Rebooting UK Financial Regulation for a Post-Brexit World

A Conference Summary

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Introduction

Inspired by the Treasury's consultation on its *Future Regulatory Framework Review* of financial services regulation in the UK, Peter Andrews (Oxera, SRC), Kevin R. James (LSE), and Eva Micheler (LSE) organized a conference at the LSE's Systemic Risk Center on 9 February 2021 entitled "Rebooting UK Financial Regulation for a Post-Brexit World". We thank the speakers and the conference participants for a fascinating set of talks and discussions, and we provide an executive summary of the conference and a brief summary of the each individual presentation below (we note that several of the presentations are available on the Systemic Risk Centre's webpage).

Executive Summary

Eva Micheler presents an overview of the conference presentations, focusing on the three key themes that emerged from the presentations and discussions: i) accountability arrangements for the regulatory system; ii) the objectives, methods, and approaches of the financial regulators; and iii) specific areas of regulation.

Since a significant proportion of the UK's financial market regulation ultimately came from the EU, Brexit will inevitably lead to profound changes in the UK's financial regulatory regime. As **Niamh Moloney** points out, the EU has a very different architecture for accountability. Moving the UK out of that architecture will require the Treasury and the UK regulators to design a new system of accountability that works for the UK. It may be tempting to impose this accountability by requiring regulators to comply with elaborate decision-making criteria, but **Katharine Braddick** and **Julia Black** both argue that this path can lead to a disastrous calcification of the regulatory regime. **Julia Black** proposes instead that the UK put into place effective accountors who have the information, skills and resources to properly monitor the regulators.

Brexit provides an opportunity for regulators to rethink both their objectives and how they approach those objectives. **Kevin R. James** argues that effective financial markets play a vital role in promoting TFP growth and in reducing financial crisis risk. Yet, no regulator is responsible for monitoring and promoting the effectiveness of the financial system as a whole. Consequently, the Treasury should explore the possibility of creating a new objective: making financial markets effective for the real economy.

Peter Andrews notes that suitability is a central pillar of the regulatory regime and yet, with the exception of the mortgage market, regulators have not collected granular data about who buys what. As a result, they have been unable to determine whether suitability is achieved in practice, which matters because many consumers are willing to buy terrible financial products. Big data and new analytical techniques now make it considerably easier to measure suitability. Regulators need to exploit this by collecting the right data. They should avoid over-regulating by using realistic experiments to design interventions, all of which should be subject to rigorous CBAs ex post, to check whether what appears to work actually does work.

Brexit is of course not the only factor transforming the UK's financial services sector. **Greg Taylor** warns that financial markets are ripe for technological disruption as financial products are both intangible and intermediated. Tech markets can lead to strong network effects and platformization, both of which create significant competitive advantages for leading firms. Financial market regulators should therefore prepare to deal with the significant implications that these features of tech markets have on the competition in the market.

The Brexit inspired review of UK financial services regulation also provides an opportunity to address important specific issues. In the drive to reduce systemic risk, the question of how to deal with insurers has long been a difficult one. Investigating the contribution that insures make to overall systemic risk, **Christoph Kaserer** finds that while most insurers are too small and too peripheral to be systemic, some insurers are systemically important. Stricter regulation of those insurers is justified.

Luis Correia da Silva examines the competitiveness of the UK's primary market. He finds that high regulatory costs and restrictive listing rules have reduced the attractiveness of the UK's IPO market. He argues that regulators should: i) take a more proportionate view of the requirements they impose upon newly listed SMEs; and ii) allow dual-class share structures so that founders could go public but still retain control. **Reinder Van Dijk** finds a more favorable picture when examining the evolution of liquidity on the London Stock Exchange: according to both the standard Bid/Ask spread measure and the cost that traders actually pay to execute, liquidity has been improving.

So, this conference suggests that the combination of Brexit and the *Treasury's Future Regulatory Framework Review* create an exciting opportunity to improve the UK's financial regulatory system.

Eva Micheler (e.micheler@lse.ac.uk) is an Associate Professor of Law at the London School of Economics.

The Future Regulatory Framework Review

Katherine Braddick discusses the goals and the public policy context of the Treasury's *Future Regulatory Framework* Review of Post-Brexit financial services regulation.

Brexit means that the UK is now responsible for the regulation of its own vital financial services sector. Brexit therefore provides the UK with a real opportunity to design a regulatory regime that supports a competitive and stable financial services sector that serves the UK economy of today and, crucially, the UK economy of tomorrow. The UK must design its regime keeping in mind the international role of the UK financial services sector, the UK's commitment to reaching net-zero carbon emissions, and the impact of new technology on the way that financial services operate. Supporting an efficient and effective financial system given these constraints requires effective and efficient regulation. Consequently, the UK is aiming to build upon its position as a major international financial centre by pursuing a strategy of high quality regulation rather than by engaging in a race to the bottom.

The Treasury's *Future Regulatory Framework (FRF)* Review explores how to go about creating such a regulatory regime. Regulators exercise enormous power, and they must therefore: i) exercise those powers taking into account the broader public policy framework set by the Government and Parliament; and ii) be accountable to Government and Parliament for how they exercise their powers. Broadly speaking, the UK's current framework of independent expert regulators directly responsible for regulations while operating within a public policy framework established by the Government and Parliament works well. Brexit provides an opportunity to review this framework to: i) optimize the split of responsibilities within this general structure; and ii) ensure that regulators are properly accountable to the Government and Parliament.

Designing a regulatory regime that achieves all of these goals is a challenging task. For example, a desire for accountability could easily lead to endless checks, balances, and reporting requirements that would calcify the regulatory regime and destroy the agility that is one of the UK regime's great strengths. The Treasury therefore welcomes debate and discussion on this task, and will provide detailed proposals for regulatory reform later this year.

Katherine Braddick is the Director General for Financial Services at HM Treasury.

Navigating The New Regulatory Relationship with the EU: Charting a New Roadmap

Niamh Moloney explores how: i) the deep EU/UK financial services relationship influences the domestic UK regulatory debate; ii) Brexit will impact the UK's engagement with international regulatory agencies; and iii) the future of the UK/EU regulatory relationship Post-Brexit.

The UK has been very effective in shaping the EU Single Rule Book, and so the core parts of the regulatory system that the UK inherits from its time in the EU. In particular, EMIR and MIFID II align with UK regulatory objectives. The UK is closely aligned with the EU's investment firm prudential regulatory system. Consequently, the fundamental regulatory building blocks of financial stability in the UK are similar to those in the EU. Hence, the UK and EU will need to work together on both political and technocratic levels as their regulatory frameworks develop and as financial markets evolve so that both parties can benefit from knowledge that the other gains.

The EU and the UK have a very different architecture for accountability. The accountability system in the EU is very diffuse and mediated in many ways because the EU regulatory system operates and interacts on a number of political and technocratic levels. The architecture of accountability in the UK will inevitably change very significantly now that the UK government is directly responsible for the UK financial regulatory system. It is vital for the Treasury and regulators to maintain the channels of communication with the regulated sector that effective regulation requires while balancing the pressure for deregulation and liberalisation without losing sight of the core objectives of the regulatory system. The question of how to strike an appropriate balance between these two objectives will be an absolutely critical part of the debate going forward.

The UK's relationships with international standard setters such as the Basel Committee and IOSCO will become much more important in the Post-Brexit world. These organizations will become pivotal for the UK as they can reduce frictions for the UK acting as a financial services hub for international markets.

The UK/EU *Joint Declaration On Financial Services* specifies that both parties will cooperate on their dealings with international standard setters, and this will be an important aspect of UK international financial diplomacy.

Turning to the UK/EU relationship in a Post-Brexit world, it is important to note that it is not just about equivalence. It is also about financial stability and the exchange of ideas about and experiences with the regulatory system. The channels through which this relationship happens will be-come mediated (on political matters) through EU institutions rather than national political or regulatory institutions. But, as the regulatory relationship evolves and becomes less political, the EU-level technocratic bodies such as ESMA will play an increasingly important role in the UK/EU regulatory relationship.

We can see the debate over equivalence taking this path now. The EU's position will of course be based upon EU interests. But, looking into the weeds of the debate, we can see that some of the political energy is seeping out of this issue and it is becoming increasingly technocratic. It will therefore be vital for the UK to develop and nurture supervisory relationships and cooperation.

Niamh Moloney (N.Moloney@lse.ac.uk) is a Professor of Law at the London School of Economics.

Accountability and UK Financial Regulators

Julia Black analyzes the structural challenges that on-shoring its financial market regulatory regime poses for the UK in the Post-Brexit world, focusing in particular upon how to hold independent regulators to account.

Prior to 2020, UK regulation sat in a dense system of multi-level governance with multi-level accountability mechanisms. The IMF, the World Bank, the Basel Committee (etc.) monitored global standards, the EU institutions monitored the EU system of regulation, and the UK Parliament and other constitutional accountability arrangements covered UK regulators. On-shoring the EU level of regulation into the UK legal regime will require considerable re-adjustments to fold that regime back into the more normal pattern of UK regulation through independent regulatory agencies. For example, Parliament and the financial regulators move from being rule takers to rule makers. Consequently, the Treasury—which has taken the lead on negotiating EU level regulations for the UK—will need to rethink its role in the new UK-centered system.

The new UK regulatory regime will need a new accountability regime, and that will require accountors who are up to the task. An effective accountor needs: i) information; ii) technical expertise; iii) financial resources; iv) appropriate organizational capacity; and v) legitimacy and authority to act as an accountor. Accountors inevitably face a difficult task as they will necessarily operate with incomplete information relative to the regulators and will find it difficult to acquire the technical expertise required to credibly monitor the regulators. Overcoming these natural difficulties requires financial resources, organizational capacity, and legitimacy.

The UK system consists of an array of accountors such as practitioner panels at the regulators, Parliament and its Select Committees, and the Treasury. The challenge the UK faces in designing an accountability regime that works is how to combine these various independent accountors into an effective *accountability system* for both individual regulators and the regulatory system as a whole. Parliament and its committees will play a crucial role in this system. Accordingly, the Treasury's *Future Regulatory Framework* Review emphasizes the importance of boosting Parliament's ability to act as an accountor by enhancing its expertise on financial markets and financial regulation. This accountability system is work in progress, and meeting this challenge will play an important role in determining the success of the UK's new regulatory regime.

Given the difficulty of designing an accountability regime that works well, government faces the temptation to curtail regulatory discretion by giving regulators elaborate decision making criteria that they must follow. Taking together the provisions of current and proposed legislation, and the annual letter the Chancellor sends to the PRA indicating what considerations it needs to take into account, the PRA, for example, must have regard to over 20 different factors when making policy. Current proposals are to expand that list, and to make it activity specific. The temptation to prescribe a highly complex decision matrix should be resisted, however, as multiple decision making criteria can create confusion and may well conflict with each other.

Ultimately the objective of accountability is about creating trust that those exercising power in the political and regulatory system do so in line with the goals and values of those on whose be-half they purport to govern.

Julia Black (j.black@lse.ac.uk) is a Professor of Law at the London School of Economics.

The Case for a New Regulatory Objective: Make Financial Markets Effective for the Real Economy

Kevin R. James finds that effective financial markets promote total factor productivity growth and reduce financial crisis risk. Yet, no institution is currently responsible for monitoring and promoting the effectiveness of the UK's financial system as a whole. The Treasury should therefore explore the possibility of making financial market effectiveness a core objective of the UK's Post-Brexit financial regulatory system.

An economy's ability to innovate—innovativity—plays a crucial role in determining overall economic performance. Innovations happen when a firm takes an idea and transforms it into a new product or process. Economic growth theory generally assumes that the supply of ideas is the binding constraint on innovation. This approach then naturally leads growth policy to focus on increasing the supply of ideas by, for example, increasing R&D spending and the level of STEM skills in the labor force. However, Kevin R. James argues that the key driver of innovation is not the supply of ideas but the strategic orientation that firms take to exploiting those ideas. This approach to innovativity leads to a focus on the factors that influence firms' strategic orientation.

Firms choose strategies to succeed, and to succeed firms must show the market that they have good projects. When financial markets work poorly, a firm shows that it has a good project by pursuing a short-run focused quick-win *Flash* strategy. When financial markets work well, a firm can pursue a long-run focused *Substance* strategy that focuses on developing the innovative potential of their project. Both Flash and Substance strategies require R&D, STEM skills, etc., but only Substance strategies lead to innovation. Financial market effectiveness therefore plays a key role in driving innovativity.

Deriving the empirical measure of financial market effectiveness implied by the theory, this analysis finds that financial market effectiveness can explain the evolution of total factor productivity growth and financial crisis risk in the US from 1880 to 2019. This analysis further suggests that the evolution of financial market effectiveness is in turn driven by the efficacy of financial regulation.

In the UK's current regulatory architecture, no institution is responsible for monitoring and promoting the overall effectiveness of UK financial markets. The Bank of England is responsible for financial stability but not for market effectiveness. The FCA is responsible for consumer protection and market integrity, that is, for dealing with specific problems that arise given markets as they are rather than on the fundamental economic detriment that arises because markets are not as effective as they could be. The current situation is therefore analogous to the pre-GFC regulatory architecture in which no institution was responsible for the stability of the financial system as a whole.

The government has made promoting economic growth a priority, and the Treasury's *Plan for Growth* sets forth ambitious proposals to increase idea production by improving UK infrastructure, increasing R&D spending, and enhancing human capital. Yet, the US evidence on growth suggests that improving idea production alone may not improve productivity growth if financial markets remain ineffective. It follows that a (very low cost) policy moonshot aimed at improving financial market effectiveness through regulatory reform could, at least potentially, significantly increase the probability that the *Plan for Growth* succeeds. The Treasury should therefore explore the possibility of making financial market effectiveness a core objective of the UK's Post-Brexit financial regulatory system, and the *Future Regulatory Framework* review provides the perfect opportunity to do so.

Kevin R. James (k.james1@lse.ac.uk) is an economist in the Systemic Risk Centre at the London School of Economics.**The presentation is based upon the following paper: James, Kevin R., Akshay Kotak, and Dimitrios Tsomocos (2021), "Innovativity, Financial Market Effectiveness, and US Economic Performance: 1880 – 2019".**

Measurement Tools for Enhancing Accountability in Conduct Regulation

Peter Andrews argues that conduct regulation in financial markets could be much more effective if: i) regulators measure the right things so that they can identify important problems; ii) use new technological tools and big data to overcome the inherent difficulties of performing those measurements; and iii) use field trials and ex post Cost Benefit Analysis to find out what approach will work to solve the problems identified.

There are or have been plenty of unscrupulous people working in financial markets, as shown by the numerous scandals of recent decades, and a large number of customers are willing to buy terrible products despite an enormous effort by regulators to design disclosure and suitability rules to protect them. Honest firms (who suffer from financial scandals) and consumers deserve better protection.

To provide that protection, regulators need a much better understanding of what is actually happening in the markets they regulate, and for that they need to measure the right things. The right things to measure are the things that are the rationale for conduct regulation and how they manifest themselves in practice. It follows that regulators need to measure the individual suitability of purchases and the price/quality relationship of financial products on the market. This information is absolutely critical for checking to see if the regulator meets its statutory objective of "ensuring…[that] markets…function well".

Performing these measurements is undeniably difficult, but they are central to understanding how retail markets actually work. So, these measurements must be made. Luckily, advances in technology and new analytical techniques can help. If the regulator wants to know about suitability and the price/quality relationship, it has to monitor who is buying what and how the market evolves over time. Big data and advanced analytical techniques provide the means to carry out these measurements, as the FCA has already shown in its published research on the UK mortgage market, which is arguably the only retail market for which it collects high quality data. Furthermore, advances in AI will make it easier to analyze contractual terms (and regulation can re-quire firms to offer less complicated products, building upon the Treasury's CAT standard idea).

Once the regulator identifies a problem (ideally before a major catastrophe develops), it will need to act promptly to address that problem. Unfortunately, it is now difficult to identify what actions and broader approaches really work, implying that it will be hard for the regulator to act effectively. To identify what works, the regulator needs: i) to carry out field trials to identify what works (which may require legislation); ii) strict external scrutiny by an independent accountor to create the incentive to act; iii) reporting requirements on suitability and the price/quality relationship so that the accountor has the information needed to properly scrutinize the regulator; and iv) a rigorous program of ex-post Cost Benefit Analysis on all significant policies so that the regulator can identify which policies have been a success and which have not.

A regulator that can identify problems because it measures the right things, that can act promptly to correct those problems because it knows what works, and that is subject to rigorous external scrutiny by an informed independent accountor will be in a good position to achieve the objectives that the Treasury and Parliament have set for conduct regulation.

Peter Andrews (peter.andrews@oxera.com) is a Senior Advisor at Oxera and a Research Associate in the LSE's Systemic Risk Centre.

Financial Gatekeepers and Competition: Lessons from Big Tech

Greg Taylor explores the key forces driving competition in Big Tech markets and the issues that these forces create for competition policy.

Financial services markets are ripe for technological disruption as they are both intangible and intermediated. Consequently, financial market regulators can benefit by examining the lessons that two decades have taught about how competition works in 'big tech' markets.

Five key forces drive competition in tech markets.

The first force is the 'Network effect'. A market is subject to a network effect if the value of a service increases as more people use that service. In such markets, a large user base provides a firm with a significant competitive advantage and may even create a natural monopoly. A firm can then create a monopolistic market presence before regulators react, and the resultant monopolistic market structure may create facts on the ground that are hard to change ex post. It fol-lows that a regulator may only be able to regulate the monopolistic player but not the market structure already established. This outcome may also create geopolitical issues when the dominant firm is from another country.

The second force is platformization in which a firm creates a platform to intermediate between two different groups. Platforms exhibit network effects. An individual on one side of the market is more likely to transact through a platform when that platform provides a gateway to many participants on the other side of that market. Furthermore, platform markets create distinct issues for regulators as the platform itself may not be providing a regulated service directly, it is just providing a venue for market participants to meet. This separation creates difficult issues for deciding liability. Platforms may also start competing with its users by launching competing products and by imposing their own rules for using the platform. The regulators may govern the platforms without having direct control over the end-rules affecting the market.

The third and fourth market forces arise from data and information. On the product side, the data that customers provide as part of their transactions is extremely valuable to firms as it enables firms to tailor their product offerings to better serve and/or better exploit customers. The algorithms that firms use to exploit customer data therefore: i) raise issues of transparency, responsibility, and collusion; and ii) make the detection of discriminatory and exploitative practices difficult. On the customer side, regulators have a special role to protect consumers who don't remain well informed and pay attention to unregulated new sources of information such as discussion forums, blogs etc.

The fifth market force is the decentralization of trust and reputation. Digitally mediated transactions often require new mechanisms to sustain the trust a market requires to function effectively, and regulation may be able to play a role is supporting these new mechanisms (not least by pre-venting them from being manipulated).

As financial markets become more tech centered, financial market regulators will benefit if they take into account the experience of other regulators wrestling with the competition issues that big tech raises.

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Reforming the Prudential Regulation of Insurance

Christoph Kaserer investigates whether or not major insurance firms should be classified as Globally Important Financial Institutions (G-SIFIs).

Following the 2008 Global Financial Crisis, the Financial Stability Board (FSB) was tasked with identifying Globally Systemically Important Financial Institutions (G-SIFIs) so that they could be regulated more strictly (which is of course costly for the individual firms so classified). Major insurance firms fell into the G-SIFI net, but they have been opposing that classification by arguing that they are not in fact systemic. The International Association of Insurance Supervisors is analyzing the question of whether or not major insurance firms are systemic now, and this presentation presents a way of thinking through that question.

Dr. Kaserer estimates the total systemic risk that the 50 largest insurance firms and the 133 largest banking firms (included for comparison) create by analyzing the distribution of firms' credit default swap (CDS) spreads. In theory, CDS spreads (and their correlations) provide a good basis for a measure of systemic risk because they provide information on the probability of firm failure, and empirically CDS spreads do respond to events which affect systemic risk. The CDS distribution therefore enables one to examine both the overall level of systemic risk created by each sector and the marginal contribution that each firm makes to overall systemic risk.

Looking at each sector's overall contribution to systemic risk first, this analysis suggests that the banking sector is by far the more important sector. Banking accounts for roughly 90% of overall systemic risk while the insurance sector accounts for only about 10%. This difference is due primarily to the fact that banking system liabilities vastly exceed insurance sector liabilities. On a per unit of liabilities basis, the banking sector and the insurance sector are roughly comparable.

Within the insurance sector, life insurance and multi-line firms account for most of the overall systemic risk created by the sector as a whole due to their size. Financial Insurance firms create substantially more risk on a per unit of liability basis, but they do not contribute very much to overall systemic risk as they are far smaller than life and multi-line firms.

Examining systemic risk on a firm-by-firm basis, Dr. Kaserer sorts the sample into 5 risk buckets. Depending upon the exact systemic risk measure one uses, the two highest systemic risk buckets contain between 7 and 16 insurance firms and between 28 and 67 banks.

So, while the insurance sector does not create as much systemic risk as the banking sector, some (but not all) individual insurance firms can be systemically important. Stricter regulation of these systemically important insurance firms seems justified.

Christoph Kaserer (christoph.kaserer@tum.de) is a Professor of Finance at the Technical University of Munich and an associate at Oxera.

Improving the Regulation of Primary and Secondary Markets

Luis Correia da Silva and Reinder Van Dijk assess: i) the international competitive position of UK primary markets and how to improve it; ii) liquidity provision in the secondary market; and iii) competition in the exchange traded derivative (ETD) market.

While the London Stock Exchange (LSE) listed more IPOs than the US in the years around 2006, the number of IPOs and the number of listed securities on the LSE has been significantly decreasing more recently. Indeed, during the period 2010-2018, the UK experienced the largest number of de-listings among European exchanges. The decline in IPOs and the delistings have led to the average listed firm increasing in both size and age.

The decline in IPOs is due to three factors: i) the direct and indirect (regulatory) costs of listing (which are particularly acute for SMEs); ii) the loss of control that a founder or a controlling family face when listing on the LSE's market due to the prohibition on dual class shares; and iii) an advisory ecosystem that pays little attention to SME firms, which leads to newly listed SMEs not obtaining analyst coverage and so to share illiquidity.

Regulation can play an important role in addressing these three factors. Regulators can take a more proportionate view of how much regulation listed SMEs require, thereby reducing the incentive for SMEs to avoid that burden by remaining private. Allowing dual-class share structures on the LSE's Premium market would enable founder or family controlled firms to list without ceding control to new shareholders and so would remove a strong disincentive to listing. While dual-class share structures are potentially open to abuse, the success of these structures in other jurisdictions suggests that it is possible to limit that potential. Finally, it may be worth exploring how to encourage funds to invest in SMEs, which would lead to the advisory ecosystem placing a higher priority on SME success.

Liquidity is vital to a market's success. And though liquidity is difficult to measure precisely as it is very multi-faceted, a range of indicators suggest that liquidity in London is improving. For example, bid/ask spreads have been steadily decreasing. And while bid/ask spreads can be misleading, looking at the costs that traders actually pay to execute also suggests that liquidity has still been improving.

The UK is a leading center for trading exchange traded derivatives (ETDs). HMT has launched a review of the 'open access' regime for ETDs. This was designed to improve cross-border capital markets; HMT will now assess its suitability for UK markets after the end of the transition period.

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