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House of Lords EU Financial Affairs Sub-Committee

29 September 2017

Dear Baroness Falkner,

Call for evidence: Inquiry into financial regulation and supervision following Brexit

The Financial Services Consumer Panel is an independent statutory body, set up to represent the interests of retail and small business consumers in the development of policy and regulation of financial services in the UK.

The emphasis of the Panel's work is on activities that are regulated by the FCA, although it may also look at the impact on consumers of activities that are related to the FCA's general duties, including the work of the EU institutions.

The Panel welcomes the opportunity to respond to this inquiry.

Sue Lewis
Chair, Financial Services Consumer Panel

Current regulatory regimes

Q1. What is your overall assessment of the EU's financial services regime, in light of its current application to the UK? To what extent is it effective and for whom?

As the Panel argued in its position paper on Brexit¹, EU financial services legislation has generally raised the bar on consumer rights and benefitted UK consumers. The Payments Account Directive, for example, has given consumers a legal right of access to a basic bank account. Another key strength of the EU has been in providing a public, strategic, overarching plan for the development and implementation of regulatory measures. This not only benefits consumers, but also financial services firms as it provides increased regulatory certainty and enhances trust and confidence in the sector.

The UK has played a central role in shaping that agenda for financial services. For example, the Solvency II Directive was heavily influenced by the UK's experience of insurance markets and raised the standard of European insurance capital requirements to match the UK's². The UK has also been influential in the development of EU conduct legislation, and is widely regarded as a global leader in this field.

However, the benefits of the EU's approach have been undermined by the fact that individual Directives and Regulations have been developed on a sectoral basis. For example, the lack of alignment on investor protection measures in MiFID II and the Insurance Distribution Directive (IDD), such as cost disclosure and restrictions on inducement, create the risk of regulatory arbitrage. By adding an insurance element to their investment products, firms may be subject to the less strict IDD regime. In another example, Key Information Documents in the PRIIPs Regulation provide product manufacturers with too much flexibility in the calculation of future performance scenarios and could lead to consumer overconfidence and disappointment in future outcomes. In the UK, the Government and FCA have often chosen to go beyond the minimum requirements of EU Directives to overcome these inconsistencies and hence generate better consumer protection.

Another weakness of the EU regime has been a lack of consistent supervision across Member States. Regulatory expertise and resources across the EU28 vary greatly and this has an impact on the ability to supervise conduct of business. It creates risks for all consumers and undermines trust in the market, especially for passported products.

The Panel believes that as the UK takes additional or complete control of its financial services legislation there will be an opportunity for shaping a regulatory regime which delivers better outcomes for consumers, in line with the FCA's statutory objectives. The Panel is currently carrying out research into how the UK could continue to influence EU and international conduct regulation following Brexit and would be happy to share its findings with the Committee once available.

Q3. What are the key differences between financial regulation as agreed at the international, EU and UK levels, and where are the gaps? How important is it to maintain a level playing field for regulation?

¹ Financial Services Consumer Panel: "Position paper on Brexit": https://www.fs-cp.org.uk/sites/default/files/brexit_paper_final_20170206.pdf

² City of London: "Shaping legislation: UK engagement in EU financial services policy-making": <https://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/Research%202016/shaping-EU-legislation.pdf>

The EU has, broadly, allowed member states to determine their own conduct requirements within the boundaries of high-level Directives. Over the years, there has been convergence between the EU's regulatory requirements and those of the UK (which is probably a reflection of the significant influence the UK has had on EU policy) but there remain areas where EU consumer protection falls short of that provided by the UK regime, notably in the areas of dispute resolution and redress as well as inducements where the UK's regime goes further than the minimum requirements under MiFID II.. The UK has often gone further than the provisions enshrined in EU law in order to give greater consistency across different products, or to ensure the intended consumer outcomes are achieved more effectively.

Maintaining a level playing field is important to ensure continued trade, choice and competition. However, trade, competition and choice must lead to good consumer outcomes, and should not lead to a 'race to the bottom'.

International standard setters have traditionally focus on developing prudential principles. However, there has recently been a push towards addressing conduct issues at the international level and various international organisations have begun to develop broad conduct principles for the regulation and supervision of financial institutions. The Financial Stability Board for example is currently carrying out work on strengthening governance frameworks to mitigate misconduct risks. The International Association of Insurance Supervisors (IAIS) has developed Insurance Code Principles that should be applied to national supervisors, including conduct requirements such as: suitability of persons, corporate governance, risk management and internal controls and conduct of business.

While international standards are not normally legally binding, they provide a broad, common framework across specific global markets. This could help to address the loss of the EU's agenda setting and overall framework for financial services regulation in the UK. As the UK leaves the EU, there will be opportunities to refocus some of the energy and resources spent on shaping the EU agenda towards influencing international fora.

Q4. Are there any particular legal or practical challenges related to incorporating the existing body of EU financial services legislation into the UK's domestic law, for example the PRA rulebook?

The Repeal Bill will 'lift and shift' EU law into the UK statute books. However, some things won't work. For example, references to EU regulatory agencies will need to be removed or replaced with UK agencies (ESMA's credit rating agencies powers for example will most likely be transferred to the FCA).

The provisions in the Repeal Bill are wide, allowing for remedying any failure of retained EU law to operate effectively and other deficiencies. The government is asking for delegated power to make 'technical' or 'administrative' changes to EU retained law. From a consumer perspective, the Panel has warned against a watering down of protection provisions through delegated powers. While there seems to have been broad agreement between consumer representatives and industry on prioritising legal and regulatory continuity, there is a risk of deregulation through the back door.

Q5. What would be the key priorities for a transitional arrangement, and how much continuity would you expect to see under such an arrangement?

Much of the analysis of the UK's exit from the EU Single Market has focussed on the ability of UK firms to operate in the EU and vice versa. There has been less examination of the potential impact that a 'hard stop' in passporting would have on consumers, or of consumers who have long-term contracts with non-UK firms. The Panel urges the Government to prioritise transitional arrangements that minimise uncertainty and disruption for consumers.

Regulatory cooperation will be essential. An MoU between UK and EU27 regulators would provide for close regulatory cooperation and barrier-free exchange of information between UK and EU regulators.

Transition, equivalence and alignment

Q6. In practical terms, how and when could a transitional arrangement be agreed and put in place? How long would such a transition need to last?

The Panel is concerned that the transitional arrangements currently being discussed are unlikely to be of sufficient length to cover long-term products.

Many insurers in the UK and the EU27 make use of passporting rights to do business cross-border and hundreds of thousands of existing insurance contracts have terms covering decades³. When the UK leaves the Single Market some insurers will lose their automatic licence to insure in the customer's jurisdiction, and may not be legally able to pay out what they owe unless they establish an authorised branch in the UK or transfer the contract to another entity. A solution needs to be found to this in time to avoid disruption or uncertainty.

Q7. What are the benefits and drawbacks of seeking equivalence? What conditions are likely to be attached by the EU to any equivalence decisions?

A framework based on equivalence would allow consumers to continue to be able to access some products and services sold in the EU.

A possible downside is that, depending on the equivalence deal that is reached, the UK may not be able to make improvements to consumer protection legislation. As we have argued, the UK currently goes beyond minimum harmonising directives in a number of consumer protection areas. For example, the UK's Financial Ombudsman Service is a model Alternative Dispute Resolution service which goes beyond provisions in the Alternative Dispute Resolution Directive. Losing the freedom to tailor legislation for the UK market could have a negative impact on UK consumers. It is also unlikely that the UK would be able to influence financial services legislation to the extent it is able to at present.

The future environment

Q9. What effect will the loss of the UK have on the development of the EU financial services framework and its capital markets?

The EU has benefitted from the UK's expertise in the development of financial services legislation. Once the UK leaves the EU, there is risk that conduct policy and consumer protection loses momentum. This is important as consumer groups at the EU level are struggling to compete with industry and feed into the EU policy making process. Depending on the outcome of the negotiations and the shape of the future relationship between the UK and the EU, the UK may be required to follow EU financial services framework closely without being able to influence it to the extent to which it is able to at present. This could have a negative impact on UK consumers.

Q10. Where is there scope for the UK to amend its regulatory regime? What precedents exist under current equivalence decisions for divergence to occur?

There is a real opportunity for the FCA to do more to prevent poor conduct, rather than address detriment that has already occurred. Misconduct, conflicts of interests, opaque pricing structures and poor customer service continue to be rife in the industry. Exiting the EU

³ ABI, "Brexit and insurance contracts: why preserving customers' rights after 2019 requires urgent action": <https://www.abi.org.uk/globalassets/files/subject/members/brexit/brexit-and-insurance-contracts.pdf>

provides an opportunity to recast regulation that has not worked well in the UK, while protecting the high standards set by the EU.

In our Brexit position paper, we highlighted examples where the UK has been prevented from providing better protection. For example, the EU has been heavily focused on disclosure. This approach is now out of date. Overloading consumers with information can lead to poor decisions and inertia. The incoming PRIIPs Regulation will require firms to produce Key Information Documents. While these may be helpful in certain EU countries, the personal projections under FCA Code of Business Sourcebook rules provide a more transparent and consistent framework. The FCA is currently obliged to require firms to provide the KID as it stems from an EU Regulation, while also allowing the more streamlined personal projections. This risks confusing consumers.

Under the Deposit Guarantee Schemes Directive, EU member states that aren't part of the single currency are required to recalculate the deposit limit every five years and adjust their own protection guarantees accordingly. Once outside the EU, the UK will be able to set its own limit, when it chooses.

The FCA claims EU legislation restricts the information it can release. As we leave the EU, the Panel would like HM Treasury to review S348 of FSMA to give the FCA legal certainty about what it can release, and enable the regulator to be more transparent.

The Panel has long argued for FSMA to be amended to require the FCA to make rules specifying what constitutes a 'reasonable' duty of care that financial services providers should owe their customers. Such a duty would set the right principle for financial services in the UK, giving them freedom to compete, innovate and trade in the new environment but in a way which does not increase risk and detriment to consumers. We believe the debate on the benefits of a duty of care should happen now, not wait until after the UK exits the EU, as the FCA proposes.

The Panel would also like to see reform in the regulation of passported products that would allow National Competent Authorities (i.e. in the UK's case, the FCA) to supervise and enforce against firms providing services or products in their country. The current patchwork of regulatory protection leads to regulatory arbitrage. Firms get authorisation in a country with lower consumer protection requirements but are still able to sell their products and services in the UK. Many firms on the FCA register have authorisation by virtue of the passport but are not directly regulated by the FCA and there is no recourse to the Financial Ombudsman if things go wrong. The FCA cannot legally point out the risks of dealing with such firms, merely advise consumers they may be able to get redress in the country of authorisation.

Absent the EU institutions, the Government, Parliament and regulators will need to initiate, implement and scrutinise financial services policy. The way power, responsibility and accountability is distributed between these institutions will have a profound impact on all users of financial services. It is vital this impact is considered in the design of the post-exit framework.

Q11. What challenges will expected innovations in financial markets, for instance in the FinTech sector, present in respect of regulation and supervision post-Brexit? How can these challenges be overcome? Can the UK maintain a competitive advantage while adapting to a new regime? If so, how?

As innovation in the financial services sector continues to erode the boundaries between financial products and services and those providing them or enabling their provision, the regulatory framework governing FinTech solutions needs to keep up. The EBA recently undertook a mapping exercise on financial innovations applied by FinTech firms in the EU, and their regulatory treatment. The research found wide variations in the regulation of Fintech firms. Nearly a third of companies were not subject to any regulatory regime at all. As the UK leaves the EU, it will need to find a way to ensure that services provided by EU FinTech companies to UK consumers are properly regulated and supervised.

As one of the global FinTech centres, the UK should take the lead in ensuring that innovation results in better consumer outcomes. There should be strong investment and innovation in RegTech so that the UK is not only able to keep pace with FinTech but also leads new, more effective and efficient forms of regulation globally.

Q12. Will leaving the EU affect the way that the UK represents itself in international fora? How can the UK continue to maintain influence when dealing with organisations such as the FSB and IOSCO in setting international standards?

As the UK leaves the EU there will be an opportunity for HM Government and the FCA to play more of a leadership role in initiating and shaping the future direction of financial services regulation at the international level. UK regulators are respected globally. Leaving the EU will allow UK regulators to use their expertise more independently to shape international standards, while respecting any agreements with the EU.

The Panel has worked with bodies such as the OECD and international consumer organisations to raise the profile of the consumer protection agenda and will continue to do so as the UK leaves the EU.

Supervision

Q13. The Commission is currently conducting a review of the European Supervisory Agencies. What, in your view, are the key areas where reform should be pursued and what might be the impact of such reform on UK supervision?

Many EU27 national competent authorities do not have a statutory consumer protection objective, or do not possess sufficient resources and expertise to supervise effectively. As a result, there is significant consumer detriment in retail banking, payments, investments, insurances, and savings in many member states. The ESA review is a good opportunity to harmonise the quality of supervision and enforcement everywhere in the EU to better protect users of financial services.

There is a need to upgrade the quality of supervision and enforcement everywhere in the EU to achieve supervisory convergence. BEUC – the EU consumer organisation – has proposed an EU supervisory authority dedicated only to conduct issues, as the consumer protection mandates of the existing ESAs have been treated as marginal issues so far.

An EU agency dedicated to conduct regulation would bring about a ‘twin-peak’ regulatory model at the EU level which would mirror the UK’s post-crisis regulatory framework. Convergence with the EU in terms of infrastructure would likely facilitate the functioning of the relationship between UK regulators and EU regulators once the UK has left the EU. This would also likely benefit supervision of cross-border activity and generally enhance consumer protection.