City or real economy: who are the financial markets for?

The indirect benefits that effective financial markets can create by improving overall economic performance vastly exceed any direct benefits that the financial services sector produces through its revenue and employment. The primary goal of financial regulation should therefore be to bring about effective financial markets. But there is now no regulator responsible for the overall effectiveness of the UK's financial services sector. ***Kevin R. James*** *suggests a way for the Treasury to correct this market effectiveness underlap.*

After the last financial crisis, the Treasury directed the Financial Conduct Authority to "Make financial markets work well". But it neglected to specify who exactly the markets should work well for. This is the issue that the Treasury's ongoing Future Framework Review of financial regulation must now resolve to ensure that the UK has the financial system it needs to thrive in the post-Brexit world.

The Treasury has two options. It can define "working well" from the perspective of the City and aim to make London the world's leading international financial centre. Or it can define "working well" from the perspective of the people and firms in the real economy and focus on making financial markets effective from that perspective.

A City strategy could realistically achieve its goal (the CityUK has a plan), and making London the world's leading IFC would indeed be fantastic for the financial services sector. If finance was a typical industry, then a City strategy would definitely make sense.

But finance is not a typical industry. Financial markets create benefits primarily through their impact on overall economic performance rather than by creating profits and jobs in the financial services sector. For example, economic research finds that effective financial markets enable non-financial firms to pursue productivity improving strategies and also contribute to financial stability. The benefits of improving the performance of the 93% of the economy not in the financial services sector vastly exceed any benefits that increasing London's share of global financial business would create. It follows that making financial markets work well from the perspective of the real economy should be the principal goal of the financial regulatory system.

Yet no regulator is responsible for the effectiveness of the financial system as a whole, as is easily seen from the fact that no regulator produces anything even remotely comparable to the FPC's *Financial Stability Report* for the subject of market effectiveness. So, just as the UK had a financial stability underlap in its regulatory architecture before the last financial crisis, it now has a market effectiveness underlap.

The FCA is the natural institution to take the lead on market effectiveness. The Treasury is therefore proposing to take a few small steps to address the market effectiveness underlap problem by giving the FCA a secondary objective to promote growth. But this is not sufficient. This secondary objective will in practice do little more than require the poor person tasked with showing that Policy X passes the CBA test to tack on a pro forma paragraph indicating that Policy X is also good for growth.

To enhance market effectiveness, the Treasury must design a regulatory architecture that forces the FCA to actively seek out opportunities to improve market performance. The FCA is not now geared up to do this as it aims to deal (at pace) with risks to markets as they are. But no amount of data about risks to markets as they are will enable the FCA to identify and exploit opportunities to make markets work better.

Eliminating the regulatory system's market effectiveness underlap therefore demands a more radical approach. I propose that the Treasury create a Financial Policy Committee for Effectiveness (FPCEff) based at the FCA to complement the FPC for Stability based at the Bank (with the FPC for Stability having the final say in event of a conflict).

FPCEff will be chaired by the FCA's CEO and will consist of inside members, representatives from other financial regulators and the government (the PRA, the Pension Regulator, the Financial Reporting Council, HMT, and BEIS), and outside members to bring in broader financial market expertise. FPCEff's mandate will be to think strategically about how to improve financial market effectiveness from the perspective of the real economy. To equip the committee to do its job, FPCEff will have a staff drawn from the regulatory community to provide the analytical depth and research capabilities needed to drive the effectiveness agenda forward. While FPCEff's exact legal powers will need to be worked out, an institution along these lines will have the mandate, incentives, and capabilities required to give the UK the effective financial markets it needs to support a successful post-Brexit economy.

Creating a regulatory body tasked with taking a strategic approach to improving financial market effectiveness is precisely the sort of bold reform that Brexit both makes possible and demands (if it is to be an economic success). The *Future Framework Review* is the perfect opportunity to pursue it.

Carpe diem, HMT!

Notes:

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