HM Treasury

Financial Services Regulation: Measuring Success

Call for Proposals

RESPONSE FROM:

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HM Treasury - Financial Services Regulation: Measuring Success

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1. Introduction

1. We are pleased to have the opportunity to make proposals on potential performance metrics for the FCA and the PRA in achieving their new secondary objective of 'advancing the competitiveness and growth of the UK economy, and in particular the financial services sector.'

2. We have a number of serious concerns:

    2.1. The fact that the Financial Services and Markets Bill in Clause 24 refers to the competitiveness and growth objective as a secondary objective recognises, quite properly, that it is subordinate to the FCA's strategic objective set out in FSMA 2000 section 1B (2) and its operational objectives set out in section 1B (3) of consumer protection, and protecting the integrity and competitiveness of the UK's financial system.

    2.2. Nevertheless, the introduction of this secondary objective has the potential to broaden the remit of the two regulators very significantly. There is a danger in this in that it could lead to a loss of focus on the primary objective. In that regard, the FCA in particular already has a poor track record when it comes to consumer protection, so the risk of making its consumer protection performance worse is a very serious one. Specific target areas on which the regulators should focus need to be identified and defined.

    2.3. In this respect the so-called 'secondary objective' as stated is not really an 'objective'. Objectives should be SMART: Specific, Measurable, Achievable, Realistic and Time-bound. The 'secondary objective' as it stands is no more than a broad goal – perhaps an aspiration or part of a wider mission-statement. The metrics should support the defined objectives.

    2.4. The areas in which new objectives are to be set must be ones in which the FCA and the PRA have the skills, competence and regulatory authority to be able to exercise appropriate oversight. It is almost certain that in many areas they will need to work with other authorities. How these relationships will work and how the boundaries of responsibility and authority will operate will also need to be defined and agreed.

2.5. Good practice normally states that organisations should not have more than, say, ten measurable objectives. Beyond this, organisational priorities tend to become unclear.

3. One thing that we do **not** want is for the FCA and the PRA in their new secondary objective of advancing the competitiveness and growth of the UK economy, and in particular the financial services sector to become cheerleaders for the companies that they are supposed to regulate. This was how the Financial Services Authority previously behaved, along with ‘light-touch’ regulation. Such behaviour contributed significantly to the financial crash of 2008.

4. There are some areas in which the current regulatory oversight by the FCA (we are less able to comment on the PRA) is deficient. Examples of these were referred to in the FCA’s recent consultation on ‘Updating and improving the UK regime for asset management’ (DP 23/2) - for instance, the lack of minimum contractual requirements between host AFMs and portfolio managers and whether rules on liquidity management and anti-dilution could be clearer**.**

5. Regulation which is not fit for purpose is clearly not going to help the competitiveness of the UK financial service industry. It looks therefore as though there is significant work that can be done under the FCA’s current primary objective that will benefit UK and financial services industry competitiveness before worrying too much about how the regulators are going to discharge their new secondary objective.

6. The excellent paper from the London Market Group (Making the UK more competitive – Metrics for success) sets out clearly a number of areas in which regulatory performance can be improved, including:

   6.1. ensuring that firms can access regulatory information quickly and easily;

   6.2. applying regulation which enables firms to adapt to new circumstances quickly and efficiently;

   6.3. attracting new market entrants by ensuring they can get the necessary approvals in a timely manner;

   6.4. reducing the cost of doing business by ensuring that firms are not overburdened with regulation which is cumbersome or simply not fit for purpose;

6.5. ensuring that firms are not constrained by regulation that is not pertinent to their business.

7. However, all these objectives can be seen to come within the scope of the FCA's primary objective of ensuring that the markets that it regulates function well, including providing an appropriate degree of protection for consumers, protecting and enhancing the integrity of the UK financial system, and to promoting effective competition in the interests of consumers. While Parliament in its wisdom is in the process of enacting this new secondary objective, we remain dubious about the merits of doing so.

8. We have identified three main areas in which there may be scope for the FCA in particular to develop specific objectives and metrics in relation to its wider secondary objective as set out in the FSM Bill:

    8.1. Promoting the adoption of digitisation by the UK financial services industry and rooting out practices designed to protect entrenched positions and frustrate disruptive competition.

    8.2. For the FCA and the PRA the need to keep ahead of rapidly developing technical developments in the application of new technology to financial services where, for example, there have been increasing concerns about poor levels of service provided by online payment firms and digital only banks – not to mention concerns about the abuse of artificial intelligence (AI) with the arrival of Chat GPT and Bard.

    8.3. Working with other agencies and parties to facilitate the move towards net-zero by UK companies by encouraging the UK financial services industry to apply the highest standards of stewardship.

9. We have made further more detailed comments in relation to the specific questions in the call for proposals in Section 3 below.

2. About UKSA

UKSA (United Kingdom Shareholders' Association)

10. UKSA is the oldest shareholder campaigning organisation in the UK, with 13,000 members. We are a not-for-profit company that represents and supports shareholders who invest in the stock market.

11. There are many agents and intermediaries active in financial markets. Unlike them, we are an organisation solely representing people who are investing their own money.

12. UKSA was formed to provide private shareholders with a voice, influence and an opportunity to meet like-minded fellow investors. It is structured as a non-profit making company with annual subscriptions. An elected Chairman and Board of Directors (all volunteers and individuals with a wide range of backgrounds and experience) monitor a regional organisation. Each region benefits from oversight by an elected regional Chairman and Committee.

13. We build relations with regulators, politicians and the media to ensure that the voice of individual shareholders is reflected in the development of law, regulation, and other forms of public policy. See www.uksa.org.uk

3. Answers to your numbered questions

Q1. Do you agree with the government's approach to the exercise of the power of direction in Clause 37 of the FSM Bill?

14. Yes, we agree with this.

Q2. What are the key metrics that the FCA and the PRA should publish in relation to their new secondary growth and competitiveness objectives?

15. This is quite a difficult question. It is easy to outline metrics to assess the overall growth and competitiveness of the UK financial services sector as a whole. Some obvious examples are:

    15.1. Absolute numbers of domestic and foreign customers

    15.2. Absolute figures for assets managed for such customers in the case of asset management, or premium income in the case of insurers, or loans outstanding in the case of banks.

16. The more challenging question is what metrics should be used for assessing how the FCA and PRA are going about achieving their secondary objective while not diluting their primary objective. For example, speeding up approval of new applicants seeking to enter the sector might be positive for growth but could risk approving entrants who would have been rejected with more thorough vetting.

17. In paragraph 8 above we set out a number of areas in which we believe that the regulatory authorities could usefully play an active role to encourage the competitiveness and growth of the UK economy, and in particular the financial services sector. We have discussed each of these areas in more detail below.

Adoption of digitisation by UK financial services industry.

18. There are many areas here that the FCA, in particular, could monitor and for which performance targets could usefully be set. However, there is one area in particular in which experience in Europe following the introduction of the Shareholder Rights Directive (SRD II) gives cause for concern.

19. Better Finance, the European Federation of Investors and Financial Services Users, working with DSW, Germany's leading association for private investors,

has recently completed its second annual review[1] of continuing barriers to shareholder engagement following the introduction of the SRD II.

20. The report, 'Barriers to Shareholder Engagement – SRD II Revisited', makes it clear that despite the importance that the EU attaches to corporate governance (the 'G' in ESG) and to shareholder engagement there are still considerable obstacles to the exercise of shareholder voting rights, including the right to participate in the AGMs of listed companies and to cast a vote. This is particularly true cross-border within the EU where a combination of long, complex and antiquated financial intermediary chains and omnibus accounts make it difficult and costly for shareholders to exercise these fundamental rights. Despite the implementation of an EU legal framework and processes that sought to facilitate shareholder engagement there have been numerous instances where shareholder rights have been obstructed or denied.

21. In 2021 a key obstacle which prevented many retail shareholders from voting was the imposition of high charges by intermediaries. These ranged from €20 to €250 per AGM for those who wanted to be able to exercise their vote. In 2022 instances of charges in excess of €250 were reported, as were expensive new 'voting packages'. The number of cases in which shareholders were obliged to pay to vote rose to 64%.

22. Furthermore, 63% of shareholders had to first get information about the AGM by themselves when this should have been provided automatically. In 2022 less than half (48%) of respondents to the study were able to vote at AGMs. Despite the fact that many respondents considered themselves knowledgeable about the whole AGM and voting process, 63% said that it remained difficult.

23. The report reaffirmed the need to make voting, particularly in cross-border situations, easier and much less costly for shareholders. The point is also made in the report that shareholders need to be confident about the security of the whole process.

24. As the UK moves toward the dematerialisation, digitisation and the use of digital technology to enable greater shareholder engagement (and more effective corporate governance) it seems likely, if the European experience is anything to go by, that the FCA will need to monitor closely the performance of intermediaries in passing shareholder rights back to the beneficial owners in a way that is easy and cost effective.

[1] Barriers to shareholder engagement | SRD II Revisited (AGM season 2022) - BETTER FINANCE

25. It is not yet clear what the full recommendations of the Digital Taskforce will be. However, it seems likely that it will recommend the introduction of changes that will facilitate greater shareholder engagement with the companies in which they have invested. Monitoring the progress of change in this area and taking action against firms seeking to frustrate change should be a key objective of the regulator. This is something which will be important if the UK financial services industry is to remain competitive on a global basis.

26. We do not propose to give a comprehensive list of actions that the regulator could take or the metrics could be set for monitoring performance in this area. However, for the European regulators Better Finance is calling for urgent improvement of the shareholder engagement process by:

    26.1. Ensuring that costs and charges no longer discriminate against shareholder voting within the single market;

    26.2. Improving the dissemination of information prior to the AGM;

    26.3. Fostering direct communication between issuers and shareholders – particularly by maximising the opportunities provided by the use of new technology;

    26.4. Improving the intermediated shareholder engagement process by ensuring that deliberate barriers to change are not erected – for example, the application of slow and complex procedures and usurious charges where these are completely unjustified. It is very likely that a similar approach in the UK is going to be appropriate to ensure that the full benefits of digitisation are achieved in a timely manner.

Keeping up with technical developments in UK financial service markets and ensuring that consumers at home and abroad benefit from them and do not suffer harm.

27. In some areas the FCA is already taking action in this area. For example, the regulator has warned e-money firms that they will need to show a significant change in culture and behaviour once new protections come into force in July (2023) under the consumer duty regime.

28. Too often it is the provider who benefits most from the introduction of new technology rather than the user. In the case of investment platforms, for example, new technology seems to have been used to frustrate competition. Providers have used different pricing models to give the appearance of competing when, in fact, pricing has been used simply to confuse the market and make value-for-money comparisons difficult. At the same time, functional

differences between the services provided by platforms have been negligible with little or no attempt made to compete on this basis. Providers have tended to offer more or less the same package – although it looks now as though this may slowly be changing. It is an area that the FCA will need to watch increasingly closely, as discussed above, with the move towards digitisation.

29. However, too often in the past the regulatory stance seems to have been very reactive – one of waiting to see how things pan-out in the market and taking action when only it is clear that consumers are being exploited. This often seems to reflect a misplaced trust by the regulator in the industry it is supposed to be regulating.

30. Nowhere is this approach more likely to prove dangerous than in the rapidly developing field of artificial intelligence (AI).

31. The regulatory authorities need to start moving fast to get ahead of the game. There are plenty of examples of tangible harms caused by AI that are already here. It is already possible for AI to replicate someone's voice and even a face - known as 'deepfakes'. The potential for scams and misinformation is significant. As was noted in a recent FT article[2], AI systems that can generate, classify and understand text are dangerous partly because they can mislead the public into taking synthetic text as meaningful. The most powerful models are already beginning to demonstrate complex capabilities such as power-seeking or actively finding ways to deceive humans.

32. Regulators, particularly in the USA, are already starting to crack down on 'deep patterns' – the use of menu after menu of confusing options aimed at maximising spending by consumers and deterring service cancellations. Increasingly companies are using data mining, algorithms and sophisticated AI to draw customers in and keep them sweet.

33. The US Federal Trade Commission has recently sued Amazon claiming that it tricked and trapped people into recurring subscriptions. Even as regulators start to crack down on dark pattern website processes, companies are turning to artificial intelligence to make their sales methods more sophisticated and potentially exploitative. As the FT recently noted, 'businesses will soon be able – if they can't already – to predict not just what to offer but also what time of

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[2] 'The Dangerous race to God-like AI'; Ian Hogarth, FT Weekend Magazine. 15/16 April 2023

day a purchase is most likely. Real-time emotion-sensing technology could be used to press offers at vulnerable moments'.[3]

34. This form of selling lends itself particularly well to financial services. The FCA in particular needs to:

    - Ensure that it has the skills, knowledge and expertise to monitor, foresee, understand and manage the increasing use of AI in the markets it regulates in the UK;
    - Work with its counterparts around the world to ensure that the UK maintains a leading position in maintaining consumer safety while at the same time avoiding inadvertently blocking or choking off potentially useful applications in the use of AI which should be of benefit to consumers.

35. It is difficult to specify exactly what metrics should be put in place to monitor performance in this area but they ought to include:

    - Reporting on engagement with and between the regulatory authorities in the USA, Europe and elsewhere to develop coherent and effective systems for jointly monitoring and managing the use of AI in financial services markets.
    - The annual publication of a strategic review of the use (and abuse) of AI in financial services markets in the UK.

36. It is one thing for providers to tempt consumers with personalised service-offerings at the point when they have a genuine need for them – and to do so at a fair price. It is something else entirely to use new technology to gear-up the ability to exploit consumers' weaknesses and vulnerabilities and get them to pay for services they do not need.

Working with other agencies and parties to facilitate the move towards net-zero by UK companies by encouraging the UK financial services industry to apply the highest standards of stewardship.

37. Work is already well under way in this area. The FCA already has its ESG strategy in place and the FCA's recent discussion paper, DP 23/1, issued earlier this year, states clearly that one of the target outcomes of the strategy is

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[3] 'AI salesbots are coming for your cash'. Brooke Masters FT Opinion; 28th June 2023

'active investor stewardship that positively influences companies' sustainability strategies'.

38. The focus for the FCA, therefore, is rightly on stewardship and applying appropriate regulation to encourage authorised UK financial services firms to take their stewardship responsibilities seriously with regard to ESG issues.

39. DP 23/1 also refers to the close working relationship between the FCA and the Transition Planning Taskforce (TPT). It goes on to refer to the TPT's Disclosure Framework and the Governance pillar of the disclosure framework which emphasises:

- Board oversight and reporting arrangements;
- Roles responsibility and accountability;
- Culture;
- Incentives and remuneration;
- Skills competencies and training.

These are all areas in which effective stewardship by asset managers and owners can play a vital role in helping to ensure that companies are progressing towards achieving net-zero or, at the very least, demonstrating that they are taking their environmental and sustainability responsibilities seriously.

40. These are also the areas in which we would like to see the FCA (and the PRA) working with other parties such as the TPT (and the FRC as the custodian of the Stewardship Code) to agree specific metrics for monitoring the effectiveness and outcomes of the FCA's own influence over the firms it regulates.

41. It is difficult, and probably impossible as well as inappropriate, for UKSA to state at this stage exactly what these metrics should be. What we would like to see is a set of up to ten objectives for the FCA which promote sound stewardship by authorised firms and which comply with SMART criteria referred to in paragraph 2.3. above.

42. We see this as being a critical area in which specific objectives and measurement criteria for the FCA (and possibly the PRA) are needed on the basis that:

42.1. At a recent event run by EY on progress towards the implementation of the TPT Guidance Framework[4] (an event at which Mark Manning from the FCA was a panel member) research by EY showed that:

- 95% of FTSE100 companies currently comply with less than 50% of the new TPT Guidance;
- Most companies have significant work to do with an average compliance score of only 24% compliance with the guidance;
- While 95% of companies have some kind of net-zero goal only 22% have an operational plan to deliver it that aligns with TPT guidance;
- 79% of companies have no information on the financial plans underpinning their Net-Zero strategy and only 1% align with TPT guidance.

It was also noted that companies are reducing emissions too slowly and not enough:

- The world needs a 45% reduction in emissions by 2030 to keep 1.5% on track;
- Most commitments fall short – only 42% of companies plan to reduce emissions by 45% or more;
- Action on commitments is happening more slowly than is needed to achieve this ambition and is on track for a 28% reduction in emissions.

Holding companies accountable over their emissions plans is vital and one of the ways of achieving this has to be through effective stewardship.

42.2. The FCA’s ESG Strategy is in most respects an excellent and relatively comprehensive document. Much of it somewhat aspirational but to the FCA’s credit there is a serious attempt to underpin each of the key actions with a target milestone consisting of an action and a deadline. However:

- Many of the milestones refer to 2022 and it would now be good to have an update on progress.

[4] EY Investor and Board Working Breakfast Session – ‘Operationalising the TPT Guidance Framework’ – London, 28th April 2023

   - Some of the milestones will need to be updated – for example, because they have been achieved and it is appropriate to move on to the next step in the process.

43. We would like to see an annual update to the ESG strategy summarising progress. In particular, we would like to see specific objectives and metrics providing feedback on progress on instilling high standards of stewardship among FCA authorised firms.

44. As mentioned, up to ten good, measurable, time-bound objectives (and metrics) which reflect the main priorities in this area are what is required.

Signed: Charles Henderson, Chairman, charles.henderson@uksa.org.uk, 07709465772

3 July 2023