

# SMARTER REGULATION

STRENGTHENING THE UK ECONOMY WITH  
FIT FOR PURPOSE REGULATION OF OUR  
FINANCIAL SERVICES

OCTOBER 2016






*By adopting a practical approach to regulatory change, and providing certainty to financial services businesses, the UK's regulatory model will cement its already world-leading status and be primed to adapt in a shifting political climate as a smarter, more fit for purpose regulatory infrastructure.*

This will empower the industry to fulfil its potential as an enabler of growth, and encourage prosperity and opportunity for everyone. The CBI is not calling for less regulation, but smarter regulation.

In this report, we offer achievable, pragmatic recommendations that will help shift our financial services regulators' approach towards change. We are at a critical juncture, and there has never been a more important time to provide the regulatory certainty that our financial services sector so desperately needs.



*The CBI is not calling for less regulation, but smarter regulation.* 

## Economic narrative

*The UK's financial services sector is the lifeblood of our wider economy. A strong financial services sector enhances social justice, encourages positive consumer outcomes and promotes economic growth for everyone. Put simply, the success of the UK economy is predicated on a strong financial services sector, securing the vital services that many of us take for granted.*

Financial services supply the very foundation upon which our whole economy can prosper, and provide the opportunities, and safeguards, that our families rely on. As a result of these services, our salaries can be paid; investments can be made in our roads and bridges; our pensions can be managed; money can be sent abroad to loved ones; companies can grow and can hire more people; our exporters can finance their trades, we can buy our first home; our currency can be converted for holidays abroad; and damages can be paid when natural disasters strike.

In the aftermath of the global financial crisis in 2008 came the nadir for public confidence in the sector. There is no denying that the wrongdoings of the sector led to disastrous implications for many businesses across the country, and fingers were justifiably pointed at the industry for the failings of our wider economy. But after eight years of intense, rapid-fire scrutiny, and a seismic shift in the political conditions in which we operate, it is high time to take stock, and look to the future competitiveness of our financial services sector and how it can best provide a benefit for everyone.

This is not to say that lessons need not be learnt from such shortcomings in the past, but we cannot confine our perspective of the industry to such a narrow lens. Our financial services sector is made up of a variety of vital subsectors that businesses and consumers rely on. It is imperative that we now broaden our focus and strengthen the sector as the vital organ of a thriving economy, pursuing a landscape that safeguards financial stability whilst giving firms the space to grow to the advantage of the whole economy.



*A strong financial services sector enhances social justice, encourages positive consumer outcomes and promotes economic growth for everyone.*



## The importance of financial services for everyone

This is a sector that matters to ordinary people. This is a sector that underpins everyday life and serves as a vehicle that delivers for all of society.

- In the last five years building societies lent more than £250 billion in the UK and approved 1.9 million mortgage loans, a third of which were to first time buyers<sup>1</sup>
- Each minute in the UK in 2015, over 72,000 payments were made by consumers and businesses – totalling more than 38 billion payments during the year<sup>2</sup>.

**It is not just about the breadth of services that the sector provides, but its geography. It is a common misconception that financial services and the City are synonymous.**

- Two-thirds of the industry's 2.2 million people (7% of our workforce) are employed outside of London<sup>3</sup>
- From across all four nations of the UK, the sector produces 12% of total economic output, contributing £66bn in tax revenue<sup>4</sup>.

Nevertheless, our financial services can perform better and must fulfil its potential for the wider economy, like providing the investment for small businesses to hire more staff and open new branches. Our perception of financial services must not be solely wrapped up in the mistakes and poor practice of the past, but also focused on the positive role that the sector, in its entirety, can play and must play in the future as a catalyst for wider economic growth. This role will define the success of the whole economy, but only if given the right conditions.



# £58.5bn

The financial services contribution to the UK's trade balance is £58.5bn, more than any other sector in the economy

The CBI is highly conscious of the distribution of the UK's financial services industry, with two-thirds of the industry's employees outside of London. Accordingly, this report's analysis is a product of extensive consultation with members in all four nations of the UK.

The CBI's financial services sector team has engaged over 200 financial services companies throughout the UK to discuss the UK's regulatory model. The CBI's analysis is also a product of in-depth interviews and discussions with over 60 members, conducted across bespoke meetings in Cardiff, Bristol, Leeds, Glasgow, Edinburgh, Belfast and London.

## The right conditions

*Businesses require certainty. Businesses in all sectors of our economy require stability and consistency from the UK's policy landscape now more than ever, in an era of unprecedented political volatility. Without a foundation of certainty, businesses cannot effectively forward plan, analyse and decide on investment opportunities, try new innovations on products and services, or guarantee job security. Financial services are no different, and as an enabler for prosperity, financial services businesses need certainty from the regulatory environment they are working in, so they can thrive and deliver for the whole economy.*

On Thursday 23 June 2016, the UK voted to leave the European Union (EU) in an historic referendum, sending political shockwaves throughout the world. Although the dust has now settled following the vote, the outlook is no clearer. Businesses large and small are uncertain about the deal the UK will achieve with its European partners, and the ambiguous nature of our future relationship with the world's largest single market is inhibiting the ability of firms to plan and prepare.

Regardless of the settlement we reach with the EU, the domestic regulators will now be supreme with regard to policy and supervision. The two new heads in place at the UK's primary regulators, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA), will be critical in consolidating the positive steps taken since the financial crisis, and in driving cultural adjustment at their respective regulators and across the regulatory landscape. There has never been such opportune, fertile ground upon which to instil such an outlook.

At a time when so many areas within the financial services landscape are uncertain, regulatory certainty is something that can be provided and must be provided in order to protect jobs and investment. We are at a critical juncture, and there has never been a more important time to provide the regulatory certainty that our financial services sector so desperately needs.



## **CBI/PwC Financial Services Survey**

The CBI/PwC financial services sector survey, now in its 26th year, provides an unrivalled barometer of industry sentiment, and our most recent survey, published in September 2016, gauges the opinion of financial services firms after the UK's decision to leave the EU.

Significantly, the data shows that CBI members feel the biggest opportunity for financial services following the decision is that of regulatory change. Asked to rank the top opportunities over the medium term for their business, the factor gaining the highest ranking was 'changes to UK financial services regulation', with 32% of members choosing this as their top opportunity.

Through our extensive engagement for this report, it is clear that the regulatory change required by firms is not radical policy reform or deregulation. Instead, it is an adjustment in the regulators' approach to change, and a shift in the way in which the regulators engage with the industry, in order to provide a fuller degree of certainty and clarity to businesses. This is an opportunity to get our regulatory model right.

Crucially, and perhaps against expectations, CBI members have stated that it is not the density or weight of regulatory policy that creates uncertainty, but it is the constant iterative regulatory change that entrenches uncertainty in their strategy, breeding an overly cautious and an overly prudent nature of decision-making.

The CBI is calling for a shift in the culture of UK regulation, towards a more engaged, consultative, focused and assured model of regulation that provides the stable ground that firms are directly calling for. With engagement and consultation, comes understanding and responsiveness. With focus and assurance, comes clarity and confidence. Businesses yearn for a regulatory culture of certainty in order for the industry to deliver for society the highest possible service.

A shift towards a culture of regulatory certainty requires a shift in the overarching philosophy of the primary regulators. This is not defined by a radical overhaul of regulatory policy, but a recalibration of the way regulators approach regulatory change.

**The Financial Services Act 2012 abolished the Financial Services Authority and split its responsibilities between two new regulators, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The Bank of England and Financial Services Act 2016 formally merged the PRA into the Bank of England.**





*CBI members want the UK's regulators to apply greater thought to the real purpose of regulation and carry out a comprehensive assessment of the impact and interdependencies of change prior to launching new measures.*



## Executive summary

*The CBI is concerned with the macroeconomic perspective – what regulatory environmental factors are pivotal to business to ensure competitiveness and growth of the sector, and vital for the products and services that consumers depend on. Instead of a comprehensive assessment of regulatory technicalities, this report sets out what an overarching regulatory culture should look like in order to give financial services firms the certainty they need, and to provide the most suitable regulatory landscape that protects consumers whilst allowing businesses to grow, compete internationally and remain at the forefront of innovation.*

We have come quite far with regulation. The separation of conduct and prudential functions has been fundamentally successful and the structural resilience of the financial system is now largely secure. CBI members praise aspects of the current landscape such as the progress made by the FCA's Project Innovate in supporting the UK's well-regarded FinTech sector. Yet in order to build on this progress, a shift in the wider approach of our regulatory framework is required. What we require is certainty over the direction of regulatory policy. But we also must ensure that the direction itself is proportionate and fit for purpose.

By adopting a practical approach to regulatory change, and providing certainty to financial services businesses, the UK's regulatory model will cement its already world-leading status and be primed to adapt in a shifting political climate as a smarter, more fit for purpose regulatory infrastructure. This will empower the industry to fulfil its potential as an enabler of growth, and encourage prosperity and opportunity for everyone in the wider economy.

Our recommendations set out 7 achievable and pragmatic ways that will help shift the regulators' approach towards change, giving businesses the certainty they need:

- 1** *More formalised collaboration between the FCA and PRA*
- 2** *A sector-wide call for evidence on the cumulative impact of regulation*
- 3** *New dialogue forums to offer direct feedback from the industry, especially for flexible portfolio firms*
- 4** *New sector engagement initiatives to ensure the best possible access – on an operational working level – to the everyday complexities of financial services businesses*
- 5** *A thorough assessment of the current criteria upon which a flexible portfolio classification is determined*
- 6** *An expansion of the FCA's Project Innovate to ensure its benefits can be scaled to provide quality regulatory guidance to more disruptors and incumbents*
- 7** *A rejection by the Government of the Treasury Select Committee's recommendation to split the FCA's enforcement function into a new separate body.*

Our regulatory policy framework is far from perfect, but the problem is not regulation itself. The real problem is the regulatory environment that creates the deep-rooted uncertainty felt by members who cannot meaningfully dedicate resources to future projects through fear of having to respond to further changes, or react to regulatory decisions that they had assumed were already finalised. An inherent regulatory culture of restlessness and tinkering inhibits the role financial services can play in enabling the wider economy, and the CBI calls on the regulators to provide certainty to its regulated entities and thus let the industry breathe.

The UK's 'regulatory landscape' refers to the regulators by which regulated financial services companies are supervised and authorised. At the start of the CBI's engagement for this review, we set off to assess the FCA and the PRA. But with the evident significance of the Payment Systems Regulator (PSR), the Competition and Markets Authority (CMA) and the Financial Ombudsman Service (FOS), we broadened our focus to assess the regulatory framework as a whole, in order to gain an all-encompassing perspective on how regulators should interact and approach their supervisory functions.

This cultural shift would put the UK's global competitiveness at the heart of the regulators' priorities, and would enrich a forward looking aspiration to provide a welcoming regulatory framework, embedding growth and innovation as part of their *raison d'être*. The shift will help the UK's financial services focus on what really matters - providing their customers with quality, modern services for the benefit of the wider economy.

The CBI is explicitly not calling for less regulation or less supervision, and our members acknowledge that the sector must have a thorough set of rules that manage the risks inherent in the system. There is clear intent, however, to push against the sentiment that the financial services sector is a utility to be regulated to the fullest degree, rather than a dynamic business sector with the space to grow and develop. Underpinning this project is the intention to ascertain what smarter regulation looks like, and whether the current landscape is fit for purpose to support the functioning of the sector, the wider economy and the services that consumers rely on.



*Smarter regulation is regulation that is fit for purpose. This is regulation that safeguards financial stability and protects consumers, without infringing on the space businesses require in order to grow and innovate. It is proportionate and targeted regulation, with the benefit of cooperative, collaborative and engaged supervision. The CBI is not calling for less regulation, nor softer regulation.*””

## Introduction

### Regulatory certainty is something we can control, and is a tool that must be deployed

Our report's broad recommendations must be practical and achievable within the current framework, thus avoiding lofty ideals about revolutionary policy change. At a time when businesses require stability, it would be inappropriate to call for radical reform, therefore this report will frame specific principles of what a fit for purpose regulatory model looks like that is achievable within the current system. The CBI understands the cost constraints of our regulatory bodies and we will therefore avoid generic criticisms or recommendations of more expenditure. Instead, we are looking to recalibrate the strategic mission of the regulators in order to build on the progress that has been made since 2012, promoting growth for financial services and the subsequent prosperity of the whole economy.

#### Our themes

To help structure the report and our discussion in a politically constructive manner, we want to focus on three key themes. The CBI believes a change to the culture of the UK's regulatory framework can best be achieved if we channel our analysis in three key areas:

- **Growth:** Enabling growth, both in the sector and the UK economy
- **International Competitiveness:** Retaining the UK's comparative advantage in financial services
- **Innovation:** Pulling to the forefront of cutting-edge innovation.

Previous CBI reports have illustrated how firms are experiencing challenges which hinder their capacity to perform their role in the economy, such as the overly combative approach of supervision, the impact of regulating 'retrospectively' and a lack of openness at the international level. Under the umbrella of calling for certainty from the regulators, this report builds on these concerns. It highlights the cumulative burden of regulatory change that is affecting the sector's ability to support the wider economy and reducing the UK's attractiveness as a global financial hub.



Over the course of our discussions around the UK, CBI members are unequivocally pushing for a constructive and balanced assessment of the system as a whole. The following points highlight some of the recurring challenges that we have explored in this report:

- The disproportionate approach to regulatory change, both within individual regulators and between regulators
- The nature of supervision for some firms, and specifically those classified to flexible portfolios, decreases the likelihood of reporting potential risk, and decreases the direct engagement that comes with a fixed portfolio classification when they are preparing to execute new projects or implement new regulatory rules
- The increasing regulatory uncertainty and constant iterative change in regulatory provisions has led the sector to a point where its main growth potential is legal and compliance; exacerbating the productivity challenge and minimising opportunities for systematising good practice and creativity to reach better economic and consumer outcomes.

Let's get real about the benefits of financial services to the wider economy. Currently, it is not about setting the rules of the game, but about holding someone responsible. When members are admitting to us that their compliance recruitment budget far outweighs the resource dedicated to future innovation, we are undoubtedly working in a climate that is not conducive to positive outcomes for consumers or business. We propose a new approach to ensure a better environment, and in so doing, secure the future prosperity of the UK's economy.

## Enabling growth, both in the sector and the UK economy

*Firms deliver growth, not regulators, but regulators must cultivate a fertile landscape in order for firms to grow*

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*Regulators play a vital role in the execution and eventual success of new business projects that create growth*

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*A disproportionate or ambiguous approach can only serve as an impediment to financial services projects that deliver vital services, and ultimately drag on business growth.*

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Following the global financial crisis in 2008, progress has been made in securing stability and protection for the wider economy. Following this advancement, the real, significant and present threat to the UK's financial stability is a lack of growth, both in the sector and in the wider economy which relies on a steadily growing availability of financial services. Given the current fragile conditions of the UK economy, there must now be greater consideration from regulators as to how their approach to regulatory change can foster or encumber growth for financial services and across the real economy as a whole.

Through the CBI's engagement across every region of the UK, smaller financial services firms have argued that the regulators' current approach to new regulation is, at best, a drag on a firm's ability to grow, and at worst, a barrier to entry. Smaller players are penalised under the current regulatory infrastructure, struggling to achieve the scale necessary to cope with constantly changing and onerous demands on compliance procedures.

Following the European Commission's Call for Evidence on the EU Regulatory Framework for Financial Services in January 2016, the Bank of England responded with the acknowledgment that 'over the past eight years, the EU has delivered a major legislative regulatory reform programme, implementing and often exceeding the post-crisis agenda agreed by G20 leaders. Around 41 legislative proposals have been agreed including new supervisory arrangements, reforms to bank regulation, new resolution regimes and steps to make derivatives markets safer'<sup>5</sup>.

The Bank of England concedes, however, that 'given the urgency of reform following the crisis, the scale and scope of the reforms and their interlinked nature, it is to be expected that there will be places where adjustment is needed, where reforms are not working as intended or where there are conflicts between different elements of the framework'<sup>6</sup>. This sheds light on how a shift in the approach to new regulation is required, and how a practical approach to new requirements can best ensure that business growth is not hampered.

## A lack of transparency

Members have pointed out that the priorities and objectives of the regulatory investigations and reviews are often not transparent and generally aspire to cover more ground than resource will allow. It is likely that the rapid pace of change has meant that regulators' processes, availability, consistency and collaboration have not been able to develop sufficiently over the past three years. The result is that a lack of clear expectations and of regular, quality and holistic feedback from the regulators leads to unnecessary miscommunication, severe delays and systematised inefficiencies.

## Ever-increasing costs of compliance

Costs and the cumulative burden of compliance, referring to the aggregate impact of all regulatory policies to which firms must adhere, are not assessed across the system as a whole, and rather increased layer by layer without regard for the interrelationships of work carried on by each regulator. This has driven up costs for consumers and caused business activity to be focused near-exclusively on compliance rather than growth-focused areas such as new innovative projects or international expansion. In the same vein as the Call for Evidence commissioned by Lord Hill in early 2016, a better understanding of the cumulative impact of regulation to firms managing the high volume of regulatory changes is critical not just to the health of the sector but for ensuring the cohesive alignment and execution of regulators' objectives.

A greater focus must be applied to small and medium sized businesses, such as our challenger banks and our local building societies. Our members feel that there is a strong disregard for the disproportionate impact that regulatory change has on their businesses. Their compliance and risk teams are smaller and their engagement with supervisors is less frequent and less direct. As a result, the proportion and complexity of burden is far greater. As firms struggle to keep pace with iterative change, we see a direct threat to their very existence, and thus, a direct threat to consumer choice.

While the government and regulators are keen to encourage more competition, the reality is that the cost of compliance hits smaller players and new entrants the hardest. Research carried out by the Building Societies Association found that for larger building societies, the estimated cost of compliance staff implementing financial regulation currently stands at about £45 per million of assets. For smaller societies the same cost is nearer £450 per million.<sup>7</sup> This underlines the disproportionate weight carried on the shoulders of smaller firms, and stresses the hurdles that exist in a small building society's pursuit of growth and innovative new products.

Challenges also exist for larger businesses. One CBI member illustrated that 10% of their investment budget is purely spent on regulatory reporting. They have seen a 50% increase in reporting over the last 5 years, and this ongoing cost of statistical returns, described by the member as 'regulation by statistics', is undermining the firm's ability to even consider new business opportunities such as expanding and personalising their online offering to customers, let alone implement such projects.

## Constant iterative change

The CBI welcomes regulation that is fit for purpose. We welcome regulation that is consistent with stability and protection. Yet with a high level of requirement imposed on businesses, the UK's regulators must tread carefully when assessing new requirements, to avoid a situation where firms of all sizes are smothered by constantly changing regulation.

Uncertainty caused by regulation through iterative change and 'tinkering' has made proper forward business and investment planning near impossible as the pattern suggests that the rules of the game will likely change in the short term, let alone the longer term in which investment decisions are made. Regulating retrospectively to address problems that were not foreseen, rolling investigation periods with no transparent objectives or firm timescales, and the need to repeatedly upgrade compliance systems all directly force business behaviour away from growing and enhancing their customer offering, in order to minimise the risks of unintentionally falling foul of new regulation.

As we move forward, a clearer focus on the overall impact of multiple layers of regulatory change - often being implemented simultaneously - is not merely desirable, but critical for our financial services to deliver the increasingly diverse products and services necessary for consumers.



## Unintended consequences

The separation of the FCA and PRA functions has brought about many positive benefits in terms of focus. But a lack of central coordination to plan and align the interactions of differing regulatory rules and policymaker imperatives has naturally led to a culture of risk aversion among firms and unintended consequences which are to the detriment of the customer. Our members say that changes to the regulatory system, such as the Retail Distribution Review and the Senior Managers Regime, have brought about some necessary tightening of rules but have also been so far-reaching as to cause a retreat, rather than growth, of services like advice and professional indemnity insurance. Our members also report similar trends in the annuities and SME hedging lines, which underline the point that the unintended result of rapid regulation can be the eventual reduction of product lines and options for consumers and businesses.

There must be a recognition of the complexities inherent in new regulatory initiatives and a willingness to address them early on from a holistic perspective. For example, our members have criticised the timing of the FCA's Asset Management Market Study data request landing at the same time as annual preparations for their financial year-end, as adequate resources were simply not available. This example is indicative of the need for small, pragmatic changes in approach for future initiatives, allotting sufficient time for the industry to more effectively engage, and the need to provide a formalised way for the regulators to plan and consider change.

## Unpredictable supervisory approach

CBI members are quick to point out that the approach of regulatory supervision can, particularly in the case of the FCA, feel disproportionate and presume guilt. The UK's regulators need to be clearer on project objectives and provide more assurance to businesses on process. This creates a more collaborative model that encourages firms to work with regulators towards the right outcome, for the benefit of consumers and business certainty, rather than solely focusing on a path to identify and punish. The system must steer away from any combative 'enforcement culture' that may have been pursued in the past, and see more cooperation to identify and tackle systemic risks and potential negative consumer impacts as early as possible.

Throughout our UK-wide research, common themes were identified by our members regarding their relationship with regulatory supervisors including: the inconsistency of messages from one supervisor to the next, excessive rotation and turnover of staff, a lack of clarity over timescales and disconnect between senior level assurances and feedback from operational supervisory teams.

More internal alignment on communication within the regulators could go a long way towards curbing ambiguity and inconsistency provided to firms, and thus avoid the consequent growth-sapping paralysis and risk-aversion, which so often translates to serious detrimental consequences for services that consumers and businesses rely on in the wider economy.

## Decreasing channels of engagement

These criticisms, significant nonetheless, are nothing new. We call on the regulators to provide more consistency in their communication and engagement with firms, but the CBI views themes such as inconsistency and disconnection as symptoms of a wider cause – the current nature of supervision. When firms do not have a direct contact to engage with and discuss potential risks with, their experience of dealing with the regulator is undermined, the effectiveness of the regulator is weakened and the firm's ability to identify and manage risk is destabilised.

Fixed portfolio firms are a small population of firms that, based on factors such as size, market presence and customer footprint, require the highest level of supervisory attention. These firms are allocated a named individual supervisor, and are proactively supervised using a firm-specific continuous assessment approach.

The majority of firms are classified as flexible portfolio. These firms are supervised through a combination of market-based thematic work and programmes of communication, engagement and education activity aligned with the key risks identified for the sector in which the firms operate. These firms use the Customer Contact Centre as their first point of contact with the FCA as they are not allocated a named individual supervisor<sup>8</sup>.

The FCA states that the purpose of the supervisory regime is to look at the culture and practices of firms to ensure they consider consumers and market integrity in everything they do<sup>9</sup>.

Following the FCA's revised strategy, their four categories for the conduct classification of firms have been simplified to two. The regulator now differentiates firms as either fixed portfolio or flexible portfolio. It is these categories that determine the nature and intensity of the FCA's conduct supervisory approach.

The CBI appreciates the scale of the problem of regulating such a vast amount of firms with limited resources. Yet our members, some of whom were downgraded to flexible portfolio classification having previously had a more direct line of communication with a supervisor, have expressed concern about the nature of their supervisory relationship under the new simplified system.

They have admitted that they are now less inclined to report potential areas of risk due to the impersonal rigmarole of reporting via the Customer Contact Centre. It is self-evident that the standard of engagement between the regulator and the regulated will decline if a direct channel of communication is replaced with 'call centre-style supervision'. Firms are curbing new opportunities and growth activity unnecessarily because this new relationship with supervisors is not collaborative or pragmatic. The flexible portfolio model results in some key market participants having an increasingly distant relationship with the regulator, and this is bad news for the industry, and bad news for the regulator.



## Unidentified risk

The CBI welcomes proportionate supervision, but not to the detriment of unreported risk. We believe the regulatory framework needs to be as robust as possible to identify risks in whichever way is most pragmatic, because risks in the system will ultimately damage the outcomes for consumers and the wider economy.

Market integrity requires a proportionate approach to regulatory change, coupled with clear, defined, evidence-based direction on future initiatives. But proportionality is not synonymous with under-engagement. If the system is too rigid, and does not appreciate the need for more frequent engagement with some firms, there is the potential for risk going unreported or identified too late. A classification as a flexible portfolio firm can lead to under-engagement and inconsistent communication from the regulator, and thus must be chosen with great care.

The CBI would welcome a thorough assessment of the current criteria upon which a classification is determined to ensure firms that require direct engagement are allocated a fixed status accordingly. The current nature of supervision places the onus on more firms to be proactive about their engagement with the regulator, and this, by nature, increases the vulnerability of unreported risk.

A more engaged, more collaborative regulator leads to more certainty for regulated firms, leading to more clarity and stability in their forward planning. Firms need to know that when they identify mistakes or risks in the system, they can quickly and efficiently communicate with knowledgeable contacts in the regulators to collectively mitigate and correct the impacts for the benefit of consumers. Direct engagement leads to supervisory consistency, which in turn leads to the certainty that our members are calling for from our regulatory structure.

## Retaining the UK's comparative advantage in financial services

*Regardless of the settlement we reach with the EU, the domestic regulators will be supreme with regard to policy and supervision, meaning it has never been a more critical time to get our domestic regulatory framework right*

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*Outside the EU, UK regulators will need to be as global in their outlook and considerations as the services they are regulating*

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*Regulatory bodies must focus on being consistent and collaborative, to give the UK a competitive edge as the place to do business*

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*To enhance the UK's position as the global hub for financial services, our domestic regulatory infrastructure must be as complementary to international competitiveness as possible.*

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*The regulatory landscape should support and enhance the UK's position as the global hub for financial services. Certain factors within our wider regulatory culture are hindering the attractiveness of the UK and firms' ability to compete successfully with international equivalents. International competitiveness goes hand-in-hand with a firm's ability to grow, and if our regulatory landscape is not conducive to businesses' ability to compete with international competitors, then our financial services sector is not fulfilling its potential as an enabling industry for the wider economy.*

### **An international outlook**

Following the UK's decision to leave the EU, the UK's regulators have a key role to play in ensuring the UK retains its world-leading and pace-setting international standing of trustworthiness and business confidence in the system. CBI members are calling on all financial services regulators to be more proactive and engaged on international forums, given we will soon cease to be part of an EU delegation. The UK's regulators have a strong track record on technical input to EU-level decision-making, but generally have been less effective in driving a strategic vision for regulation, with notable exceptions including the Financial Stability Board around structural reform.

In tackling this challenge, UK regulators will need to be proactive in rapidly updating their skillsets in order to effectively engage with other global regulators and drive global legislative attitudes. The sector stands ready to help this process, pursuing new ways of collaborating to aid the capabilities of our regulators in constructing and disseminating best practice thinking both with our European neighbours and further afield in key jurisdictions including Hong Kong, Singapore and the USA.

While the legislative remit and objectives of the UK regulators currently do not give cause for policy implementation to take regard for how the sector might be advantaged or disadvantaged internationally, changes in the UK's global positioning will necessitate this consideration going forward. Previous examples of 'gold-plating' internationally-agreed rules by making them more onerous or more comprehensive than neighbouring jurisdictions, as well as front-running regulation ahead of global norms, will need to be curbed to ensure consistency in global operations but also to avoid resulting competitive detriments for UK firms which translate into a loss of services and higher costs for UK consumers.

## Regulatory consistency

When competing internationally, whether this means UK businesses competing against international competitors or the UK, as a financial services hub, competing against the likes of Germany or Ireland for firms to invest here, our regulatory bodies must be consistent and collaborative to give the UK a competitive edge.

Following the Financial Services Act 2012, the Financial Services Authority was abolished and its responsibilities split between two new UK regulators – the PRA and the FCA. While CBI members understand the split in regulatory competencies, they are eager to point out that consistency must be at the heart of this structure, three years on after its formation. The CBI proposes that more must be done to find common ground for collaboration and more must be done to ensure consistency in requirements and messages. We welcome the FCA's aim to interact more, where appropriate, with the PRA, but we would like to see more consistency and more formalised collaboration.

A lack of joint-planning, coordination and information-sharing between the regulators can lead to substantial regulatory complexity when operating within the sector, with serious consequences for UK financial services to compete internationally. Resultant mixed signals, shortage in guidance, duplicated effort and ambiguity lead firms to constantly reassess certain activities and pricing to ensure viability in an increasingly costly environment. The CBI understands that the rules and remits of the FCA and the PRA cannot, by nature of a dual-regulatory framework, be wholly aligned. However, this does not mean that the advice and responses coming from each respective regulator can be contradictory.

A CBI member in Scotland described a recent project where contradictory messages from the FCA and the PRA led to more than six months of delay to the implementation of their project. While the PRA were encouraging the business to move away from a reliance on a certain area of their business, the FCA slowed their transition, requesting an 'excessive level of detail' in the firm's pursuit of authorisation, demonstrating a 'clear lack of business model knowledge' and providing no guidance over the potential delay the firm was about to face. The inconsistency between the regulators and the uncertainty created by a lack of communication led to high costs for the business. The costs accrued from this project's delay will be picked up by the customer.

## Avoiding duplication

Consistency between regulators in their data requirements would, where possible, reduce duplication and therefore the overall burden of compliance. Members have given examples where the same data has been requested by both the FCA and the PRA, but requested in different formats, which has resulted in resources being utilised unnecessarily due to an easily-rectifiable inconsistency. It is important to note that we are calling for more consistency and collaboration, building on the interaction that already exists. Our members have praised the interaction that does take place between the regulators, with the specific example expressed of the collaboration that existed for the initial stages of the Senior Managers Regime (SMR).

## Implementation & execution

In order for UK businesses to be internationally competitive, and for the UK as a whole to retain its world-leading status as a financial services hub, firms must do business in a regulatory environment where regulators are consistent in their approach, providing certainty and stability to the industry. Yet this is not merely confined to consistency in approach between regulators, but also consistency in their expectation of how regulatory policy is implemented.

Adopting the example of the SMR, CBI members were quick to note that they have been disappointed with the irregularity in the way the SMR has been implemented between firms. Concerns were already prevalent around the regime's effect on international competitiveness, by threatening the ability of firms looking to attract talent in the UK over other countries. But our members' concerns were heightened by the inconsistency in the way the SMR has been interpreted and subsequently implemented by different businesses. Once again, more certainty is required from the regulators to ensure businesses are given the best chance of remaining internationally competitive as well as consistent in their adoption of regulatory initiatives.

**In light of an uncertain international landscape in the coming years, now is a more critical time than ever to get our domestic regulatory framework right, so our businesses can compete internationally and the UK can remain as a global financial services hub. Regardless of our settlement with the EU, our domestic infrastructure will now be supreme and we call on the UK's regulators to provide the much-needed certainty to businesses through increased consistency and collaboration between regulatory bodies, to ensure financial services can thrive for the benefit of the whole economy.**

## Pulling to the forefront of cutting-edge innovation

*Regulators need to ensure they remain open to supporting innovation from both disruptors with entrepreneurial ideas and incumbents with intrapreneurial products*

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*Sudden regulatory change instils uncertainty and has the potential to curb current innovations and damage the progress that has been made to date as companies become more cautious*

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*Regulatory change means technological change, and this cost eats the lion's share of innovation budgets*

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*The UK regulatory landscape should empower firms to research, experiment and innovate to provide the cutting-edge services that businesses require, but our current approach to regulatory change is still preventing firms from innovating and diversifying their business offering. The pace and burden of regulatory change is stifling the ability of firms to dedicate meaningful resource to innovation, which is subsequently inflicting damage on the sector, and the wider economy, for the future.*

A CBI member in Yorkshire admitted that recent plans to develop an app - so their customers could access account services and information on their smartphones - were shelved. The resource that had originally been authorised for the creation of the app was diverted to the compliance team due to the extra resource required to deal with a new wave of regulation. This experience mirrors the response from many members who have concluded that 'the only growth area left in financial services is compliance'. As a world-leading financial services hub, this cannot be sustained, and the regulators' approach to new regulation must change to give firms the breathing space they need to innovate for the benefit of their customers.

Another member recalled that they had spent 10 weekends upgrading their IT system just to comply with data collection requirements, let alone the other seemingly endless regulatory iterations. In simple terms, this is time and money they could have spent improving their digital offer, giving customers cheaper and more personalised services. This is about overall approach, engagement and recognising that the market participants have a vested interest, and the resources to assist, in producing better outcomes for consumers.

The iterative and layered effect of regulatory change leads to significant innovation opportunity costs as compliance absorbs a firm's recruitment, investment and business planning agendas. New and more accessible products and services are being actively eschewed, to the detriment of consumers, as firms lose the bandwidth on changing their systems to the needs of constant regulatory upgrades. Regulatory change means technological change, and this cost eats the lion's share of innovation budgets.

## Fostering financial innovation

The CBI is interested not just in shifting the approach to change, but also in building on progress already made. CBI members have been resolute that the FCA's Project Innovate and the subsequent launching of the regulatory sandbox are worthy steps in the right direction for supporting new innovation. We recognise the FCA's work in helping to foster an innovative environment and many members agree that the UK has one of the most progressive and innovation-friendly regulatory environments in the world. This approach extends to the PSR, which also has an innovation objective.

The regulators' approach to innovation, however, must maintain momentum and capitalise on the support of its early plaudits. Project Innovate does not have the resource it needs to achieve the scale necessary to stay relevant. Moreover, the FCA needs to ensure it remains open to supporting innovative ideas from both disruptors with entrepreneurial ideas and incumbents with intrapreneurial products. For example, some large incumbents stated that the regulatory sandbox has placed too much focus on FinTech disruptors and their testing of new products. The CBI notes that the original remit of the sandbox does set out a commitment to test new financial technology from all firms of any size. As a result, the CBI urges the FCA to restate and reinforce their commitment to innovation from firms of all sizes – both for the benefit of firms but also to keep the regulator at the cutting-edge of developments.





## Understanding new business models

The regulators must continue to develop their supervisory teams to ensure their knowledge and understanding of unfamiliar business models does not undermine the ability of firms to proactively engage with the regulators. As outlined in the previous section, CBI members have demonstrated an apparent disconnect between the senior level messaging of regulators and the overly cautious outlook by some supervisory staff, which manifests itself in slow or inconsistent decision-making. This is particularly noteworthy in the realm of innovation, where the regulators' commitment to support innovation must be matched by a proactive supervisory team who are forward looking and proactive in their approach to understanding new products and business models.

CBI members have praised the FCA's policy team for its forward thinking messaging and direction on article 36H of the Regulated Activities Order for peer-to-peer agreements. But they have expressed that this messaging is often not aligned with the FCA's supervisory team, who have been accused of adopting a narrow-minded interpretation of the article. Consistency in thinking between regulators, and within regulators, is crucial to the success of new FinTech firms and innovative products.



## Upskilling for the future

The skillsets and resource allocation within the regulators are a cause for concern for members as they have identified an extreme variance in the quality of feedback, guidance and supervision they receive depending on which part of a regulator they are dealing with. Given the pace of ground-breaking change in the sector, supervisors often find themselves either insufficiently trained to deal with the financial technology that is under review, or insufficiently resourced for comprehensive data analysis, leading to a situation where they are unable to stay on top of sector trends. Consequently, innovative products and services are being delayed, shelved or blocked unnecessarily, as inadequate technical expertise or deficient market intelligence paralyse regulatory decision-making. In a fast-paced sector, with new technology developing in all areas of financial services, businesses need certainty from the regulatory system that the regulators are equipped for a changing landscape, and alert to new business models that require a degree of flexibility in approach.

## Building engagement

CBI members are critical of the FCA's thematic reviews due to their poor track-record in assessing emerging risks relating to an issue or product. The CBI welcomes the efforts by regulators to understand more about what is going on in a specific sector to build up a greater understanding of new products and new business models. This is absolutely critical for the success of innovative products in the UK. However, we would strongly encourage new ways of engaging with regulated firms to build on this progress.

The FCA states that they 'can apply the thematic process to a large variety of situations, firms and groups of consumers. It allows investigation into key risks, and its focus on a specific risk allows for further detailed work in the particular area of concern'<sup>10</sup>. But our members would like to see more focus applied to these reviews to limit any unnecessary resource allocated to it, and more clarity over the output achieved from such projects. They have admitted that the announcement of a thematic review in a particular area can spark investor panic, therefore the CBI urges the regulator to give greater clarity on the direction of thematic reviews and apply greater focus to their desired outcomes. The CBI also encourages the regulators to consider new ways of assessing current or emerging risk in innovative areas of financial services, such as sector secondments, practitioner working groups and firm open days.

The UK's payment systems have achieved world-leading status through market-led research and innovation, founded on evidence-based change coupled with strong, pragmatic business cases for implementation. This recipe for success must be replicated in the wider financial services industry, allowing businesses the scope and resource to innovate, to achieve a cutting-edge and fully financially inclusive sector. The UK regulatory landscape must empower firms to research and experiment to provide the pioneering, innovative services that consumers and businesses require. In order to assist firms in innovating and diversifying their business offering, there must be a shift in the regulators' approach to change, giving firms the certainty, consistency and bandwidth to be forward looking.

Our recommendations set out 7 achievable and pragmatic ways that will help shift the regulators' approach towards change, giving businesses the certainty they need:

- 1** *More formalised collaboration between the FCA and PRA*
- 2** *A sector-wide call for evidence on the cumulative impact of regulation*
- 3** *New dialogue forums to offer direct feedback from the industry, especially for flexible portfolio firms*
- 4** *New sector engagement initiatives to ensure the best possible access – on an operational working level – to the everyday complexities of financial services businesses*
- 5** *A thorough assessment of the current criteria upon which a flexible portfolio classification is determined*
- 6** *An expansion of the FCA's Project Innovate to ensure its benefits can be scaled to provide quality regulatory guidance to more disruptors and incumbents*
- 7** *A rejection by the Government of the Treasury Select Committee's recommendation to split the FCA's enforcement function into a new separate body.*

*By adopting a practical approach to regulatory change, and providing certainty to financial services businesses, the UK's regulatory model will cement its already world-leading status and be primed to adapt in a shifting political climate as a smarter, more fit for purpose regulatory infrastructure. This will empower the industry to fulfil its potential as an enabler of growth, and encourage prosperity and opportunity for everyone.*

### **The CBI is not calling for less regulation, but smarter regulation**

The CBI's recommendations set out practical examples that are consistent with what an overarching regulatory culture should look like, in order to give financial services firms the certainty they need, and to provide the most fitting regulatory landscape in which businesses can grow, compete internationally and remain at the forefront of innovation.

In order to build on the progress that has been made since 2012, we are looking to fine-tune the strategic direction of the regulators. A shift towards a culture of regulatory certainty requires a shift in the overarching philosophy of the primary regulators. This is not defined by a radical overhaul of regulatory policy, but a recalibration of the way regulators approach regulatory change.

## 1 *More formalised collaboration between the FCA and PRA*

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CBI members understand the split in regulatory competencies, but consistency must be at the heart of this structure, three years on after its formation. The CBI is proposing that more must be done to find common ground for collaboration and more must be done to ensure consistency in requirements and messages. We welcome the FCA's aim to interact, where appropriate, with the PRA, but we would like to see more consistency and more formalised collaboration, to build on the successful interaction that already takes place.

The CBI understands that the rules and remits of the FCA and the PRA cannot, by nature of a dual-regulatory framework, be wholly aligned. On the contrary, this does not mean that the advice and responses coming from each respective regulator can be contradictory. Consistency between regulators in their data requirements would, where possible, reduce duplication and therefore the overall burden of compliance. In addition, the CBI would encourage the regulators to implement a shared Customer Relationship Management (CRM) system, in order to widen the access to key information that has already been supplied by the regulated company.

## 2 *A sector-wide call for evidence on the cumulative impact of regulation*

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CBI members have stated that the costs and the cumulative burden of compliance are not assessed across the system as a whole, and rather increased layer by layer without regard for the system. This has driven up costs for consumers and caused business activity to be focused near-exclusively on compliance rather than growth-focused areas.

In the same vein as the Call for Evidence commissioned by Lord Hill in early 2016 for the European Commission, a better understanding of the cumulative impact of regulation to firms managing the high volume of regulatory changes is critical to our financial services sector. A cumulative impact assessment would crystallise where regulatory objectives are succeeding and where they are not, illustrate the true scale of impact that regulatory change imposes on regulated companies, and help inform the regulators on how best to approach regulatory change in the future.

### **3** *New dialogue forums to offer direct feedback from the industry, especially for flexible portfolio firms*

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For companies under flexible portfolio supervision, regular opportunities to engage with the regulators is vital in order to gain clarity over the direction of the regulators, as well as to provide a platform to share their thoughts with other regulated companies and articulate their concerns. This will also be a useful forum for the regulator in gaining valuable market intelligence to inform their work going forward in identifying key risk areas.

### **4** *New sector engagement initiatives to ensure the best possible access – on an operational working level – to the everyday complexities of financial services businesses*

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The regulators must continue to develop their supervisory teams to ensure their knowledge and understanding of unfamiliar business models does not undermine the ability of firms to proactively engage with the regulators. The CBI calls on the regulators to refocus resource on new sector engagement initiatives including:

- **Sector secondments**
- **Practitioner working groups**
- **Firm open days.**

In a fast-paced sector, with new technology developing in all areas of financial services, businesses need certainty from the regulatory system that the regulators are equipped for a changing landscape and alert to new business models that require a degree of flexibility in approach. Once again, firms under flexible portfolio supervision would benefit significantly from greater opportunities to engage with the regulators, who in turn would gain a greater understanding of market interdependencies and trends.

## **5** *A thorough assessment of the current criteria upon which a flexible portfolio classification is determined*

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The CBI welcomes proportionate supervision, but not to the detriment of unreported risk. We believe the regulatory framework needs to be as robust as possible to identify risks in whichever way is most pragmatic, because risks in the system will ultimately damage the outcomes for consumers and the wider economy. A system that is too rigid or does not thoroughly analyse the need for more frequent engagement creates the potential for unreported risk.

A firm that is classified to flexible portfolio supervision creates the potential for unreported risk through under-engagement and inconsistent communication from the regulator. The CBI would welcome a thorough assessment of the current criteria upon which a classification is determined to ensure firms that require direct engagement are allocated a fixed status accordingly. The current nature of supervision heightens risk as the onus is now on more firms to be more proactive about their engagement with the regulator, which has the potential to increase vulnerability of unintended consequences.

## **6** *An expansion of the FCA's Project Innovate to ensure its benefits can be scaled to provide quality regulatory guidance to more disruptors and incumbents*

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The regulator's approach to innovation must maintain momentum and live up to the praise of its early plaudits. The FCA needs to ensure it remains open to supporting innovative ideas from both disruptors and incumbents. The CBI appreciates that the original remit of the regulatory sandbox does set out a commitment to test new financial technology from all firms of any size, but we urge the FCA to restate and reinforce their commitment to innovation from firms of all sizes. To complement this, the CBI calls on the FCA to expand the resource allocation of Project Innovate as a whole to ensure its benefits can be provided to more firms.



## **7** *A rejection by the Government of the Treasury Select Committee's recommendation to split the FCA's enforcement function into a new separate body*

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Following the UK's decision to leave the EU, businesses require certainty and stability now more than ever. Further separation of the UK's regulators would increase uncertainty and instability, as regulated companies would once again have to adapt to a new infrastructure. This is a time to steady the ship, rather than inflict more structural change which would leave the regulatory infrastructure vulnerable to problems of coordination and coherence.

These 7 recommendations are achievable and pragmatic ways that will help shift the regulators' approach towards change, offering a stable footing for business. Underpinning these easy-to-implement recommendations is our members' appeal for a shift in the culture of UK regulation, towards a more engaged, consultative, focused and assured model of regulation that provides the stable yet fertile ground that firms are directly calling for. The CBI is not calling for less regulation, but smarter regulation.

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