

# Slaughter and May's banking and investment services column: August 2023

by Financial Regulation group, Slaughter and May

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The **Financial Regulation group** at Slaughter and May, including **Nick Bonsall**, **Selmin Hakki** and **Emily Bradley**, regularly share their thoughts with Practical Law Financial Services subscribers on topical developments in the banking and investment services sector.

In their column for August 2023, they consider the constantly evolving nature of financial regulation, the focus at UK and EU level on financial services firms' pricing strategies for consumer products and services, and getting the right balance in the regulatory relationship with artificial intelligence (AI) and explainability.

## A financial regulatory revolution

As every lawyer knows, regulation does not stand still; it evolves to meet shifts in market dynamics, respond to financial crises, reflect new risks and old risks in new guises.

It is "business as usual" for incremental changes to be made to the regulatory framework to keep it fit for purpose. But is the UK on the cusp of an unprecedented amount of regulatory change? The government's **smarter regulatory framework review**, to be implemented via the Financial Services and Markets Act 2023 (FSMA 2023), promises a new and improved version of the rulebook with "the agility and flexibility needed to respond quickly and effectively to emerging challenges and to help UK firms seize new business opportunities in a rapidly changing global economy." Meanwhile, the tasks of setting a regulatory and supervisory approach for developing technologies and advancing the green agenda require attention, as do numerous other ongoing initiatives (the shift in expectations as a result of the coming into force of the Consumer Duty, the ring-fencing review, increased regulation of the cryptoasset market, to name but a few).

This backdrop is challenging as regulators are required "to carry out both continuous "dynamic regulation" to maintain frameworks and periodic "revolutions" to keep up with fundamental shifts in regulated markets - sometimes doing both at the same time" (as explained in this Bank Underground [blogpost](#) from December 2021). Meanwhile, legal and compliance teams must find a way to navigate the years ahead. As a minimum,

they have a role to play in designing systems and policies for firms to keep on top of requirements and to secure compliance in both the UK and the EU, as the two regimes diverge. (While the level of areas of divergence between the UK and EU regulatory landscape is modest and relatively uncontroversial as it stands, the two regimes are likely to drift further apart over time.) They will also need to cope with the UK's status as a "third country" facing 27 EU member states with varying third country regimes and the consequent need for local advice in those member states.

On the plus side, shaping the final outcomes of the next iteration of the UK financial regulatory framework will require significant industry input and engagement so the door is very much open for firms to develop and communicate proposals for positive change to the regulators, particularly policy initiatives that will promote UK growth and competitiveness.

Financial regulation may never arrive at a final and perfect end-state, but it has never been more important, or challenging, to keep in touch with reform proposals and developments.

## The price of regulation in financial services

Let's check in on implementation of the **Consumer Duty** (now in effect for new and existing products and services) which requires firms to act to deliver good outcomes for retail customers, including on price and value. Transparency about pricing practices promises

to be a fertile area of scrutiny going forward and firms have needed to re-evaluate their pricing strategies, particularly for customers who are deemed to be vulnerable, to ensure they are not charging excessively high rates or fees.

The European Commission's [retail investment package](#), adopted on 24 May 2023, aims to empower retail investors to make investment decisions that are aligned with their needs and preferences, while ensuring that they are treated fairly and duly protected. The package includes a [Retail Investment Strategy](#) that would require manufacturers and distributors of investment products to ensure that these products bring real "value for money" to retail investors.

Both the EU and UK regulators are therefore interested in the relationship between the price a consumer pays for a product or service and the benefits they receive from it. (Their approaches are somewhat distinct, however: where the UK takes an agile, outcomes-based approach, the EU is more prescriptive when it comes to what represents value for money. We say more on this in a [longer piece](#) on our website.)

The FCA's objectives include promoting competition in the interests of consumers, to safeguard market integrity, and to secure an appropriate degree of protection for consumers. In advancing these objectives, there have been instances where the FCA has intervened to set a cap on prices charged to consumers. High-cost short-term credit (HCSTC) (2014), workplace personal pension schemes (2015) and early exit pension charges (2016) spring to mind. In October 2018, the FCA published a [discussion paper](#) (DP18/9) launching a debate on fair pricing in the broad context of financial services. The [feedback statement](#) (FS19/4) warned: "[i]ssues of fairness in pricing are likely to become increasingly prevalent and complex in the future, particularly as firms' use of new technologies and data becomes more sophisticated." A package of remedies to address the issues identified in the FCA's [general insurance pricing practices market study final report](#) (MS18/1.3) followed (2021).

Most recently, the FCA has been [monitoring interest rate decisions](#), making it clear that it wants to see firms ensuring that their customers are benefiting from better value savings products:

"While the FCA does not set prices in retail financial services markets, we do have a statutory objective to make sure markets operate with effective competition in the interests of consumers. We are closely monitoring how firms

pass through rate changes and as I mentioned to the Committee we have recently expressed our concerns to firms regarding some practices we have observed."

The FCA is also using its regulatory powers to ensure that [competition in the cash savings market](#) is working well and delivering fair outcomes. It has also been reported that the FCA has written to investment platforms requesting details on "client interest turn" (the difference between the interest they pay customers on their cash deposits and that earned from investing this cash in the money markets).

As the cost of living continues to rise, firms can expect an increasingly strict approach to fair pricing in financial services.

### You're AI-ways on our mind: AI and explainability

We last heard from the Bank of England, PRA and FCA on AI in their joint October 2022 [discussion paper](#) (DP5/22) which, significantly, predated the launch of ChatGPT and the ensuing political pressure to "deal with" the risks posed by generative AI.

Whether the FCA's thinking on AI has evolved in response to this change in mood is a live question—particularly as the spectre of a [National Audit Office probe](#) hovers. The most recent [Regulatory Initiatives Grid](#) suggests that we will have to wait until Q4 2023 to get the follow up to DP5/22.

In this interim vacuum, Nikhil Rathi's (Chief Executive of the FCA) comments on AI in a [speech](#) delivered in mid-July are of interest. And particularly interesting are his comments on the explainability of AI models.

Appropriate transparency and explainability sits at the heart of the government's proposed framework for the regulation of AI, unveiled in its March 2023 [white paper](#). The word "appropriate" is important here. As the white paper elaborates, while sufficient AI explainability is a vital buttress against legal risk and wider harms, "logic and decision-making in AI systems cannot always be meaningfully explained in a way that is intelligible to humans, although in many settings this poses no substantial risk".

The FCA is well aware of these tensions. In an FCA Insight [blogpost](#) from May 2019, it is observed that there might "be a trade-off between the ability to meet demands for an explanation and the ability to supply more accurate predictions at reasonable time and cost".

In response to this challenge, the blogpost advocated for a concept of "sufficient interpretability", the "point where supply and demand meet and where society finds the right balance between the benefits of...AI...and the need to make sense of its predictions and decisions" (and this may depend on context).

Mr Rathi's recent speech suggests that the regulatory relationship with explainability remains ambivalent. While not addressing this issue explicitly, he questions whether to make a great cup of tea you need to understand the intricacies of Brownian motion and energy transfer. He further asks whether we can "really

conclude that a human decision-maker is always more transparent and less biased than an AI model? Both need controls and checks."

Further to the FCA's earlier formulation of "sufficient interpretability", is Mr Rathi suggesting that the scales should tip away from the need to make sense of AI's predictions and decisions? Perhaps this is a stretch, and we will have to wait until later in the year to find out. But as the power of AI builds at pace, and AI seems poised to change how we live forever, how we as a society feel about explainability has arguably never been more important.

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