated Activities Regime to regulate certain activities outside the RAO?

10.1 Positive Money supports a new Designated Activities Regime (DAR) being established, but a robust democratic process must be in place to scrutinise replacement regulation and ensure it is fit for purpose — such as the new Financial Services Joint Committee we have proposed.

10.2 We are concerned that regulatory gaps will be introduced as rules pass from retained EU law into the DAR. We strongly advise the government to consult further on the proposal for HM Treasury to have the powers to modify the application of the core DAR framework for certain activities, or to add additional elements.

10.3 The new Financial Services Joint Committee (proposed in our answer to question 5) should have the opportunity to consider and amend the replacement regulations being introduced within the DAR to make sure they are fit for purpose. The committee should also have the ability, time and resources to to call for consultations on proposed new regulation where they deem it appropriate.

Question 11: Do you agree with the government's proposal for HM Treasury to have the ability to apply ''have regards'' and to place obligations on the regulators to make rules in relation to specific areas of regulation?

11.1 Positive Money agrees with the government's proposal for HM Treasury to have the ability to apply 'have regards' and to place obligations on regulators in specific areas. We consider this essential to allow for the government and regulators to coordinate effectively within the comprehensive FSMA model.

11.2 Effective coordination on specific areas of regulation between regulators and the government will have to be undertaken in order for regulators to continue to meet their primary objectives in the medium to long term. The Future Regulatory Framework must therefore allow for the government to direct regulatory decision-making to align with relevant public policy objectives, including through the targeted application of 'have regards' and placing of obligations on regulators. For example, we consider that for the government to meet binding commitments on climate, regulators will need to be directed to set clear requirements for firms to operate within safe environmental limits.