“Making retail finance regulation work for consumers…”

PUTTING CUSTOMERS FIRST

Hilary Cooper
Andrew Freeman

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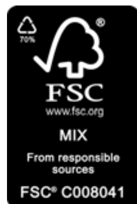

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As usual, special effort has been made to ensure accuracy of quotations and statistics in the report. Any errors that remain are the responsibility of the authors.

Hilary Cooper and Andrew Freeman
January 2014

Foreword

There are three reasons why regulation of retail financial services is so substantial and complex. First, retail financial services are important. They matter to us all on a daily basis through our bank accounts, mortgages, pensions, insurance and savings. Second, they are complex. Even for the most sophisticated market participants, understanding financial services is difficult. No one can have a full appreciation of the complete workings of the financial system and many find it bewildering to identify the benefits and risks of the array of products on offer.

Third, the potential for failure in the delivery of financial services is greater than in virtually any other market. This derives from the nature of the product itself – money. Conflicts are endemic to financial services arising from the fungible nature of money. The user wants to get the highest possible returns at the lowest risk; the provider seeks to extract the highest rewards for themselves by charging large fees and in some cases resorting to fraud.

Inevitably then the regulation of retail financial services is extensive and elaborate. This report provides an important way of cutting through the opaqueness of regulation to see the core underlying principles. In particular, it appropriately places emphasis on outcomes rather than inputs to financial services. The need for this arises from the fact that at present much financial service regulation is process driven with a focus on detailed inputs. It is very prescriptive, seeking to lay down how financial institutions should organise their business and deliver their services.

This is onerous for both the regulator and the regulated firm and, as the report describes, often gives rise to costs that are disproportionate to the benefits derived, particularly for routine financial products on which average household expenditures are

comparatively modest. In contrast, other financial services involve lifetime consumption decisions on which substantial proportions of household budgets are spent. Examples include mortgages and pensions.

The risks incurred in purchasing these products are particularly great for the most vulnerable members of society – the elderly, the disabled and those in debt. What an 'outcome' approach to regulation does in comparison to an 'input' approach is to focus regulation appropriately on those products and groups in society that are most vulnerable to exploitation.

Competition in financial markets provides an important check on potential abuse and proposals to promote competition through enhanced consumer information are to be welcomed. However, competition is not sufficient on its own and may in some circumstances be a source of not a remedy for financial misconduct. For example, some surveys have recorded lower levels of trust in financial markets than in banks, despite the high level of competition in mutual fund and asset management industries.

Similarly, financial education has an important role to play in helping customers to evaluate products and services but there are limitations to the extent to which it can provide effective consumer protection, particularly for the most vulnerable members of society. One only has to recall that it was the sophisticated professional wholesale investors not naïve retail investors who were particularly badly misled by the complex financial instruments that were transacted before the financial crisis.

Critical to restoring trust in retail financial services is a change in the culture and conduct of financial institutions, which realigns their interests with those of their customers. While there are significant moves in the right direction, it is unclear whether they will translate into compelling changes in attitudes and conduct among those working in financial institutions. So long as banks and other financial institutions are owned and run by people who have incentives to maximise their returns at the expense of their customers then there will be a conflict between the interests of those providing and those using financial

services. What is required to address this is a combination of structural approaches to the ownership and governance of banks that align their interests more closely with those of their customers and tougher enforcement of regulation to deter breaches of public laws.

This report provides an imaginative and powerful analysis of the problems confronting retail financial services and the way in which regulation can be used most effectively to address them. It warrants careful attention from anyone concerned about protecting our retail financial services and restoring public confidence in them.

Colin Mayer
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Executive summary

It is difficult to think of a topic that is more likely to inspire irritation, confusion, indifference or downright lethargy than the regulation of retail financial services. The landscape is complex, wide and deep. Policies have altered with alarming frequency, often in response to scandals. Regulation is dense and opaque to non-experts, be they politicians or the general public and consumers of financial products.

That said, there could hardly be a more important subject for careful attention and analysis. This report points out that retail finance touches the vast bulk of the UK population, many of whom have daily contact with it, via bank transactions, direct debits, investment decisions and so on. A few key decisions can and do affect people's entire well-being, particularly in retirement. As we will explore below, mortgages and pensions have special prominence thanks to the extent to which their outcomes can greatly alter people's lives. For others the inability to engage with the channels through which financial products and services are dispensed is a major disadvantage, often condemning people to lifelong exploitation in the form of more expense or, perhaps worse, to seek refuge in the black economy.

For all its importance, retail finance and, crucially, its regulation, are poorly understood. Whether or not we have a regulatory regime that offers consumers an appropriate degree of protection (including from themselves) for an acceptable set of costs and trade-offs is wide open for debate. The finance industry broadly believes that it suffers an absurd regulatory burden – of all UK industries, it is the one worst troubled by red tape, as regulators demand exquisite detail on processes and procedures at considerable cost. By contrast, other sectors such as energy

and telecoms have less prescriptive regimes, even though they also have considerable impact on the finances of the typical household or individual.

This report attempts to summarise and explain the main issues facing anyone trying to establish an effective balance between protecting consumers and monitoring and disciplining providers of financial services. As will become clear, the UK is going through significant legislative and regulatory change. Several vital agencies are in the process of finding their feet or simply being established. Although it might seem academic, it is of national importance that the emerging regime pays attention where it is genuinely needed rather than micro-managing every aspect of an industry that plays a key role in the economy. One of the aims of this report is to explain the emerging responsibilities and mandates of the various parties involved both as regulators and as champions of consumer protection, including some that are in the process of creating and then articulating their strategies and priorities.

Our main recommendations are made against a background of widespread misbehaviour by financial institutions, some of which have forfeited public trust as a result of their shoddy treatment of customers over many years. During the writing of the report, the spotlight turned on the UK's energy companies, which overtook banks as champions of public disaffection – clearly regulatory and competitive regimes are coming under growing scrutiny.

We might observe that, to some extent, banks and other financial institutions have the regulatory regime they deserve. That is not to argue that it is fit for purpose, however. Many banks have embarked on major efforts to change their cultures and place much greater emphasis on being fairer to their customers. As these efforts mature it is important that the regulatory machine also evolves.

We believe that adherence to a single principle would go a long way to securing an evolution that will lead to regulation of retail finance that is fair, efficient and proportionate. Put simply, where regulation is shaped from the outset by the outcomes that consumers are experiencing then it is likely to have many of the

right characteristics, including the correct proportion of attention on each product or service.

If instead, and as they often do today, regulators continue to focus in minute detail on each process and input – requiring endless detail on who made what decision in what meeting and how many and which boxes were ticked at every stage of every process – they are likely to impose an unnecessarily costly burden on the industry and thereby actually harm consumers. As we have seen too often, they are likely to be reactive, only spotting problems after the event.

Moreover, this approach inevitably takes institutions as its focus and not the wider market – a 'vertical' view that often means siloed teams of regulators are unable collectively to see the wood for the trees. An outcomes-based approach would adopt a wider, more 'horizontal' view, looking across the industry at products and services and assessing where the greatest risk of problems or poor outcomes lies for consumers.

The simplest way to explain this principle is to compare the risks attached to purchasing a lifetime product such as a pension, with those for taking out a cash ISA. The outcome of the former is certain to have a much greater significance on the consumer's financial health over the long term. This suggests there is a need for a significant regulatory focus, identifying who is particularly vulnerable and what protections are needed, and then, crucially, ensuring that the industry is delivering what has been agreed by looking at what consumers actually experience – the outcomes, not the input.

By contrast, a cash ISA is a simple product. It tends to be purchased rather than sold, and there is relatively little risk for the consumer, particularly while interest rates are negligible. An outcomes-based approach that confirmed these features would allow this product to be sold quickly, without fuss and without inconveniencing the purchaser. By the same token, the seller could dispense with lengthy compliance requirements, beyond those needed to protect against financial crime and meet basic customer data needs, shedding unnecessary costs.

This report makes several recommendations that flow from this central observation, including the importance of matching

an outcomes-focused approach with strong sanctions where institutions do not play fair. It also recognises the significant barriers that remain to winning over hearts and minds to a new regulatory approach, given the public's view of the sector, and the very considerable challenges that will continue to beset those who are vulnerable or disadvantaged in today's increasingly complex financial world.

The recommendations are summarised below, but it is important to state that they are best read in the context of the overall report because the subject matter is complex and at times theoretical. As in many major policy areas, the lack of a reliable base of evidence is a hindrance, making it difficult to come to a holistic view of the overall costs and benefits of the current regulatory regime.

Summary of recommendations

1. Retail finance regulation should firmly endorse an *outcomes-based approach*, which puts acting in consumers' best interests at the heart of business conduct and, by extension, regulation of that conduct. All parties should agree in detail on what this means in principle and in practice, and take appropriate action to deliver on this commitment.

2. The *intense micro-management* that is peculiar to regulation in the financial sector *should be challenged* and resource pared back accordingly. Vertical regulation – focused on supervising and monitoring businesses – should give way to horizontal regulation – focused on markets and consumer outcomes. The Financial Conduct Authority (FCA) should relinquish its historic attachment to resource-intensive monitoring and supervision of inputs and processes in order to make a reality of an outcomes-focused approach, where what matters is what consumers actually get out of buying financial products or services.

3. The quid pro quo for focusing on outcomes rather than inputs is that *sanctions for misconduct should be swift and uncompromising*.

The FCA's increased activity on deterrence, enforcement and fines will be further strengthened by recent legislation, providing for a new licensing regime and greater use of criminal and civil sanctions against individuals. This should be followed by a clear commitment to supporting all agencies in delivering an effective enforcement regime for firms that transgress.

4 The *provision of generic financial advice and education needs to be further developed and strengthened in order to support improved consumer financial capability* with particular consideration given to how best to access hard to reach groups and those who are vulnerable to getting into debt. There should be a much greater emphasis on using advertising and public broadcasting to promote messages to consumers about the risks and potential consequences of entering into certain types of transaction. Alongside this, further consideration should be given to how best to 'nudge' consumers into beneficial financial behaviours, such as saving for future needs. There may be scope for policy to go even further, building for instance on the experience of pension auto-enrolment, to consider whether default 'opt-in' options might work in other areas, such as house insurance, where under-consumption exposes people to real risk of harm.

5 Regulators and consumer organisations should work together to produce *tools that support improved consumer outcomes*. There should be a drive to produce aggregation or best buy tables that incorporate quality measures as well as price parameters. Independent league tables should be produced based on survey and statistical data showing which institutions and products offer best customer service, satisfaction and outcomes. The industry should sign up to clear standards on transparency and product clarity that do not rely on reams of pages of terms and conditions, meeting the banking commissioners' stipulation that information provided to consumers should be 'crystal clear' to enable effective comparison and choice.

6 The industry should continue to work with stakeholders to develop policies to *support the needs of the increasing number of*

highly vulnerable consumers, particularly among the elderly. Initiatives such as the recently launched Dementia Friendly Financial Services Charter should be built on and wider consideration given to the needs of other groups with disabilities or other profound challenges. This should include consideration of how to support the industry in interacting sensitively and appropriately with carers, and develop better systems for managing power of attorney and other third party representation. Government, charities, consumer organisations and financial institutions should join together to design new initiatives to support vulnerable people and their carers, consider the possibility of tapping into expertise from retired financial practitioners willing to volunteer their services, and establish structures to facilitate this.

7 There should be much sharper *segmentation and differentiation of markets* for the purpose of regulation. Regulatory resources should focus more clearly on groups of consumers who experience the greatest risk of significant harm, prioritising the types of products where this harm is most likely to occur, those that are long-term, complex and not easily reversed. This should lead to a clearer view being developed of proportionality in regulation with less resource put into areas where consumers have perfectly good capabilities, or potential detriment is relatively small because of the nature of the product.

8 Leaders within financial services should work with stakeholders to make progress in rebuilding public trust and take the lead in demonstrating how they plan to deliver *high standards of professionalism and integrity* within the sector and what form of external moderation would best support this. The welcome sign that performance incentives are moving away from sales targets towards measures of consumer satisfaction and outcomes needs to be bolstered by a similar alignment of incentives and remuneration at board level if the change at lower levels is to be at all meaningful, with organisations reforming their systems for training, appraisal and promotion accordingly.

9 Finally, further work should be carried out to consider how to *move corporations away from the short-termism that pits shareholder interest against consumer interest*, including engendering greater commitment to long-term values and giving more control to those with a long-term stake. This should be combined with measures to better empower non-executive directors and consider how to introduce greater diversity and challenge at board level.

1 Introduction

This report examines the state of UK retail finance and makes policy recommendations for the future evolution of the market. It focuses in particular on regulation and the role this plays in the safe and effective operation of the sector. A starting premise is that, in light of the report of the Independent Commission on Banking, the investigations by the Parliamentary Commission on Banking Standards and recent financial services legislation,[1] banks face a mass of prescriptive regulation and a combination of consumer disapproval or indifference and widespread suspicion and hostility. Some of this suspicion is deserved given a series of scandals and errors that have shaken public trust and confidence. Some serves to illustrate the fundamental challenge of constructing a functioning sector that offers consumers reasonable protections while allowing banks to compete profitably under a sensible regulatory umbrella.

The retail finance sector includes all businesses that offer financial services and products to consumers. This includes banks, whose core activity is taking in deposits from consumers and providing services such as current accounts, debit and credit cards, overdrafts and savings. It also includes other organisations such as insurers, investment firms, mutuals (building societies, credit unions and friendly societies) and businesses such as payday lenders, the subject of recent widespread public scrutiny. Together the sector provides banking services and a wider range of products such as personal and business loans, mortgages, insurance, pensions and wealth management.

Many financial products are highly technical and complex, and, as George Osborne remarked in a speech on banking reform in February 2013, some financial transactions actually constitute 'some of the most important moments in your life… when you bought your own home with a mortgage, when you

took the plunge and started your own business, when you retired and drew on your pension'.[2] So while they may be one-off events they can, at least in some cases, be hugely expensive and life-changing if they go wrong, making them qualitatively different from buying a loaf of bread or a pair of shoes.

Any consideration of the current state of the UK retail finance market has to acknowledge a starting point of low public trust and esteem, particularly in relation to banks. The Which? consumer insight tracker consistently reports low public confidence in the sector – 43 per cent of respondents in November 2013 said they do not trust long-term financial products.[3] A YouGov report on trust in banking is no more complimentary: just 16 per cent of those surveyed agreed that banks 'generally provide good quality products and services which are sold responsibly' while 58 per cent described the industry as 'at best unprofessional, and at worst dishonest'.[4]

The reputation of banking plumbed new lows following the financial crisis that began in 2007. Banks that had behaved irresponsibly were nevertheless deemed 'too big to fail' and were bailed out with tax-payers' money. Public anger was directed at individuals whose reckless behaviour contributed to banking failures and at payouts and 'fat cat' bonuses. These continued at levels that were deemed by many to be unmerited and unacceptable in the wake of the economic crisis that followed the banking collapses, and the £133 billion of public money spent shoring them up.

Alongside this, fundamental issues of trust surfaced in a series of scandals that included Payment Protection Insurance (PPI) mis-selling (itself an echo of earlier scandals on endowment mis-selling), the mis-selling of interest-rate swaps to small firms, some of which went bust as a result, and, most recently, the LIBOR scandal, where some banks were rigging data determining the interest rate at which banks lend to each other. Such was the impact of these revelations that a Parliamentary Commission on Banking Standards (PCBS) was established in July 2012 to bring forward recommendations on professional standards and culture within the sector, with a view to these being embedded in legislation. A year later the banking

commissioners' blistering report pointed to inadequate accountabilities, a misalignment of reward and risk for senior staff, and dysfunctional culture and practices among both banks and regulators.[5]

Faith organisations also became increasingly vocal in the debate on morality around this time. A series of public meetings in St Paul's Cathedral in April 2013 brought together senior church leaders with business and public figures to discuss 'The City and the Common Good'. In July 2013, the Archbishop of Canterbury went further, expressing disquiet at the operation of payday lenders and proposing the use of church premises to help support credit unions, with a stated intention of competing Wonga out of existence.

This report details recent developments in the approach to financial regulation in response to the series of crises outlined above. It looks at the underlying economic and social justification for regulation of the retail finance sector and considers the regulatory burden on the industry and economic costs it imposes, alongside the very real need to protect consumers. It concludes with an alternative vision for how these competing aims might be reconciled.

2 Response to crisis

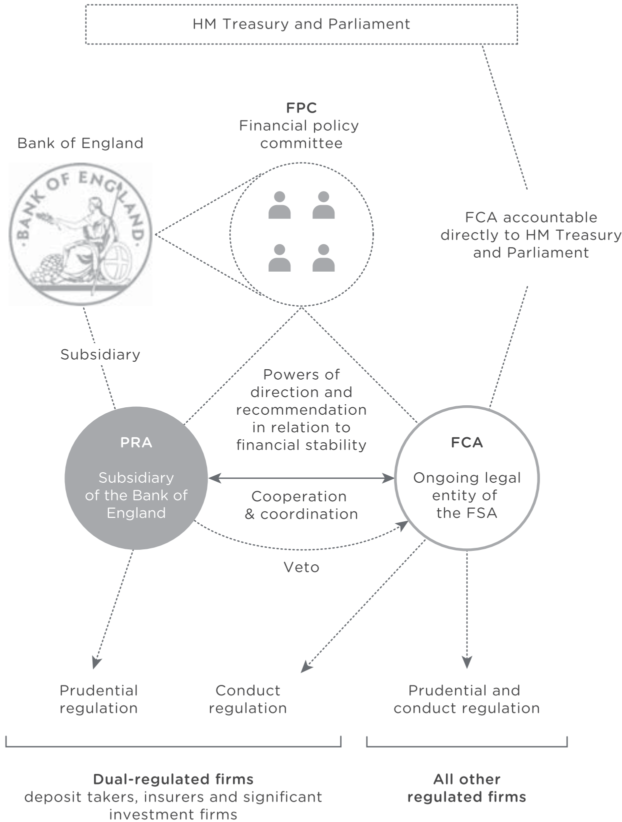
Twin peaks: the new landscape

In the years leading up to the financial crisis, regulation was primarily undertaken by the Financial Services Authority (FSA), a kind of super-regulator brought in after the 1997 election, with powers defined in the Financial Services and Markets Act 2000.[6] The FSA had dual responsibility for, on the one hand, *prudential regulation* – activity that might jeopardise the stability of individual businesses – *micro-prudential* – or lead to systemic risks for the financial system as a whole – *macro-prudential* – and, on the other hand, *conduct regulation*, essentially pertaining to standards and behaviour in the relationship between individual financial institutions and their customers.

Following the financial crisis and the bank bail-outs that ensued there was a general view that the FSA had paid inadequate attention to the prudential regulation of banks and the banking system, failing to spot or alert others to emerging signs of risk and, in effect becoming a watch-dog that did not bark. This was in part blamed on the multiple objectives of the regulator leading to insufficient attention being paid to what were becoming increasingly destabilising systemic risks.

In order to address these perceived failings, the Financial Services Act 2012 established a new regulatory infrastructure, separating and tightening up functions and introducing new regulatory powers. It provided for the FSA to be split into two separate organisations or 'twin peaks': the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). It also changed the way in which macro-prudential regulation of systemic risk was delivered. The new regulatory architecture, which formally came into effect in April 2013, is summarised in figure 1.[7] At a macro level, the Treasury has overall responsibility for the financial system and for legislation governing financial

Figure 1 **The new regulatory architecture**



regulation. The role of the Bank of England is to protect and enhance financial stability, and to manage financial crises. The new Financial Policy Committee is charged with identifying, monitoring and managing risk to the system.

The FCA supervises conduct for around 26,000 financial firms and undertakes micro-prudential regulation for roughly 23,000 of these firms. The rest – deposit takers (banks, building societies and credit unions), insurers and major investment firms

– are 'dual-regulated', overseen by the PRA for micro-prudential performance and the FCA for business conduct.

Making banks safer

Alongside these institutional changes the Independent Commission on Banking (ICB), chaired by Sir John Vickers, was set up to consider what structural changes were needed within the sector to ensure that volatile, risk-taking investment banking could not in future threaten the stability of the whole banking system, and with it the wider economy. While this was partly about reducing the risk of bank failure, it was more particularly about addressing what had come to be seen as an implicit guarantee that some banks were too big to fail – a situation described by Sir Mervyn King in the light of the extreme risk-taking behaviour preceding the financial crisis as 'the biggest moral hazard in history'.[8]

The recommendations of the ICB, as summarised in its final report in September 2011,[9] have fed through into the Financial Services (Banking Reform) Act 2013. The key thrust is to separate core retail deposits – essential to the operation of an effective banking sector – from wholesale and investment banking activities – the more speculative and often risk-taking part of the sector. This is to be achieved by establishing a ring-fence around core banking activity, requiring ring-fenced banks to be separate legal entities with independent governance. The timescale for implementation is set for 2019.[10]

By seeking to insulate the core banking system from the risk-taking investment sector of the market, the measure is intended to signal that banks undertaking risky activities will in future be allowed to fail. At the same time, capital and liquidity requirements for banks are to be strengthened as a result of both UK and expected European regulation, the aim being to increase the future resilience of the sector to financial instability and reduce the overall risk of bank failure. It will fall to the PRA to oversee compliance with these new rules.

Turning the spotlight on conduct

The FCA was formally established in April 2013. Gearing up for the change, Martin Wheatley, as CEO designate, launched its first strategic document, *The Journey to the FCA*, in October 2012 stating,

The FCA offers a huge opportunity for the regulator and firms to start afresh, and work in partnership to reset how we deal with conduct in financial services. We see it as the role of the regulator to not only make the relevant markets work well but also to help firms get back to putting their customers at the heart of how they do business.[11]

In delivering this vision, the FCA has a single overarching strategic objective, set out in statute, which simply requires it to ensure that the relevant markets work well. This is supported by three statutory operational objectives:

- *to deliver consumer protection* – securing an appropriate degree of protection for consumers – intended to ensure that consumers get financial services and products that meet their needs from firms they can trust
- *to enhance market integrity* – including protecting the financial system from financial crime or market abuse and delivering markets and financial systems that are sound, stable and resilient, with transparent pricing information
- *to build competitive markets* – promoting effective competition in the interests of consumers

The addition of an objective on competition to the FCA's remit had been proposed by the ICB and endorsed by the Government, and this found expression in the Financial Services Act 2012. A few months into the FCA's operation, Martin Wheatley, now in post as chief executive, described this competition mandate as 'the single most significant change in our objectives as a regulator', noting, 'Markets that work well for consumers and for firms benefit everyone and benefit the UK economy.'[12]

The establishment of the FCA in the wake of the recent conduct scandals brings with it a shift to a more proactive and

judgement-based approach to conduct regulation, with the intention of intervening earlier to prevent consumer harm before it arises. Martin Wheatley's speech to the British Bankers' Association summed up the change in philosophy behind this:

The global world of regulation has moved on from the belief that providing information to people combined with some conduct rules over the people selling products will lead to good outcomes… The FCA is going to put at its core a much better way of protecting consumers and making sure they get a fair deal… rather than going in after something has gone wrong.[13]

In support of this changed approach the FCA has new powers granted by the Financial Services Act 2012 which include:

- *product intervention* – the ability, subject to consultation, to ban financial products considered harmful (or to make temporary bans pending further investigation)
- *financial promotions* – power to ban misleading promotions and publish details
- *publicising enforcement actions* – power to make public the issue of a 'warning notice' proposing disciplinary action

This more proactive stance will be supported by improvements in intelligence gathering (including responding to super-complaints, listening to comments from consumer organisations and whistle-blowers, and analysing data from the financial ombudsman) and a new risk-based style of supervision with resource reallocated accordingly. A new Policy, Risk and Research Division within the FCA will act as an internal radar to identify and address emerging risks and there will be a greater emphasis on carrying out market studies or thematic reviews (looking at more focused issues) and working with consumer and competition bodies to identify and respond to issues of concern or address areas of emerging risk before they take hold.

The FCA will also continue to deploy the established bread and butter regulatory tools including rule-making, where the FCA Handbook is the relevant reference point, publishing

guidance, preparing and issuing codes, and checking that businesses are complying with relevant legislation and the rules and principles that govern the sector, in particular the six *Treating Customers Fairly*[14] outcomes which stipulated that firms should work towards:

- consumers being confident they are dealing with firms where the fair treatment of customers is central to the corporate culture
- products and services marketed and sold in the retail market being designed to meet the needs of identified consumer groups and targeted accordingly
- consumers being provided with clear information and kept appropriately informed before, during and after the point of sale
- where consumers receive advice, the advice being suitable and taking account of their circumstances
- consumers being provided with products that perform as firms have led them to expect and the associated service is of an acceptable standard and as they have been led to expect
- consumers not being faced with unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

Firms seeking to operate in the sector will encounter a regulatory life-cycle that begins with authorisation and the granting of a licence, is likely to include approval of senior staff, then supervisory oversight of risk, conduct and compliance backed up with regular reporting and provision of data to the FCA, and finally the potential for a range of sanctions and enforcement action should conduct fall short of expectations.

The FCA's budget for ongoing regulatory activity in 2013/14, as set out in its business plan, is £445.7 million. This feeds through into an annual funding requirement for the year of £432.1 million, nearly all of which is met through a levy on the financial sector (appropriately apportioned) rather than from public funds. As would be expected, more than half the costs (59 per cent) are for staffing, with 70 per cent of staff engaged on the front-line activities of 'authorisations', 'supervision',

'enforcement/financial crime' and 'markets, policy, risk and research'.

In its first year of operation the FCA has set itself three strategic priorities:

- to address key forward-looking risks and the underlying drivers of risk
- to deliver against its core statutory objectives (see above)
- to address crystallised (existing) risk such as LIBOR, PPI and interest-rate swaps

Box 1 summarises some of the key initiatives that will be progressed in 2013/14 to deliver these priorities, giving a flavour of the range and scope of the FCA's current and planned regulatory activity, alongside its routine and ongoing supervisory work.

Box 1 **Key initiatives to be implemented in 2013/14 to deliver the FCA's three strategic priorities**

Complaints data: *In the course of its supervisory work the FCA will look at key stages of complaints handling by firms and whether it ensures fair treatment of complainants. This work will also assess whether firms make effective use of complaints data to identify emerging conduct issues and take action as a result.*

Consumer credit: *Regulatory responsibility for mainstream credit such as credit cards and personal loans and high cost forms of credit such as payday lending is to transfer to the FCA from the OFT in April 2014. The FCA will consult on the proposed regulatory regime in preparation for implementation.*

Financial incentives: *Mis-selling was shown by the FSA to be directly linked to inappropriate financial incentives which firms failed to manage. Regulatory guidance now requires firms to have controls in place to manage incentive schemes*

responsibly. The FCA will be actively reviewing how this is performing.

Financial promotions: *A dedicated team will be reviewing promotions to ensure their information is fair, clear and not misleading, taking action where appropriate.*

Fund fee structure: *The FCA will carry out work that looks at how asset management firms operate charging structures and whether these promote informed consumer choice, and will respond accordingly.*

Insurance-price comparison firms: *The FCA will review the risks that price comparison websites present to consumers – particularly those for motor and home insurance products – and assess whether they comply with regulatory requirements.*

Interest-only mortgages: *Work has already been undertaken to look at the risk of existing interest-only mortgage customers being unable to repay the amount due at the end of the mortgage term. Further action by the FCA will now build on this.*

Managing clients assets (CASS): *The FCA plans to increase the supervision of firms holding clients' money and the safe custody of assets through more intrusive visits to firms, thematic and desk-based reviews, and appropriate enforcement action.*

Mobile banking and payments: *The FCA will respond to the Payments Council's launch of payment by mobile phone by taking action to ensure that firms have measures in place to protect consumers, by providing information about their service and ensuring that customers' funds are kept secure.*

Mortgage arrears and forbearance management: *This objective relates to the fair treatment of mortgage borrowers experiencing financial difficulties, including work to*

investigate how firms comply with rules on arrears management.

Mortgage market review (MMR): *New rules on mortgage lending will come into effect in April 2014 covering responsible lending, distribution and disclosure and arrears management (as well as prudential requirements for non-deposit taking lenders). The FCA will support the industry in preparation for this.*
Product governance: *The FCA will scrutinise how firms design, operate and distribute products. This extends previous point of sale obligations to the entire distribution chain, requiring firms to ensure that their governance of the design and delivery of products delivers fair results for consumers.*
Product intervention: *The FCA has new powers to ban products that pose unacceptable risks to consumers, subject to consultation (unless there is a need for prompt intervention). This might include restrictions on certain product features or prohibiting the promotion of particular types of products to some or all consumers.*

Retail investment advice: *Following changes to rules at the end of 2012, advisers can no longer receive commission for selling investments, and will have to be better qualified and clearer about how much of the market they cover. If firms are not complying the FCA may tighten or amend the rules to deliver the desired outcomes.*

Wealth management: *The FCA intends to make wealth management a key focus in order to ensure that customers of wealth management firms receive – and can be shown to receive – portfolios that match their risk appetite and investment objectives.*

Regulators must prove themselves too

In building its own corporate governance and culture the FCA will be aware of the view of many commentators that regulation

itself may be subject to failure. In their book *The Regulatory Challenge* Bishop, Kay and Mayer went so far as to argue that 'the market route should be preferred… even if the market shows some signs of failure: regulators, too, can fail, and often do'.[15] Forms of regulatory failure that crop up in the literature include 'regulatory capture' (where regulators become too influenced by those they regulate), lobbying of regulators by businesses, consumers or politicians, as well as the risk that there is insufficient knowledge and expertise within regulatory bodies for them to be able to perform their role effectively. This may be aggravated by staff retention issues as financial firms compete to recruit former regulators into their businesses.[16] All of these issues have arguably beset recent regulatory regimes in financial services, and need to be guarded against in the future. Perhaps most important has been the complaint that a lack of political will to regulate effectively was a leading cause of the debacle in the lead up to the financial crisis.[17]

Dissatisfaction with past regulatory performance has also focused on perceived inefficiencies and burdens in the regulatory process. The House of Commons Treasury Committee report into the future role of the FCA noted that its predecessor had been criticised for being 'overly bureaucratic' and having a culture that is 'overly legislative and self-protecting through box ticking', also citing complaints that there were 'too many new rules and communications from the FSA with little clarity as to their relative importance'.[18] Commentators have highlighted the risk that there may now be a tendency for over-regulation in order to minimise the risk of failure. This may be particularly acute in the aftermath of crisis and recrimination within the regulatory arena, with the risk that past criticisms of under-regulation will cause the pendulum to swing too far the other way.

Mindful of the complaints raised in the past about regulatory behaviour and culture, the FCA has explained its approach to regulation and how this represents a departure from the previous regime, and has defined the outcomes and key success factors that it will be working to and the controls

in place to ensure that it is operating efficiently and effectively with the right calibre of staff. Whether this will enable it to mitigate all the risks of regulatory failure is a matter for future debate.

3 Regulation: theory and practice

Why regulate?

In its most general sense, regulation is defined in the academic literature as 'the intentional use of authority to affect behaviour of a different party, according to set standards, involving instruments of information-gathering and behaviour modification'.[19] A recent review described regulation as 'part of modern life', one of society's defining features in which regulatory levers are used to 'tame markets in the public interest'.[20]

Retail finance is far from the only area that is subject to regulatory controls. Large infrastructure sectors such as rail and civil aviation and utilities – energy, water and telecommunications – have elements of natural monopoly, with the result that they came under the purview of regulatory bodies following the large-scale privatisations of the 1980s. These sectors are subject to 'economic regulation', with regulators expected to 'promote effective competition where this is possible and provide a proxy for competition, with protection of consumer interests at its heart, where it is not meaningful to introduce competition'.[21] Economic regulation often involves capping the prices that dominant companies can charge, while also seeking to provide a return on their assets and investments, aiming to create a system of incentives and penalties 'to replicate the outcome of competition'.[22] Regulators in these sectors have concurrent powers to make a market reference to the Competition Commission where they believe further investigation of market behaviour is warranted.

Regulation and market failure

Regulation in retail finance, as we have seen, is governed by a general principle of 'making markets work well', advancing

consumer protection, financial integrity and promoting competition. Its key driver is different from that of the economic regulators where large-scale natural monopolies create a need for intervention to protect consumers. In retail finance the most powerful underpinning argument for intervention through regulation is the correction of specific market failure.

It is generally held that the retail finance market suffers from a significant market failure arising from asymmetry of information. In a nutshell, this means that those buying financial products and services do not generally have access to the same level of information and knowledge as the people selling them.

If information asymmetry creates a power imbalance in favour of those selling retail financial products, it is compounded by other features of the market which can make it more difficult for consumers to make effective choices. This is particularly the case with long-term products such as mortgages, pensions (including annuities) and some investment products, which are frequently:

- high-value transactions, bought only once or twice, so ruling out the ability for consumers to learn from repeat purchases
- long term in nature, only revealing their quality many years after they were purchased
- inherently complex, making it difficult to assess their merits
- often not reversible or only reversible with significant penalties

A Treasury Committee report on retail banking contrasted these characteristics of the retail finance market with markets such as restaurant meals, groceries, clothes or newspapers where it is easier to see what is being sold and repeat purchases are common so that 'the customer can assess the quality and price of what is on offer and make an informed choice'.[23]

Where financial transactions are not long term, are relatively easily understood (with no hidden traps) and clearly reversible, such as when opening a current account or depositing money in a cash ISA, the regulatory arguments for protecting consumers from the consequences of information asymmetry are significantly less powerful, although clearly there remain de

minimis requirements to meet anti-money laundering and basic customer data needs. Nevertheless the long-winded process of complying with regulatory form filling beyond these minimum standards is for many consumers out of kilter with any presumed benefit when taking out these sorts of products.

However, there are other structural problems with the retail finance market that arguably do call for corrective intervention. A lack of competition in the market, with market share concentrated in a small number of firms, not only keeps prices high but risks firms exploiting their position of dominance to engage in uncompetitive practices such as colluding over product terms or imposing unnecessary restrictions or charges. If new firms are unable to come in and challenge them, or if there are artificial barriers for consumers who wish to move from one firm's product to another – as has been well documented in the case of personal current accounts – then clearly some kind of response is called for.

Information asymmetry and low levels of competition can lead to the further problems of 'adverse selection' and 'moral hazard'. Adverse selection occurs where it is easier for firms that behave dishonestly or negligently towards their customers to survive than those who act with integrity, creating a situation in which the market is dominated by such firms. Moral hazard arises where an individual or institution has an incentive to take risks or behave inappropriately because the costs of doing so are incurred by someone else. The recent debacle over PPI mis-selling is one example of moral hazard, which many would argue was compounded by sales targets and incentives that encouraged and rewarded inappropriate selling.[24]

These features of the retail finance market produce the phenomenon of 'conduct risk' where firms and individuals have every opportunity to exploit their position and behave in a way that disadvantages consumers. This might mean being less than transparent about the exclusions and small print applying to insurance products. Or it might be selling inappropriate products such as risky investments to people who need a predictable and guaranteed return on their money, or simply selling products that people do not need, as exemplified in the

current scandal over credit card protection products, deemed to be unnecessary as most customers are already protected. Indeed the FCA has suggested that such behaviour can become part of what it calls 'financial sector wiring' where 'some firms' cultures, processes and products have been designed to enable them to profit from consumer errors and to exploit their superior access to, or understanding of, information on financial products and services'.[25]

Regulation responds to such conduct risk by seeking to provide appropriate levels of consumer protection. The 1984 Gower Report, one of the earliest to tackle these issues, summarised this aptly by stating that the objective is not to 'achieve the impossible task of protecting fools from their own folly' but to 'protect reasonable people from being made fools of'.[26]

Who are we protecting and why?

In exploring this issue of consumer protection it is pertinent to consider who those consumers are and what challenges they may face. In previous generations large swathes of the working class saved through mutual societies to provide insurance against financial difficulty,[27] and many also resorted to a variety of formal and informal providers of credit when times got hard. However, only a minority of the population held cash in deposit banks, or engaged in more complex financial and investment transactions. Those who did so were not just generally the better off, but also tended to be the more highly educated.

Today the reach of the mainstream retail finance market is close to universal. According to the Treasury Committee report *Competition and Choice in Retail Banking*, 93 per cent of adults in the UK hold at least one current account, amounting to 71 million accounts in the country in total.[28] The sustained rise in home ownership in recent decades (albeit currently stalling) vastly expanded the proportion of the population taking out mortgages and associated insurance products – at the time of the 2011 Census, 33 per cent of households were buying their property with a mortgage or loan, and another 31 per cent owned their home outright. This has been accompanied by a surge in

credit-fuelled consumption supported by overdrafts, credit card debt and loans of one kind or another, such that unsecured debt has tripled in 20 years to reach £158 billion in 2013.[29] Financial de-regulation delivered a bewildering array of new products and players to service all this. It is arguable that these changes took place at a time when a changing culture towards money and morality was affecting the behaviour of both consumers and producers.[30] Consumer gratification prevailed and the temptation for financial providers to put short-term gain above long-term customer relationships intensified.

With a vast new cornucopia of products and services on offer, there are clearly groups who are particularly at risk. While it is hard enough for the average consumer to understand financial products, those with low numeracy or literacy skills or without access to informal networks of advice from family or friends are especially vulnerable. Even where it is clear to people what the financial risks are, there are circumstances – such as with payday loans providing short-term cash at very high rates of interest – where basic economic need and a lack of alternative sources of credit can expose those on low incomes to the potential for exploitation, often on a quite shocking scale – recent publicity over the activities of payday loan companies, for instance, has highlighted annualised interest rates that are routinely in the region of 5,000 per cent.[31]

Among those with few resources and low numeracy and financial skills there is a group who form the 'unbanked' minority, who are exposed to various forms of financial exclusion as they are unable to use electronic payments to receive income or purchase goods or services and are also unable to secure reductions available for online purchasing or direct debit payment, or in many cases to access cheaper forms of credit. It is estimated that around 1.5 million adults have no bank account and a further 1.1 million use only a Post Office Card Account, which enables them to receive benefit payments electronically, but apart from ATM cash withdrawals, offers no other banking facilities.[32]

The introduction of Universal Credit – simplifying benefit payments into a single transfer – may accentuate challenges for

those already at a disadvantage.[33] A crucial feature of the new system is that benefit recipients will be responsible for paying all of their bills, including rent, from Universal Credit. This replaces a situation where Housing Benefit was often paid directly to landlords – with an estimated 660,000 claimants expected to be affected by this particular change. While the Government has likened Universal Credit to how people receiving a salary manage their money, it is increasingly being recognised that some of those affected may not have the right financial skills to take on this responsibility, and may find the switch to less frequent monthly payments of benefit a particular challenge, increasing the risk of them falling into arrears with their landlord or facing financial difficulties more broadly. These challenges are underlined by research by the Citizens Advice Bureau into Universal Credit preparedness, which suggests that 92 per cent of future Universal Credit recipients will struggle with at least one of five core areas assessed – budgeting, monthly payments, banking, staying informed and internet access – and 38 per cent will struggle in all areas.[34]

Demographic change may also increase consumer vulnerability. We are witnessing the growth of an increasingly elderly population so that there are not just more older people, but more who are living to increasingly old ages, often with challenging medical conditions, including dementia. Some may have significant financial or capital resources and, while many older people are extremely adept at managing their finances, others lack financial know-how or suffer from declining faculties or reduced confidence in their financial abilities over time. Others may have very limited resources and little resilience when things go wrong. Without support, therefore, many older people are liable to make poorly informed decisions and are potentially highly vulnerable to inappropriate advice. The tale of a 94-year-old woman being sold a five-year investment product linked to penalties for early withdrawal, far from being apocryphal, is actually true.[35]

Consumer behaviour

This discussion of potentially vulnerable groups leads into the wider issue of financial capability across all consumers. Poor capability is cited by the FCA as a significant further driver of conduct risk, reinforcing market failures. The Money Advice Service is preparing a financial capability strategy to be launched in 2014. This will update the FSA's strategy for 2006–11, *Financial Capability in the UK*, issued in 2006, which sought to develop 'informed, confident consumers who are better able to take control of their finances'.[36]

In 2013 the Money Advice Service published new research into financial behaviour. It explores a number of factors that can lead to low capability and poor outcomes – including low confidence, inadequate skills or knowledge and more behavioural drivers such as opportunity, attitudes and motivation. In attempting to gauge current levels of financial capability, the research highlights a number of areas of concern: 16 per cent of the population cannot read a bank statement, nearly three in ten cannot pick the best out of three ISA options and one in three do not understand the impact of inflation on their eventual returns.[37]

Even with the right information, knowledge and skills, economic theorists are now recognising that people do not always make choices in a rational and calculated way and that behavioural biases and mental short cuts may lead people to misjudge important facts or behave inconsistently. In other words, normal human thought processes can lead to choices that are 'predictably mistaken'. Again, this can have significant implications for conduct risk in a market such as financial services, where complex and long-term products offer plenty of scope to exploit such behaviour.

Table 1, taken from a recent FCA publication on behavioural economics,[38] illustrates how our deep-seated preferences, beliefs and mental rules of thumb can affect the sorts of financial choices that we make.

The FCA report goes on to give examples of how firms might take advantage of these biases and behaviours. For instance, one feature of 'present bias' is the tendency to procrastinate, not reassessing whether products bought in the past still offer the best value for money, or not cancelling

Table 1 **Ten behavioural biases and effects in retail financial markets**

Our preferences are influenced by emotions and psychological experiences	Rules of thumb can lead to incorrect beliefs	We use decision-making short-cuts when assessing available information
Present bias e.g. spending on a credit card for immediate gratification	**Overconfidence** e.g. excessive belief in one's ability to pick winning stocks	**Framing, salience and limited attention** e.g. overestimating the value of a packaged bank account because it is presented in a particularly attractive way
Reference dependence and loss aversion e.g. believing that insurance added on to a base product is cheap because the base price is much higher	**Over-extrapolation** e.g. extrapolating form just a few years of investment returns to the future	**Mental accounting and narrow framing** e.g. investment decisions be made asset-by-asset rather than considering the whole investment portfolio
Regret and other emotions e.g. buying insurance for peace of mind	**Projection bias** e.g. taking out a payday loan without considering payment difficulties that may arise in the future	**Decision-making rules of thumb** e.g. investment may be split equally across all the funds in a pension scheme, rather than making a careful allocation decision
		Persuasion and social influence e.g. following financial advice because an adviser is likeable

Source: *FCA, Applying Behavioural Economics at the Financial Conduct Authority*, 2013

products despite intending to do so. Firms can deliberately exploit this by offering products with high initial returns that are then significantly reduced – as is the case with many cash ISA first-year bonuses – or offering 'free' trial periods for products, which quickly segue into monthly deductions. Another behavioural bias that is often played on is 'framing', where certain information is made more salient and consumers

therefore pay limited attention to other relevant facts. Because consumers often base decisions on upfront headline prices for products – a practice likely to be accentuated by price comparison websites – firms can exploit this by placing less favourable terms or unnecessary add-ons in less conspicuous places.

This analysis has particularly worrying implications for consumer borrowing. The Money Advice Service study of financial capabilities found that 16 per cent of those questioned say they continue to buy things even when they know they cannot afford to,[39] and behavioural economics suggests many more take out loans with little reference to their future ability to pay them off. With credit companies, including payday lenders, making credit all too easy and tempting to access, this can set vulnerable consumers on a slippery slope.

These core ingredients of information asymmetry, uncompetitive markets and poor financial skills, accentuated by behavioural biases, produce a potent cocktail of conduct risk for regulators to tackle, interacting in complex and often unpredictable ways to put consumers at risk.

What are the limits?

Despite the many challenges that consumers face, it is also important to acknowledge that protecting consumers cannot be raised above all else. At some point a line has to be drawn such that consumers take responsibility for their actions in the spirit of *caveat emptor* (let the buyer beware). As Martin Wheatley aptly put it in his speech to the British Bankers' Association in January 2012:

> *I am acutely aware that any intervention has the potential risk for moral hazard – where, by bailing people out for their poor decision-making there is no natural justice and they are free to act irresponsibly again… it is therefore imperative that intervention does not make for a zero-failure regime, and that investors are not completely absolved of the responsibility for their own decisions… if a consumer makes a fully informed decision that subsequently goes wrong, then that is down to them… But we have to be realistic… this is about… balance.*[40]

How does regulation work in practice?

Addressing market failure through regulation begins with the 'fit and proper' principle, which seeks to mitigate the risk of adverse selection by screening and approving firms and senior individuals before allowing them to operate in the sector. Firms must be authorised (generally by either the FCA or the PRA), meeting a set of minimum operating conditions in order to be granted a licence. For individuals, a system of approved persons applies to senior personnel and determines who can exercise certain controlled functions or occupy certain positions, with individual accountabilities defined.

The banking commissioners proposed that the approved persons regime be reformed, arguing that under the current system 'meaningful responsibilities were not in practice attributable to anyone', with the result that senior managers 'fell back on the claim that everyone was party to a decision, so that no individual could be held squarely to blame – the Murder on the Orient Express defence'.[41] A new senior persons regime (for all financial institutions) is planned, with operational responsibilities clearly assigned to specific senior individuals who are to be held to account for their decisions. Sitting alongside this, a new, more extensive, licensing regime will apply to all staff whose behaviour might seriously harm a business, its reputation or its customers, with contractual obligations defined in a new set of banking standards.

In addition to authorisation and approval, regulators use deterrence and enforcement to maintain standards, making use of redress schemes where firms are deemed to have failed consumers, publicising promotion bans and enforcement warnings (with the impact on reputation intended to act as a future deterrent), removing firms or individuals who do not meet industry standards, and in the extreme pursuing criminal prosecutions where for instance there has been market manipulation or insider dealing.

The FCA's business plan for 2013/14[42] set out its intention to adopt a more aggressive approach to enforcement and deterrence by pursuing more cases, including more against individuals, and by imposing tougher penalties and fines. The banking commissioners made further proposals to strengthen

industry sanctions. This has led to a new criminal offence of reckless misconduct in the management of a bank, carrying a custodial sentence alongside a licensing regime giving scope to use existing civil powers to sanction individuals through fines, restrictions or even a ban from operating within the industry.

The commissioners also called on the PRA and the FCA to review their penalty regime to allow for a further substantial increase in fines on firms, and the fledgling Competition and Market Authority has similarly indicated that it will be seeking bigger fines for anti-competitive behaviour. To underpin enforcement the PCBS has called for adequate provision of resources and leadership to pursue difficult enforcement cases, arguing for a new statutory enforcement body to be established within the FCA.

What of moral hazard and poor conduct? Adherence to the FCA's principles and rules, including those around *Treating Customers Fairly*,[43] is monitored via a range of regulatory tools that include:

- requests for data and other evidence from firms to demonstrate compliance
- direct supervision of firms' systems and practices to identify where remedial action is needed, for instance around incentive structures or corporate culture
- market or thematic studies in areas of potential risk to consumers, which may lead to new guidance or rules that firms will need to comply with
- event-driven work responding to notified risk, supported where necessary by new product intervention powers

Supervision is intended to be forward-looking and judgement-based, with the intensity of supervision based on likely risk, so many smaller firms will have more limited contact with regulators than in the past. It makes use of the new Firm Systemic Framework, which focuses on high-level risk in a firm's business model or overall strategy to identify where structures, processes or management practices may cause harm to consumers, testing this out and conducting deeper inquiries where appropriate.[44]

The FCA will also sharpen its work with consumers and consumer bodies aiming to:

- provide information about scams, counter mis-information or improve consumer understanding of the market
- seek 'canary in the mine' early intelligence from the Financial Ombudsman Service, the Money Advice Service, Citizens Advice Bureau and the FCA's own helpline to decide where to intervene or be more proactive
- be guided on policy and practice by the consumer network – which includes the Money Advice Service and CAB – and its own Financial Services Consumer Panel
- respond to super-complaints within the stipulated 90-day period

The FCA's final tool is its new competition objective – requiring it to identify and address competition problems – and a competition duty, requiring it to adopt a more pro-competition approach to regulation, both by promoting competition as a means of meeting operational objectives and by assessing the impact of new regulatory measures on competition. A focus on competition supported by the safety nets of the Financial Ombudsman Service and the Financial Services Compensation Scheme (protecting consumer deposits against default up to a limit of £85,000) is a key part of the regulatory jigsaw, with the FCA recognising that heavy-handed regulation 'could stifle innovation and competition [which] could in turn lead to greater harm, since competition delivers to consumers the choice of products they want at the lowest available price'.[45]

Addressing competition problems may involve the use of rule-making powers, or may be done via an assessment of a firm's competitive position in a particular market as part of the supervisory process or perhaps involve responding to the findings of broader market studies or thematic reviews.[46] Where further action is indicated the FCA will liaise closely with the competition authorities (through mutually agreed memoranda of understanding) to ensure that the organisation with the most appropriate resources, expertise and potential remedy powers then responds.

In delivering against its competition duty, the FCA has already acted to address potential barriers to market entry by making the authorisation process for firms simpler and clearer, and providing better support as they navigate through its requirements. It has also introduced a mobilisation phase to give support to firms wanting to come into the sector, allowing authorisation to happen at an earlier stage than in the past so that new participants do not have to build up an expensive infrastructure before finding out whether they meet the requisite standards.

4 Assessing the impact

Weighing benefits against costs

In assessing the impact of regulation it is easy to see that there is a trade-off between the benefits it can confer on consumers and the wider economic costs it brings. As Bishop, Kay and Mayer put it, 'Regulation… may impose excessively high costs on the providers of services and discourage innovation in new forms of service. It is therefore important in evaluating the merits of regulation to examine its overall effects on consumer welfare.'[47]

FCA Risk Outlook 2013 provides a helpful framework for conceptualising the opposing effects that regulation can have on overall welfare, using the two concepts 'consumer detriment' and 'detriment to society'.[48] 'Consumer detriment' arises where, in the absence of effective regulation, lives are affected through failings or misconduct in the financial sector that result in the wrong products ending up in the wrong hands. 'Detriment to society' occurs where regulation has a negative impact such that people are not able to get access to the right products – firms may not be investing in innovating new products to meet changing needs, regulatory burdens may cause sales forces to be withdrawn or mean that too few new entrants come into the industry to allow competition to flourish.

Weighing up all of these factors should lead to an overall assessment of proportionality: providing an answer to the question of whether the burden or restrictions imposed through regulation are proportionate to the benefits that are expected to result. Where this is quantified, for instance through cost-benefit analysis, an assessment of proportionality would require analysis of whether the costs imposed are outweighed by the benefits achieved for consumers.

The FCA uses cost-benefit analysis and post implementation reviews to assess new regulatory rules or policies, in effect

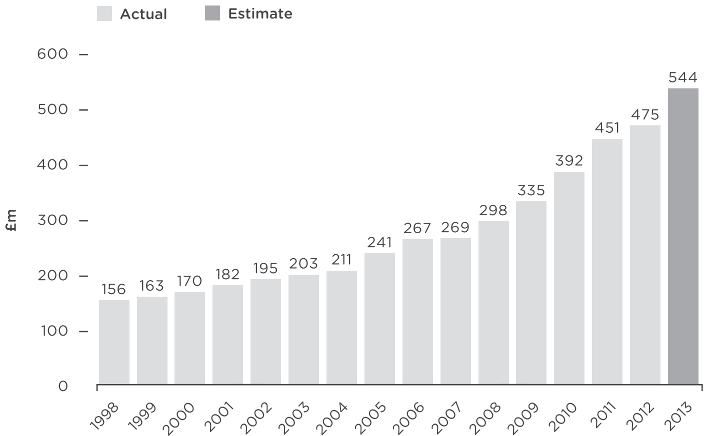
analysing incremental changes in regulation. However, a systematic assessment of proportionality for the regulatory regime as a whole appears to be lacking – while there is good theoretical work available on the measurements of costs and benefits,[49] no single piece of work has been carried out which attempts to quantify whether the overall cost of conducting and complying with retail finance regulation is outweighed by the benefits it brings for consumers.[50] The remainder of this section on impact will therefore discuss what is known about costs and benefits and what general conclusions might be drawn.

Impact on firms and the industry

Financial services firms incur direct costs in the form of fees and levies paid to support the activities of the two key regulatory authorities and the bodies for whom they have statutory responsibility, including the Financial Ombudsman Service, the Financial Services Compensation Scheme, and the Money Advice Service.[51] Figure 2 provides an illustrative overview of the rise in the budgets of the FSA (and predecessor bodies) over the 15 years since 1998, using analysis done for the Salz review of Barclays Business Practices, concluding with an estimated budget for the FCA/PRA in 2013 (in practice their combined budget is even higher than was estimated at the time the Salz report was being prepared, as shown in Figure 3). Over this period, the budget for financial services regulation has increased more than threefold. The steepest increases have been in the last six years, with regulatory budgets more than doubling since 2007 at a time of low relative inflation. This undoubtedly at least in part reflects an increase in the scope and range of regulatory activity, feeding through into higher costs and a higher industry levy.

It is also worth noting by way of comparison that the resources put into financial services regulation are considerably greater than in other sectors. As figure 3 shows, spend on financial services regulation is more than six times the amount spent on regulating the communications sector and around eight times that of energy regulation, although financial services only

Figure 2 **Budget of financial regulators 1998–2013**

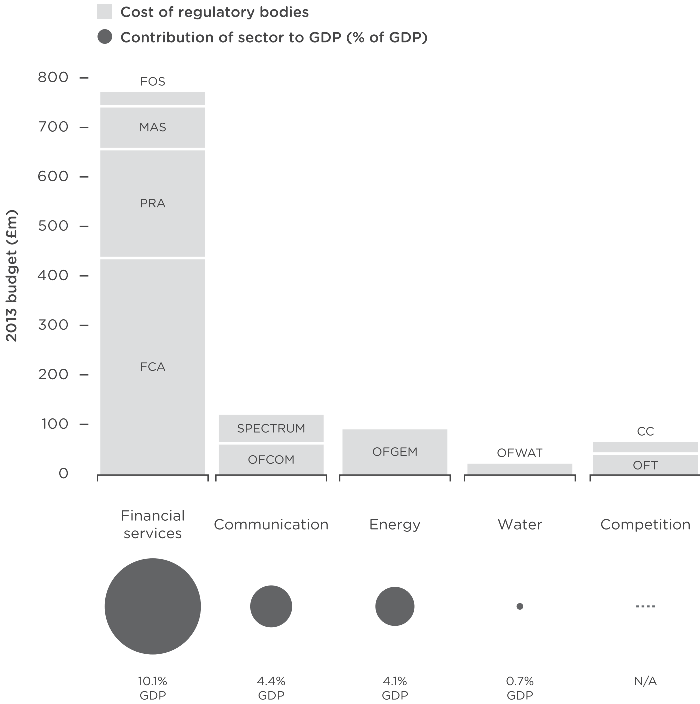


Source: Salz, Salz Review: An Independent Review of Barclays' Business Practices, 2013

contribute a little over twice as much to GDP as these sectors. Clearly there is an element of comparing apples and pears in this observation: given the systemic importance of financial services (some of the costs shown, albeit a minority, are for prudential regulation) and the capacity for harm in the sector, one would expect some disparity, but arguably not on this sort of scale.

Alongside the industry levy to support regulatory bodies, firms also have to meet the indirect costs of complying with regulatory requirements. Compliance costs arise from activities that would not have been undertaken in the absence of regulation. They include the following in-house costs:

- compliance departments determining and overseeing how regulatory expectations are met
- training of staff in relation to compliance activity
- employee time and costs in complying with regulatory processes (such as issuing of letters, and providing information and explanatory material to customers)



Source: Frontier Economics

- record-keeping to provide evidence of compliance and senior management time in engaging with regulatory authorities and overseeing the compliance function

Compliance costs may increase for some firms under dual regulation unless assurances that the burden will be controlled, for instance by ensuring that duplicate information requests are minimised and single processes followed wherever possible, are realised in practice.

In 2006, the FSA asked Deloitte to look at the cost of regulatory compliance in two wholesale sectors and one retail sector – investment and pensions advice (IPA).[52] Although limited to one part of the retail sector and conducted just before the Treating Customers Fairly initiative (which the FSA recognised in the report would have increased costs),[53] this study nevertheless confirmed that compliance costs across all three sectors were a cause for concern in some areas, citing in particular record-keeping and providing evidence as areas where firms 'recorded cumulatively significant costs… spread across a large number of separate rules'. Incremental costs of compliance were found to be greater in the IPA sector, notably around advising and selling activities, such as point of sale disclosure. Again, recognising the limitations of the study's scope, the analysis of responses from firms providing IPA found that the reported incremental costs of compliance in the areas analysed would, if added together, amount to roughly three times the direct costs of fees.[54]

Examples collected as part of this research on how compliance impacts on operational costs in larger institutions showed the effect was varied and wide-ranging. It was noted that the sales process for something as straightforward as an instant access savings account could take up to 45 minutes to complete, that product launch timescales were often significantly delayed by governance procedures required to ensure regulatory compliance, and that the annual product review process – assessing a business's entire product range, including legacy products, for conduct risk – was extremely costly and time-consuming. Reference was also made to the high administrative burden of sending explanatory letters to consumers, often several times a year, as required by regulation, and to the volume of routine data requests made by regulators, as well as the costs incurred when additional requirements such as an externally conducted skilled persons review are imposed. More generally there was a view that while supervision had become more strategic in its focus it was nevertheless highly resource-intensive for the business, and that if not pursuing a zero-risk regime, the FCA was certainly considered to be operating with a low risk threshold, with knock-

on effects on behaviour and decision-making across the business.

As with direct costs, there is evidence that compliance costs have risen over time. Even before the new regulatory regime was introduced, the House of Commons Treasury Committee report on the FCA noted concerns that the costs of regulation had risen in the last few years and would rise further as the new bodies were put in place, citing the Association of Independent Financial Advisers as saying, 'The costs of coping with FSA regulation appear to keep rising… regulation… has been characterised by a considerable number of waves of different requirements with the result that a degree of regulatory fatigue has set in.'[55] The Salz review of Barclays Bank also backs this up, citing internal data showing that Barclays had approximately 1,500 compliance staff in 2012, up from 600 in 2008.

The FCA pulls few punches in *FCA Risk Outlook 2013*:

> *The volume of change will continue to create operational challenges for firms… as they prepare for, implement and ensure on-going compliance with new regulatory requirements… Compliance functions will remain under significant pressure with questions over whether those sectors that were more lightly regulated in the past will be able to find sufficient compliance staff. For firms that need to manage compliance with a range of regulators from multiple jurisdictions, the challenge will be particularly acute.*[56]

The FCA's prediction is supported by survey data collected by the consultancy firm Huntswood, which found that firms had already begun to experience increased contact and intervention by the FSA as early as May 2012, with more than 60 per cent of firms surveyed saying they were spending more time assisting supervisors now than they did a year ago.[57]

Costs to the economy

Alongside the industry costs of regulation, wider economic costs may arise from:

- higher costs of production, likely to be passed on to consumers in higher prices

- withdrawal of products or services or less innovation, reducing consumer choice
- increased barriers to market entry, leading to reduced competitiveness

It can be assumed that both the direct and indirect costs of complying with regulation, adding to the costs of production, are passed on in higher prices for consumers. Consumers themselves face significant transaction costs arising from regulation, often facing a barrage of questioning, form filling and defensive communications on the regulatory conditions surrounding their purchase, which almost certainly deters some transactions from taking place at all.

An indirect effect of regulation may be to push firms into less regulated markets or shadow banking where there may be less competition, lower operating costs with fewer regulatory rules, and opportunities for easy exploitation of higher-risk, more profitable strategies. Clearly this creates significant potential risks to consumers and wider systemic stability. The higher the cost of complying with regulatory rules the greater this risk is likely to be.

Even more significant is the risk that regulation will inhibit new product development and the innovation that drives economic creativity and delivers consumers the product choice that they are seeking. While this might arise from overly risk-averse oversight of product development processes by regulators, it is just as likely to be the result of self-censorship as firms focus on meeting the demands of the regulator rather than of consumers. One financial institution illustrated this by quoting the example of an extremely popular savings account that introduced the innovation of a lottery element, which took two years to come to market and was very nearly stopped by fears about the regulatory response.

The FCA itself notes the risk that 'new regulation may also lead to precipitous withdrawal of firms from business areas and products', giving the example of firms potentially restricting interest-only mortgages because of 'concerns about retrospective regulatory judgements on lending decisions'.[58] Another recent

example of withdrawal from a market is provided by businesses that have closed down their independent financial adviser service in response to the rule changes around retail investment advice. These rules were brought in to address consumer detriment in that market, arising from a potential conflict of interest in adviser fees, but are also producing the consequence that investment advice will have to be paid for, will be harder for consumers – particularly those with fewer resources – to access, and in certain cases will no longer be offered.

Regulation may impose barriers to market entry for aspiring new businesses, through, for instance, the high fixed costs of meeting authorisation requirements or, once established, of meeting the industry levy and running an internal compliance function. Some economists have argued that incumbent firms welcome a measure of regulatory cost precisely because of its effect in deterring new entrants.

As discussed, the FCA's competition duty requires it to minimise the risk that regulation will create such barriers. The FCA has taken steps to address this in its approach to requirements at authorisation stage, and its business plan also states that it has 'reviewed prudential and conduct requirements… to ensure they are proportionate and do not pose unnecessary barriers to entry and expansion' adding that 'there is no evidence that they are causing particular difficulty for prospective banks'.[59] Establishing a counter-factual – whether potential new financial providers have been deterred – is always fraught with difficulty, however. And as we have seen, regulation is imposing very significant financial and compliance costs on firms. It is hard to ignore this when considering the impact on existing and prospective businesses.

What gain to consumers?

If a key benefit of effective regulation is the avoidance of consumer detriment arising from the wrong products ending up in the wrong hands, then evidence from mis-selling episodes may provide some indication of the scale of potential benefit. Compensation payments in these cases are specifically designed

to put consumers back in the position they would have been in without the mis-selling (although there may not always be agreement on how this should be interpreted). The industry had already paid out £12 billion in compensation for PPI by August 2013 (with the final cost expected to be considerably higher) and the compensation costs of the interest-rate swap scandal are similarly expected to run into billions while the newly exposed credit card protection mis-selling is also likely to run up a compensation bill close to a billion, again reflecting detriment arising from the sale of unsuitable or unnecessary products. In each of these cases and the no doubt many other examples that could be cited, the clear implication is that the failure to address a serious conduct issue – mis-selling – before it escalated led to significant financial loss by consumers. This loss is generally incurred over long timescales, as it was for instance in the case of PPI, so cannot be set directly against annual costs such as the industry levy.

Where a significant incident of this sort occurs there will be transactional costs affecting firms and, in the end, consumers. The Treasury's impact assessment of the move to the new regulatory regime used the assumption that an incident such as PPI might affect 100,000 consumers, and cost the industry £5,000 per customer simply in administering the complaint and determining the compensation (excluding the compensation payment itself), leading to the conclusion that the economic benefit to business of avoiding an episode of this kind in the future would be £500 million. This is in addition to the administrative costs that would be saved by regulators, the Financial Ombudsman Service and other consumer bodies in managing and referring complaints, not to mention the costs to consumers of pursuing a complaint.[60]

Other manifestations of consumer detriment may not be as stark nor their costs as apparent. They may arise from consumers purchasing products that are unsuitable for their circumstances, perhaps because they are too risky, or because affordability was not properly considered or insufficient allowance was made for future events such as interest-rate rises.[61] Or it may be that they are sold poor value or deficient products that are not properly

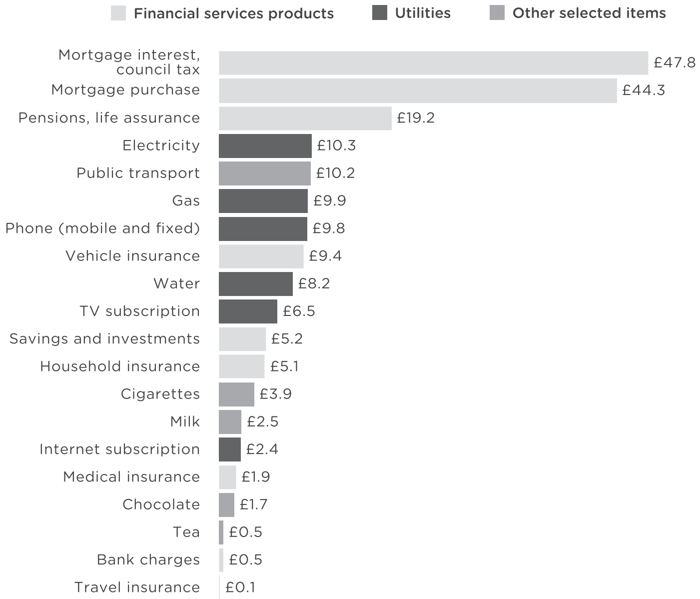
meeting their needs. A 2012 report by the National Audit Office concluded from an analysis of complaints against firms in 2010/11 that unscrupulous behaviour by firms in the consumer credit market was costing consumers at least £450 million a year. Although a small fraction of total consumer debt, as the report notes, it is 'the most vulnerable consumers [who are] potentially most at risk'.[62] Similarly, the 2013 market study of workplace pension schemes by the Office of Fair Trading (OFT), in the wake of auto-enrolment, identified about £40 billion of savings in older schemes that is at risk of poor value from high charges or poor scheme governance, arguing for action – in this case by the Department for Work and Pensions (DWP) and the Pensions Regulator – to protect savers in the future.[63] Detriment here would be the difference between the actual return on the £40 billion and the return that should have been achieved for consumers. Clearly regulation cannot realistically remove all potential areas of consumer detriment – these examples should therefore be read as illustrative of some of the benefits for consumers that might be achieved by action to tackle detriment rather than a quantification of the totality of possible benefit.

Regulation can bring other benefits to consumers, for instance where it supports increased competition that delivers lower prices and increased choice.[64] More generally it can be argued that the safety net of regulation may have wider economic benefits if it increases overall consumer confidence in retail finance products,[65] leading to an increase in consumption. In this case removal of regulation could have negative consequences for consumers and the economy more widely, perhaps particularly at a time of high sensitivity to mis-selling and misconduct generally.

Where should our priorities lie?

Regulation cannot, and arguably should not, protect all consumers from all eventualities, any more than it can aspire to a zero-failure regime. Clearly blatant mis-selling or financial crime must be addressed and the FCA has many systems in place to track early signs of misconduct. In seeking to establish priorities

Figure 4 **Average UK household weekly expenditure on selected items, 2011**



Source: *ONS, Family Spending 2012*, table A11

for regulation outside these more extreme situations, though, further thought needs to be given to where the potential benefit would be greatest.

One approach would be to look at patterns of consumer spending. Figure 4 shows how much of the average household budget (£487 per week in 2011) was spent on financial products and on a range of utilities. More was spent on mortgages than on any other item, with spending on pensions and life assurance also significant. Interestingly, though, combined spending on household utilities – electricity, gas, phone, internet and water – made up nearly twice as much of weekly outlay as spend on standard financial items such as savings and investments, insurance and bank charges.

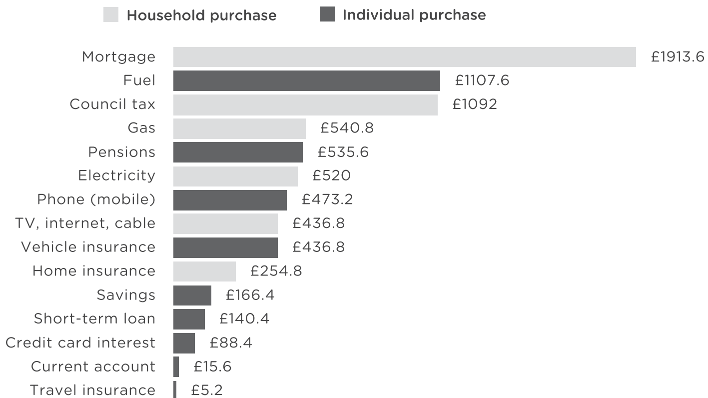
Figure 5 **Spending patterns of a family with median income and wealth, 2013**

Characterised by:

- Median wealth and income
- £70k outstanding mortage, 15 years remaining
- £50k pension pot
- £500 current account balance, with use of authorised and unauthorised overdraft
- Regular savings account, restriction on withdrawals
- Taken out a £7.5k loan for five years
- £800 average credit card balance (incurring charges)

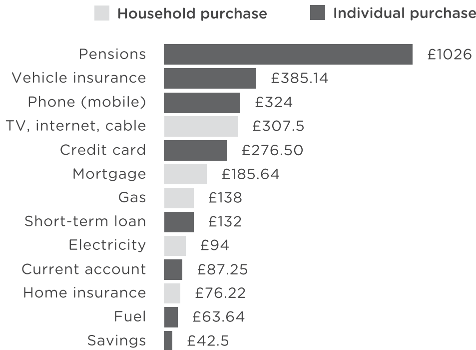
Source: Frontier Economics, 2013

Figure 5a **Average annual spending of a family with median income and wealth, 2013**



Frontier Economics has analysed spend data further to produce an in-depth assessment of the likely spending patterns of a typical family with median wealth and median income – characterised as the 'squeezed middle' (figure 5). It has set this alongside a market analysis of the highest and lowest prices available for representative products that this family might buy. Leaving aside mortgages and pensions, this suggests that in absolute terms this typical family type could make roughly the

Figure 5b **Potential savings for a family with median income and wealth, 2013**



same overall savings by changing utilities suppliers as it could by changing routine financial purchases.

Many of these products are very similar in the potential they provide for exploiting information asymmetries or dysfunctional behaviour traits using all the familiar ploys of complex tariffs and discount structures and an over-focus on eye-catching upfront pricing discussed earlier in this report. From the point of view of potential consumer detriment, therefore, there is probably not much to choose between a 24-month mobile-phone deal, a complex electricity supply contract or a standard insurance product or ISA.

What does this tell us? We have seen that the resources put into retail finance regulation are high compared with other sectors, at least in part because of the sector's much greater focus on monitoring inputs and processes. Yet for many routine, renewable financial products such as household, vehicle or travel insurance or standard savings products, spending by a typical family is actually pretty low and less than their outlay on items such as renewable utilities contracts, while the savings that could be made by switching between the best and the worst deals is not significantly different between the two types of product. On the face of it this would argue for some scaling back of the

regulatory resource put into lower-impact financial products that have regular opportunities for renewal and/or switching, and where, provided there is not actual mis-selling, poor outcomes are easier to define and communicate.

But – and this is a big but – retail finance is also unique in providing lifetime products that are building up wealth, such as mortgages, pensions and investments. These are significant not just because, as figure 5 shows, they are where a very high proportion of household spending goes, but more particularly because of the long-term importance to consumers of this wealth accumulation. With new provisions for auto-enrolment into employer pension schemes, even more consumers will be making challenging long-term choices. And long-term products are precisely where the peculiarly problematic features of the retail finance market are most pronounced, notably the long lags, often years, before the product value becomes clear, the difficulties in cancelling these products, the fact that such products may be bought only once or twice in a lifetime making learning difficult, and the inherent complexity of the products themselves. These *are* qualitatively different from mobile-phone contracts.

If retail finance regulation is most effectively focused on certain types of long-term product – with the FCA's Mortgage Market Review being an example of the type of action that can be taken to support better outcomes[66] – there is also the issue of whether certain types of consumer or market merit particular attention. Referring back to earlier discussions of consumer vulnerability and capability, two prime areas would seem to be consumers who are exposed to risks from borrowing and debt, and the growing population of the elderly who might depend on financial products for income, but at the same time may face challenges in managing them effectively.

Consumer credit will come under the purview of the FCA from April 2014. The FCA issued a consultation document in October 2013 setting out how it proposes to regulate this market, where 50,000 firms currently have credit licences.[67] Clearly this is an area where consumer vulnerability, sometimes combined with poor financial capability, is particularly acute and the potential consumer detriment from misguided borrowing very

Figure 6 **Median level of assets, by age of household head, 2006–08**

Source: Rowlingson, *Wealth Inequality: Key Facts*, 2012

large.[68] Much attention has focused on payday lending. The FCA document proposes mandatory affordability checks for these loans, as well as limiting to two the number of loan roll-overs that will be permitted, and a similar restriction on the number of times a continuous payment authority can be used to access funds from the borrower's account. The new Financial Services (Banking Reform) Act also puts a duty on the FCA to impose a cap on the cost of payday loans, covering charges such as arrangement and penalty fees and the interest rate charged. But the issues go wider than payday loans, with bank overdraft fees, credit card and other charges also posing risks,[69] and as figure 6 shows, significant variations evident in the highest and lowest prices charged for credit card and no doubt other forms of debt.

If anyone is in doubt about the significance of the growth in the elderly population, analysis by the Institute for Fiscal

Studies (IFS) gives a very clear picture of the scale of change. The IFS data show that non-working pensioner households made up 16.7 per cent (1 in 6) of all household types in 2010/11, and were the second-largest category after working couples with children. They were also growing faster than any other household group.[70] While older households may not always have high incomes, they are often asset rich. Survey data collected by the Office for National Statistics and analysed for a report prepared for the University of Birmingham show that 60–64 year olds are the age group with the highest levels of wealth and those above the age of 50 remain on average much wealthier than the under 50s for most of their life (with the exception of wealth in pension pots), as illustrated in figure 6.[71]

The most significant forms of wealth are property (usually the family home) and pensions (the value of accrued pension benefits), which again underlines the importance of ensuring that consumers are adequately protected when making these long-term investments. For older age groups, though, it is the line for total financial wealth – defined in the Office for National Statistics survey as savings minus outstanding debts (net wealth) – that is of particular interest. As figure 6 shows, for every age group over 50, up to and including those aged over 85, median financial wealth is between £10,000 and £20,000. This is a relatively liquid asset for saving or investing in retail finance products concentrated in these age groups, with all the attendant issues this raises, not least because in many cases this may form a significant part of the regular income of people who may be asset rich, but quite often income poor.

These figures on average wealth mask the fact that sitting alongside relatively wealthy pensioners is another group of people who are on a low income with precious few assets, who are also increasingly of concern. While Age UK already highlights the problems of pensioner debt, the OFT has also started to recognise the problems faced by elderly people, not just in relation to their particular vulnerability once they are in debt, which they identify as a rising problem,[72] but also as a result of their exposure more generally to uncompetitive markets, from exit fees for retirement homes to mobility aid

charges.[73] Whatever their level of resources, poor health or restricted mobility, capability issues in understanding continually evolving financial products, and patchy ability to deal with new technologies may all place the elderly at a disadvantage in navigating financial services, and argue for greater consideration to be given to their needs.[74]

To conclude, there clearly is an argument to be made that the direct and compliance costs of regulation in the retail finance sector are at historically high levels and also proportionately higher than in other regulated sectors, and that for some routine products this may amount to disproportionate regulation. Weighing alongside this are arguments surrounding the uniqueness of many long-term financial products which, when combined with the expansion in the reach of these products in recent decades and changes in the behaviour of consumers and businesses, has magnified the potential for consumer detriment. Last but not least is the issue of identifying and protecting groups of consumers who face particular risks and vulnerabilities. All of this does not in itself justify the much higher resources going into retail finance regulation – rather this is an issue that warrants further consideration in relation to the types of regulatory tools used and the evidence of their effectiveness.

5 Can it be done better?

Given the resources put into financial services regulation one might expect some bang for the buck. It is particularly surprising, therefore, to put it mildly, that the PCBS was forced to conclude,

The failure of regulators to prevent a decline in banking standards is as remarkable as their failure to spot the accumulation of systemic risk and to identify appalling conduct failures, such as the widespread mis-selling of PPI… and LIBOR manipulation. The public might be left wondering what purpose was served by almost 4,000 regulatory staff at a cost of around £500 million, the bill for which is ultimately footed by the consumer.[75]

If something went wrong not just with prudential regulation but also with conduct regulation what is needed to put it right? How far was Andy Haldane justified in described the regulatory regime that was in place in the lead up to the financial crisis as 'Byzantine in… complexity… Heath Robinson in… design',[76] describing a situation where, as he saw it, regulators treated reform like a decorator papering over old cracks, instead of stripping the system back and starting afresh?[77]

A pause to look at history

To consider this further, it is instructive to take the instance of PPI mis-selling as a case study of how inadequate conduct regulation allowed such mis-selling to continue unabated. The PCBS report spends some time analysing what was happening in the industry, and focuses in particular on the extent to which it had become mired in process so that 'supervisors failed to focus on major risks and instead spent their time implementing processes and monitoring compliance against rules and…

plans'.[78] This is aptly summarised in the evidence of one witness to the PCBS enquiry on the mis-selling issue:

It actually got down to, 'This box ought to be this size rather than this size.' I think a lot of this could have been changed if someone had come in… and said, 'We don't need to go through any of that. We think, as a matter of principle 6, this is treating customers unfairly. Please explain yourselves.'[79]

Yet neither the regulator nor the banks themselves – where senior management intervention was shockingly absent – stood back from the box-ticking to tackle this bigger issue of principle, despite numerous warnings from the wider sector well before the 2005 super complaint brought by Citizens Advice. Indeed the Chief Executive of the Financial Ombudsman Service provided evidence to the PCBS that it had alerted the FSA to the problem of PPI mis-selling very early on and had subsequently written to point out that the FSA's response of relying on individual consumer complaints was not appropriate given the scale of the problem.[80]

In reflecting on the previous regulatory regime in a speech in June 2011, Sir Mervyn King warned against a continuation of micro-regulation and box-ticking, arguing, 'The obsession with detail was in fact a hindrance to seeing the big picture… Process – more reporting, more regulators, more committees – does not lead to a safer banking system.'[81]

As the banking commissioners also argue, it was not just the obsession with detail that was at issue, but the fact that this was managed by junior regulatory staff, with the consequence that there was almost no contact at senior levels between regulators and the regulated on strategic issues of risk or performance. This encouraged a situation in which compliance with the rules and the box-ticking – the letter rather than the spirit of conduct compliance – became the norm, consuming vast resources in both the regulator and the industry, while banks were allowed to continue with practices that led to poor standards.

If bureaucratic box-ticking was a costly distraction, it might also have been damaging as a defensive strategy. It can be argued that where front-line staff are focused on complying with

box-ticking regulatory requirements around *how* they are selling a product, this may distract them from considering the detail of *what* they are selling and whether it is appropriate for the particular consumer they are serving. This over-focus on whether they can demonstrate they have gone through the correct procedures at a technical level may therefore increase the likelihood of mis-selling or just plain poor customer service by distracting from the bigger picture of fairness or appropriateness. Haldane, in another of his papers, puts forward a similar argument in relation to defensive practices in the health sector, where fear of redress may cause practitioners to over prescribe or over-refer patients to hospital, with sometimes adverse consequences for their health, which would have been avoided by stepping back to look at the bigger picture. As Haldane succinctly puts it, 'defensive, backside-covering behaviour… may have increased risk in the system'.[82]

Regulating process or outcomes?

With the FCA only a short period into its new shoes the jury is still very much out on how it will in practice deliver its regulatory role. The FCA's stated purpose of taking a proactive, judgement-based approach to intervention, tackling problems before they escalate, is at least in part designed to prevent a new PPI incident, as is the requirement to respond within 90 days to super-complaints from consumer bodies. Moreover, as it refocuses supervision away from smaller firms towards those considered larger, higher risk or higher impact, and turns the spotlight on to business strategy, the FCA has also signalled that it is committed to the principle that managers take responsibility themselves for leadership and controls, with the expectation that they are able to demonstrate the actions that they have taken to resolve conduct issues promptly. As of October 2013, the FCA has not used its product intervention powers, suggesting this may be very much a last resort, with the hope being that stronger management oversight, earlier contact and 'deep dives' to explore product development processes as part of the Firm Systemic Framework supervision process will avert the need to act later.

Nevertheless it remains the case that the retail finance sector continues to use a wider range of routine regulatory levers than other regulated sectors and to use them more intensively. Business strategy supervision for large businesses – unique to financial services – is proving highly resource-intensive for both parties and often focused on demonstrating process as much as outcomes. Similarly the data collection burden in the industry shows no sign of diminishing.[83]

This perhaps suggests that, à la Haldane, new regulatory approaches have been largely grafted on top of familiar input and process-based tools. In the PCBS report the banking commissioners raise early concerns about this happening, arguing in the chapter on conduct regulation that it is time for the FCA to reign in 'mechanical data collection and box-ticking' in favour of a 'much greater emphasis on the exercise of judgement', in order to move away from the FSA's practice of 'putting form before substance'.[84] They note, however, that the FCA is 'housed in the same building as the FSA, has many of the same staff, and many of the same systems' creating a risk that this 'will make the transfer to a new judgment-based approach more difficult... than for the PRA'.[85]

The banking commissioners also express concern that the FCA's more proactive approach to regulation might become *too* intrusive, particularly in relation to product intervention and oversight of firms' management processes. They recommend that the Treasury Committee be briefed within six months (implying a report around the end of 2013) on the risk that the PRA and the FCA 'may appear to be acting as shadow directors' as a result of their new supervisory approach.[86] In concluding their review of the role of regulators, the commissioners also call for an inquiry in three years time (2016) into the supervisory and regulatory practices of the new regulators by the Treasury Select Committee, including assessing whether the FCA's approach to data collection has been appropriate.[87]

With deterrence and enforcement now high up the agenda, and strengthened further by new legislation, the arguments for standing back from micro-regulation driven by process and adopting a genuinely principles-based and outcome-focused

approach to regulation buttressed by high penalties for transgression seem stronger than ever. Government, regulators and the industry should now turn their attention to how this might best be achieved.

6 An alternative vision

Preparing for the future

Change is clearly on the horizon for the retail finance sector as new business models come forward to challenge the existing big names and more collective approaches to financial provision and inclusion are developed. London's Metro Bank is one such model; Islamic banking is another potential growth area; and renewed interest in credit unions (financial cooperatives operating in local areas to offer small loans), community development investment funds and regional banks may also start to bear fruit. Elsewhere in the sector significant new approaches to lending are emerging, mobilising pools of non-bank funds to finance lending directly through peer-to-peer or crowd funding schemes.

As ever, technology will play a big part in shaping the sector's future. Ownership of smart phones and tablets increases apace, with the potential for new forms of electronic and mobile payment systems to effect transformational change now becoming apparent, not least from examples now emerging from African economies.[88] Changes to the fundamental wiring of the sector, including 'disintermediation' – financial transactions taking place without the intermediary of the traditional clearing bank system – are likely to be only a matter of time.

Back on the ground the sector must adapt to new regulatory structures, including the new independent payments regulator and potentially increased regulatory control arising out of EU provisions. Banks will have the additional challenges of establishing new governance structures with separation of functions in response to the Financial Services (Banking Reform) Act and of meeting stronger capital and liquidity requirements.

Against this backdrop of uncertainty and change a new vision for conduct regulation must be crafted and action taken to

effect the changes in culture and behaviour that will be required to deliver it.

What do the key players want?

Clearly consumers want to be confident that they are being treated properly, not hoodwinked into purchases that offer poor value. But they also do not want to be swamped with endless bureaucracy for the simplest of transactions. The financial industry wants regulation that provides space for innovation and new products and keeps down costs and compliance burdens. The regulator wants to show that it can deliver a good deal for consumers, protecting those most at risk, while also containing costs.

How should regulation be reframed to deliver this?

We believe that adherence to a single principle would go a long way to securing an evolution that will lead to regulation of retail finance that is fair, efficient and proportionate. Put simply, if regulation is shaped from the outset by the outcomes that consumers are experiencing then it is likely to have many of the right characteristics, including the correct proportion of attention paid to each product or service.

If, instead and as it often does today, regulation continues to focus in minute detail on each process and input – requiring endless detail on who made what decision in what meeting and how many and which boxes were ticked at every stage of every process – then it is likely to impose an unnecessarily costly burden on the industry and thereby actually harm consumers. As we have seen too often, it is likely to be reactive, only spotting problems after the event. Moreover, this approach inevitably takes institutions as its focus and not the wider market – a 'vertical' view that often means siloed teams of regulators are unable collectively to see the wood for the trees. An outcomes-based approach would adopt a wider, more 'horizontal' view, looking across the industry at products and services and assessing where the greatest risk of problems or poor outcomes lies for consumers.

How can we move towards delivering this?

A first step must be a clearer restatement of the overarching imperative of fair treatment, with the regulator and the industry jointly embracing the principle of delivering outcomes that are in the collective best interest of consumers, and signing up to a shared vision of what these are. Financial organisations must move beyond paying lip service to this principle, as they have in the past, so that they are genuinely only designing products and services that they would be happy to see their own family and friends being sold.

There is already a considerable body of documentation to start from in determining what good outcomes look like for consumers. The original six principles set out in *Treating Customers Fairly*[89] define high-level outcomes. These are given substance through regulatory rules, including the Conduct of Business Rules and there is a body of guidance produced by the FCA for businesses to interpret or refer to when deciding what successful implementation of conduct rules would mean in practice.

A clear focus on outcomes should be matched with a significant scaling back of the regulatory resource put into systems, inputs and processes. At present it appears that the FCA is subscribing to the principle of outcomes-based regulation while continuing to run alongside this the FSA's previous practice of focusing on inputs and process, manifest in activity recording, data collection. and monitoring and business strategy supervision, much of which is about how things are done, not about what outcomes are delivered. Some of this will remain necessary – the baby need not be thrown out with the bath water – but there also needs to be a real recognition that as a regulatory practice these processes are highly resource-intensive for both the regulators and the industry and have no great track record of providing linkages through to desired outcomes. As already flagged by the banking commissioners, it needs to be subjected to challenge and review in order to identify what needs to be stopped.

Rather than the FCA's present intense focus on vertical scrutiny of practice and process within individual firms there is a clear need for regulatory priorities and resource to focus more

single-mindedly on horizontal scrutiny of markets, identifying where risk lies for different types of consumer with the aim of maintaining a proportionate regulatory response linked to outcomes. The FCA's objectives and organisational structure are arguably compatible with such an approach and there are already market and thematic reviews being undertaken which build in analysis of risk, considering the full range of consumer detriment from outcomes that have small monetary value but affect a large number of people, to the reverse, large detriment affecting relatively small numbers.

Further attention should now be given to market segmentation in order to identify clearly the types of consumers and products where the risk of harm is greatest and poor decision-making and mistakes that have material impact are rife. A proactive approach to securing better outcomes for these higher-risk groups – including those with poor financial capabilities or constrained resources – in areas of highest impact would enable regulatory priorities to be revisited and recast accordingly, with more resource targeted on high risk areas and less in areas where consumers have perfectly good capabilities or where potential detriment is relatively small because of the nature of the market.

A relentless focus of regulation on consumer outcomes would argue for greater emphasis to be given to those regulatory tools that directly deal with outcomes. Many such tools are already in place, under consideration or could be quickly developed – product interventions if detriment can be demonstrated, rules and guidance around reasonable treatment of consumers (eg not moving them on to the least competitive interest rate when bonuses expire), assessment by regulators of product complexity, testing of consumer understanding and surveys or mystery shopping to test actual consumer experience and outcomes.

There is a quid pro quo for a shift away from process-bound to outcomes-based regulation. Once the principle of acting in consumers' best interest is embraced and action is taken genuinely to embed this behaviour from board level down, then provided all parties are clear about what this means in practice

and how it will be assessed through regulation there should be no holding back from applying strong sanctions to both individuals and businesses (as already proposed by the banking commissioners) when the industry is shown to be acting against this core principle.

What is getting in the way?

A shift to outcome and principles-based regulation undoubtedly requires a significant change in regulatory culture. Driven by the previous input-focused approach, and fuelled by public suspicion of the financial sector, the tendency may continue to be to regulate more, while what is required is to regulate better.

A change to a regulatory approach that pares back much of its micro-management and vertical scrutiny of firms crucially also requires trust in the sector. Regulators must be convinced, of course, but it also means winning over the hearts and minds of politicians, opinion formers and the public.

There can be no doubt that we have witnessed a monumental breakdown in public trust in the financial industry to behave morally and put the interests of consumers and the reputation of their institution at the heart of what they do. As the MP and Banking Commissioner Pat McFadden put it in the lead up to the publication of the Commissioners' report, 'It looked as though the customer was there to be fleeced, reputational damage could be ignored and deals were a combination of a war to outwit the person on the other end and a cartel to fix the price.'[90]

The root causes of this systemic loss of integrity have been variously ascribed to the 'infection' of investment banking cultures that crossed over into the wider retail sector during the frenetic years leading up to the financial crisis; issues of governance, in particular short-termism and the lack of commitment to long-term outcomes driving similar responses within the industry; and behind all this incentives and remuneration that directly rewarded this behaviour while providing insufficient penalties and accountabilities for wrong-doing – the merry-go-round of a one-way bet.

Without wishing to view the past as a golden age, it is worth noting the chasm between the British Social Attitudes Survey in 1983, when 90 per cent of respondents agreed banks were well run, and the position in 2012, when just 19 per cent thought they were. Core values of customer service are easier to sustain where there are direct personal interactions between businesses and their consumers, and incentives to establish a strong long-term client relationship. Perhaps it should be no surprise that with financial transactions becoming increasingly complex, de-personalised and one-off, and with the relentless drive towards ever-bigger short-term gain, the risks of consumer detriment have intensified and the brakes on poor conduct diminished.

Institutional governance is critical in all this. It is argued that as long as banks and other financial institutions are owned and run by people who have high-powered incentives to maximise returns and remain focused on the short term then there is a conflict between their interests and those of their consumers.[91] This seems to be reinforced by practices that frequently deliver ineffectual checks and balances from non-executives, auditors and other independent overseers.

It is argued that market structure and lack of competition is also a barrier to change. There is no doubt that the market is heavily concentrated. Data from Mintel on personal current accounts – an entry product that can be used to develop a more ongoing relationship – show that the Big 5 banks – Lloyds, Royal Bank of Scotland, Barclays, HSBC and Santander – had 87 per cent of the market in 2012, up from their 71 per cent share in 2007, as the financial crisis ushered in crisis-led bank-to-bank and bank-to-building-society mergers, alongside a significant exit of overseas businesses. The mortgage market is similarly concentrated with the five largest providers taking three-quarters of new lending and nearly two-thirds of existing mortgages. Other parts of the market, such as for savings, are less concentrated, however.

Effective competition as exemplified by consumer choice and switching between providers is also patchy. The OFT's review of the personal current account market published in early

2013 found little evidence of progress in increasing competition with charging structures remaining complex and little evidence of consumer switching.[92] In fact less than 5 per cent of customers change their bank account each year, compared with the roughly 15 per cent who change gas or electricity supplier and over 35 per cent who change car insurer.[93] There are, of course, significant numbers of new customers to banking each year as young people or people arriving from overseas take out accounts, with banks competing to attract this business – Lloyds Bank estimates that its total annual churn rate from the combination of switching and new accounts is around 8 per cent.

Change is on the way. The Lloyds and Royal Bank of Scotland divestments required by the European Commission will have some impact on market structure. Since September 2013 banks have been required to operate a seven-day switching service for current accounts, due for review by the Payments Council in 2015, and there are growing calls for a more radical approach to bank account portability, linked to some form of personal ID such as mobile-phone numbers. The FCA has a clear remit and duty on competition and the Government endorsed the banking commissioners' recommendation that the 'Competition and Markets Authority immediately commence a full market study of competition in the retail and SME banking sectors to be completed on a timescale consistent with a Market Investigation Reference by the end of 2015'.[94]

All of this comes amid signs that perhaps the market is becoming more contestable. In 2010 Metro Bank became the first new high street bank for 100 years, its unique selling point being a focus on service rather than price, and in particular the offer of seven-day and evening opening to customers of its 19 Greater London stores. Marks & Spencer also began offering banking services in 2012, and the Post Office, which has in excess of 11,000 branches, is returning to the current account market. In other parts of the retail sector, too, new approaches are taking root. By mid-2013 the peer-to-peer lender Zopa had matched more than £320 million to borrowers since its launch in 2005, with £107 million of this being in the last 12 months of that period.[95] As changes in technology continue to change the

landscape of banking the scope for new players to set up and challenge the traditional banking model will only accelerate.

Ironically, there is also an argument that fierce competition for standard retail products does exist and can actually drive practices that lead to poor consumer outcomes. The argument is that vehicles such as best buy websites and newspaper league tables favour a focus on price so that for instance they reward front-end loaded saver accounts and other cut-price starter deals and more generally downplay non-price features of financial products. Indeed there is considerable evidence that the loans that were offered alongside PPI had such low margins, as providers competed for business, that the less conspicuous insurance add on was used as the profit vehicle. Any provider who tries to break out from this – by fully costing their loan offer or ending teaser rates and instead offering lower entry rates without the evaporating first-year bonus – experiences a crippling decline in new sales. This phenomenon amounts to a form of Prisoner's Dilemma: many in the industry may want to act differently, but no one institution can take the risk of doing it on its own. Only if everyone makes the change, whether voluntarily or through regulation to end poor outcomes (as happened with PPI, leading to more realistic loan rates), can the overall gain be realised.

7 The journey required: competition, capability and culture

The FCA's founding document, *The Journey to the FCA*, states, 'If we tried to address all the symptoms rather than the root causes of [market] failures, the cost would be prohibitive and… could stifle innovation and competition.'[96]

As has been argued, these root causes are many and complex, and include issues around competition in the sector, varying financial capabilities and behavioural biases among consumers and above all the culture and behaviour of businesses. Action to tackle these three core issues – competition, capability and culture – must now form a core part of a new approach to financial services regulation.

Much is happening on competition, with market studies by the Competition and Markets Authority potentially providing a line in the sand for considering further action, supported by the FCA's continuing remit on competition. Meanwhile regulators and consumer bodies can and should do more to promote transparency and comparability of financial products, no less an issue now than it was when Sir Donald Cruikshank reported in 2000 on the difficulty of comparing products in the sector.[97] This should not be about reams of terms and conditions and boxes ticked during a sales process – key information such as the interest rate applied during the product life time needs to be clearly and simply presented upfront in all communications, not tucked away out of sight.

What of consumer capability? How do we move towards the banking commissioners' aspiration of seeing 'a more financially literate population… better capable of exerting meaningful choice, stimulating competition and exerting market discipline on banks'?[98]

Financial literacy is now included in the new national curriculum for schools – covering issues from personal

budgeting to taxes, credit and debt. The Money Advice Service is working with stakeholders to develop a new Financial Capability Strategy for the UK, which it will publish in 2014, and noted in its call for evidence that the FSA's 2006 strategy exceeded its target of reaching 10 million people and 'changed the way we think about financial capability'.[99] Debate on the relative effectiveness of education and advice as opposed to actions to change motivations and behaviour is now to the fore and likely to be addressed in the new strategy. Both the FCA and the Money Advice Service have indicated that they intend to use behavioural insights in designing future interventions to support capability, including consideration of 'nudge' techniques that encourage people to overcome resistance or inertia, building on the emerging evidence of the effectiveness of such approaches.[100]

Those taking action to advance consumer capabilities will need to consider issues of inclusion, likely to require innovative approaches to reaching out to groups such as parents or carers at home, the unemployed, disabled, and mature or retired people who are not traditionally accessed through online, workplace or classroom-based provision. As part of this expanded reach there is scope for much greater use of advertising and public broadcasting using the full range of newspaper, TV and social media to make people aware of the sources of support available when making financial decisions and more generally to get across messages around the risks and consequences of entering into particular types of financial transaction, and the importance of making checks before purchasing products and seeking support in switching when they no longer offer value for money. A development that might be considered for the future as part of a package of improving capabilities is the use of decision-trees within online tools, where these can supplement generic guidance with more structured pointers to possible action.

Finally there is the issue of how to support those whose financial capabilities are more severely limited. The industry is beginning to recognise the challenges posed by disabled consumers and vulnerable elderly people, particularly those with long-term conditions such as dementia. A wider debate is needed on how to protect these sorts of highly vulnerable consumers,

how to deal more effectively with power of attorney and other third party representation, and to consider whether new support structures might be developed to bring in expertise to work alongside charities and other organisations to support them and their carers in managing their financial affairs effectively.[101]

Most important of all in the journey to a new vision for financial services regulation is to tackle the issues of culture and behaviour in the sector. In his last interview as Bank of England governor in April 2013, Sir Mervyn King called for an end to demonising individual bankers. Certainly if something is not changed the public and the regulatory scrutiny of banks is in danger of becoming a stranglehold for both sides, just as a permanently grounded teenager consumes massive resources of supervision while being given no opportunity to change and no incentive to prove they can behave differently.

The new chief executive of Barclays Bank, Antony Jenkins, has gone on record as saying, 'We must never again be in a position of rewarding people for making the bank money in a way which is unethical or inconsistent with our values' not least because, as he said, 'In doing so, we damaged our ability to make long-term sustainable returns.'[102] Barclays reports that it has changed its bonus structure for branch staff so that rewards are based on the level of service they provide for customers, rather than the value of high-profit products they can sell, and has required all of its staff to sign up to a new ethical code of conduct with performance standards that it says will be based on respect, integrity, excellence and stewardship. Other organisations have reported similar changes, with one citing a change in assessing performance in managing insurance products, which now rewards the number of claims approved and paid, as a key indicator of consumer satisfaction.[103]

There are also wider signs of change. The incoming chief executive of Swinton Insurance reported his own company to the FCA in March 2012 following a full review of business on taking over, which revealed a problem with insurance sales practices, incurring a £7.4 million fine, one of the highest of its kind, as a result. Elsewhere, research carried out by YouGov with 20 leading UK banking figures (primarily chairs and chief

executives) reported an acceptance of and appetite for change and 'doing whatever it takes to restore trust', as put into words by one senior banker, 'We don't want people to come to work... and leave their values system at the front door.'[104]

Fine words, but the public has to believe that where organisations appear to be changing their spots, they really mean it. As the banking commissioners note,

Poor standards... are not the result of absent or deficient company value statements... Nor are they the result of the inadequate deployment of the latest management jargon to promulgate concepts of shared values. They are, at least in part, a reflection of the flagrant disregard for the numerous sensible codes that already existed.

The appropriate tone and standard of behaviour at the top... is a necessary condition for sustained improvements in standards and culture. However it is far from sufficient... For lasting change, the tone in the middle and at the bottom are also important.[105]

Wider policy for the sector is responding, seeking to coax a change in culture and behaviour or alternatively apply the cosh where this seems to be called for. On the positive side of the balance sheet there have been calls for some time for there to be a professional standards body, perhaps along the lines of the General Medical Council, which would be the custodian of an independent code of conduct for all bank staff, and for all bankers to receive formal training before working in the sector including in ethical behaviour.[106] Other proposals have included the establishment of a register of bankers and the development of a new and clearer set of rules on standards in the industry. On the negative are the proposed new deterrents put forward by the PCBS: accountabilities to apply to individuals when things go wrong alongside stronger criminal and civil sanctions.[107] Recognising that remuneration has been a key driver of poor conduct – with the PCBS arguing that it 'incentivised misconduct and excessive risk-taking, reinforcing a culture where poor standards were often considered normal'[108] – the commissioners proposed a new remuneration code, at least for

bankers, to better align risks and rewards, which would allow for much more remuneration to be deferred and for much longer, with provision in some cases to cancel deferred payments.

Changes are also proposed to the context in which the sector operates. Reforms to counteract short-termism and lack of commitment to long-term goals and values have been put forward[109] and the separation of investment from retail banking may itself have an effect if the hypothesis of cross-contamination of cultures was correct.[110] Added to this there are calls from all sides for greater diversity and specifically for more women in the board room and on the trading floor – the 'What if the Lehman Brothers had been the Lehman Sisters?' argument suggesting that a different mix of drivers and behaviours might help inject a change of culture. Further checks on behaviour will still be needed at board level, however, with arguments continuing to be made for a strengthening of the input from independent non-executives and external auditors. And it has been noted that reform of incentives for staff at middle and junior levels will only be fully effective if it is matched by changes to rewards at senior level to ensure that these also align with stated commitments to consumer outcomes.

Ultimately trust will be earned once more only when financial institutions are seen to change the way they treat consumers and demonstrate guardianship of their reputations and when scandals become a thing of the past.

8 Policy recommendations

Our main recommendations are made against a background of widespread misbehaviour by financial institutions, some of which have forfeited public trust as a result of their shoddy treatment of customers over many years. During the writing of the report, the spotlight turned on the UK's energy companies, which overtook banks as champions of public disaffection – clearly regulatory and competitive regimes are coming under growing scrutiny.

We might observe that, to some extent, banks and other financial institutions have the regulatory regime they deserve. That is not to argue that it is fit for purpose, however. Many banks have embarked on major efforts to change their cultures and place much greater emphasis on being fairer to their customers. As these efforts mature it is important that the regulatory machine also evolves.

We believe that adherence to a single principle would go a long way to securing an evolution that will lead to regulation of retail finance that is fair, efficient and proportionate. Put simply, where regulation is shaped from the outset by the outcomes that consumers are experiencing then it is likely to have many of the right characteristics, including the correct proportion of attention on each product or service.

If instead, and as they often do today, regulators continue to focus in minute detail on each process and input – requiring endless detail on who made what decision in what meeting and how many and which boxes were ticked at every stage of every process – they are likely to impose an unnecessarily costly burden on the industry and thereby actually harm consumers. As we have seen too often, they are likely to be reactive, only spotting problems after the event.

Moreover, this approach inevitably takes institutions as its focus and not the wider market – a 'vertical' view that often means siloed teams of regulators are unable collectively to see the wood for the trees. An outcomes-based approach would adopt a wider, more 'horizontal' view, looking across the industry at products and services and assessing where the greatest risk of problems or poor outcomes lies for consumers.

The simplest way to explain this principle is to compare the risks attached to purchasing a lifetime product such as a pension, with those for taking out a cash ISA. The outcome of the former is certain to have a much greater significance on the consumer's financial health over the long term. This suggests there is a need for a significant regulatory focus, identifying who is particularly vulnerable and what protections are needed, and then, crucially, ensuring that the industry is delivering what has been agreed by looking at what consumers actually experience – the outcomes, not the input.

By contrast, a cash ISA is a simple product. It tends to be purchased rather than sold, and there is relatively little risk for the consumer, particularly while interest rates are negligible. An outcomes-based approach that confirmed these features would allow this product to be sold quickly, without fuss and without inconveniencing the purchaser. By the same token, the seller could dispense with lengthy compliance requirements, beyond those needed to protect against financial crime and meet basic customer data needs, shedding unnecessary costs.

This report makes several recommendations, which flow from this central observation, including the importance of matching an outcomes-focused approach with strong sanctions where institutions do not play fair. It also recognises the significant barriers that remain to winning over hearts and minds to a new regulatory approach, given the public's view of the sector, and the very considerable challenges that will continue to beset those who are vulnerable or disadvantaged in today's increasingly complex financial world.

Policy recommendations

1. Retail finance regulation should firmly endorse an *outcomes-based approach*, which puts acting in consumers' best interests at the heart of business conduct and, by extension, regulation of that conduct. All parties should agree in detail on what this means in principle and in practice, and take appropriate action to deliver on this commitment.

2. The *intense micro-management* that is peculiar to regulation in the financial sector *should be challenged* and resource pared back accordingly. Vertical regulation – focused on supervising and monitoring businesses – should give way to horizontal regulation – focused on markets and consumer outcomes. The Financial Conduct Authority (FCA) should relinquish its historic attachment to resource-intensive monitoring and supervision of inputs and processes in order to make a reality of an outcomes-focused approach, where what matters is what consumers actually get out of buying financial products or services.

3. The quid pro quo for focusing on outcomes rather than inputs is that *sanctions for misconduct should be swift and uncompromising*. The FCA's increased activity on deterrence, enforcement and fines will be further strengthened by recent legislation, providing for a new licensing regime and greater use of criminal and civil sanctions against individuals. This should be followed by a clear commitment to supporting all agencies in delivering an effective enforcement regime for firms that transgress.

4. The *provision of generic financial advice and education needs to be further developed and strengthened in order to support improved consumer financial capability* with particular consideration given to how best to access hard to reach groups and those who are vulnerable to getting into debt. There should be a much greater emphasis on using advertising and public broadcasting to promote messages to consumers about the risks and potential consequences of entering into certain types of transaction. Alongside this, further consideration should be given to how

best to 'nudge' consumers into beneficial financial behaviours, such as saving for future needs. There may be scope for policy to go even further, building for instance on the experience of pension auto-enrolment, to consider whether default 'opt-in' options might work in other areas, such as house insurance, where under-consumption exposes people to real risk of harm.

5 Regulators and consumer organisations should work together to produce *tools that support improved consumer outcomes*. There should be a drive to produce aggregation or best buy tables that incorporate quality measures as well as price parameters. Independent league tables should be produced based on survey and statistical data showing which institutions and products offer best customer service, satisfaction and outcomes. The industry should sign up to clear standards on transparency and product clarity that do not rely on reams of pages of terms and conditions, meeting the banking commissioners' stipulation that information provided to consumers should be 'crystal clear' to enable effective comparison and choice.

6 The industry should continue to work with stakeholders to develop policies to *support the needs of the increasing number of highly vulnerable consumers*, particularly among the elderly. Initiatives such as the recently launched Dementia Friendly Financial Services Charter should be built on and wider consideration given to the needs of other groups with disabilities or other profound challenges. This should include consideration of how to support the industry in interacting sensitively and appropriately with carers, and develop better systems for managing power of attorney and other third party representation. Government, charities, consumer organisations and financial institutions should join together to design new initiatives to support vulnerable people and their carers, consider the possibility of tapping into expertise from retired financial practitioners willing to volunteer their services, and establish structures to facilitate this.

7 There should be much sharper *segmentation and differentiation of markets* for the purpose of regulation. Regulatory resources should focus more clearly on groups of consumers who experience the greatest risk of significant harm, prioritising the types of products where this harm is most likely to occur, those that are long-term, complex and not easily reversed. This should lead to a clearer view being developed of proportionality in regulation with less resource put into areas where consumers have perfectly good capabilities, or potential detriment is relatively small because of the nature of the product.

8 Leaders within financial services should work with stakeholders to make progress in rebuilding public trust and take the lead in demonstrating how they plan to deliver *high standards of professionalism and integrity* within the sector and what form of external moderation would best support this. The welcome sign that performance incentives are moving away from sales targets towards measures of consumer satisfaction and outcomes needs to be bolstered by a similar alignment of incentives and remuneration at board level if the change at lower levels is to be at all meaningful, with organisations reforming their systems for training, appraisal and promotion accordingly.

9 Finally, further work should be carried out to consider how to *move corporations away from the short-termism that pits shareholder interest against consumer interest*, including engendering greater commitment to long-term values and giving more control to those with a long-term stake. This should be combined with measures to better empower non-executive directors and consider how to introduce greater diversity and challenge at board level.

Notes

1 The Financial Services Act 2012 has been passed. The Financial Services (Banking Reform) Bill was published on 4 Feb 2013 and received royal assent in December 2013, as this report was being finalised. Much of this legislation proceeds by amending the Financial Services and Markets Act 2000.

2 Speech by Chancellor of the Exchequer at JP Morgan in Bournemouth, 4 Feb 2013.

3 Which? Consumer Insight, 'Which industry sectors/ organisations do people most trust and distrust?', Nov 2013, http://consumerinsight.which.co.uk/tracker?utf8=%E2%9C%93&d[age_band][]=&d[income_band][]=&d[region][]=&d[data_month]=1311&d[from_month]=&d[sort_by]=default&d[open_in]=trust&d[v]=52 (accessed 10 Jan 2014).

4 S Shakespeare et al, 'Public trust in banking', paper presented at Spring Symposium of YouGov, Cambridge, Apr 2013.

5 House of Lords and House of Commons, *Changing Banking for Good*, report of the Parliamentary Commission on Banking Standards, HL 27-1, HC 175-1, Jun 2013.

6 Before the FSA a panoply of regulatory bodies had overseen the sector, most of them established in the late 1980s in the wake of the Big Bang. For a history of regulatory provision and development in the sector before this see Peter Andrews, 'Financial regulation: protecting consumers from poor value?', *Oxera*, Aug 2012.

7 FCA, *Business Plan 2013/14*, Financial Conduct Authority, 2013, Appendix 1, www.fsa.gov.uk/static/pubs/plan/bp2013-14.pdf (accessed 13 Dec 2013).

8 Speech by Mervyn King to Scottish business organisations, Edinburgh, 20 Oct 2009.

9 ICB, *Final Report: Recommendations*, Independent Commission on Banking, Sep 2011, www.ecgi.org/documents/icb_final_report_12sep2011.pdf (accessed 15 Dec 2013).

10 Developments in European regulatory requirements may in practice have an impact on how this change is implemented in the UK.

11 M Wheatley, 'Launch of the Journey to the FCA', speech, 16 Oct 2012, www.fsa.gov.uk/library/communication/speeches/2012/1016-mw.shtml (accessed 15 Dec 2013). See also FSA, *Journey to the FCA*, Financial Services Authority, Oct 2012, www.fca.org.uk/your-fca/documents/fsa-journey-to-the-fca (accessed 13 Dec 2013).

12 FCA, *The FCA's Approach to Achieving Its Objectives*, Financial Conduct Authority, 2013, www.fca.org.uk/static/documents/fca-approach-advancing-objectives.pdf (accessed 13 Dec 2013).

13 M Wheatley, 'My vision for the FCA', speech to British Bankers' Association, 25 Jan 2012, www.fsa.gov.uk/library/communication/speeches/2012/0125-mw.shtml (accessed 13 Dec 2013).

14 Conduct expectations in relation to consumers were set out in FSA, *Treating Customers Fairly: Towards fair outcomes for consumers*, Financial Services Authority, 2006, www.fca.org.uk/static/fca/documents/fsa-tcf-towards.pdf (accessed 15 Dec 2013), Firms must also comply with 11 principles for businesses, covering issues ranging from integrity to management and control, financial prudence and customers' interests, breach of any of which makes a firm liable to disciplinary sanctions. Following

the publication of *Treating Customers Fairly* the regulator began to make it clear that it would be willing to take action against companies for breaches of these principles, even if there was no technical breach of the rulebook. The FCA has confirmed that protecting these six consumer outcomes remains central to their regulatory approach.

15 M Bishop, J Kay and C Mayer (eds), *The Regulatory Challenge*, Oxford University Press, 1995.

16 Indeed, Lord Turner, former chairman of the FSA, is quoted in a House of Commons report as saying that 'it is true that while complaining about the quality [of staff], they [regulated firms] also sometimes nick them'. See House of Commons Treasury Committee, *Financial Conduct Authority*, Minutes of evidence, HC 1574, 'How the FCA should approach its work', 13 Jan 2012, para 127, www.publications.parliament.uk/pa/cm201012/cmselect/ cmtreasy/1574/157407.htm (accessed 13 Dec 2013).

17 For instance the FSA board report *The Failure of the Royal Bank of Scotland* argues that one of the contributory factors in the collapse was 'a light-touch approach to regulation which arose from a sustained political emphasis on the need for the FSA to be "light touch" in its approach and mindful of London's competitive position'. See FSA, *The Failure of the Royal Bank of Scotland*, Financial Services Authority, Dec 2011, www.fsa.gov.uk/ pubs/other/rbs.pdf (accessed 13 Dec 2013).

18 House of Commons Treasury Committee, *Financial Conduct Authority*, Minutes of Evidence, 13 Jan 2012, www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1574/157403.htm (accessed 13 Dec 2013).

19 J Black, 'Decentring regulation: understanding the role of regulation and self-regulation in a "post-regulatory" world', *Current Legal Problems* 54, 2001, pp 103–47.

20 S Saggar, 'Regulation and Fairness: An emerging opportunity', Policy Network Discussion Paper, 2012.

21 BIS, *Principles for Economic Regulation*, Department for Business, Innovation and Skills, 2011.

22 Ibid.

23 House of Commons Treasury Committee, *Competition and Choice in Retail Banking*, HC 612-1, 2 Apr 2011.

24 The Salz review of Barclays Bank noted that in 2009 a sales person would earn two and a half times more commission for selling a loan with PPI than for selling a loan without PPI and that Barclays used the penetration rate of PPI sales as a key performance indicator. Staggeringly, PPI comprised between 32 per cent and 42 per cent of Barclays' UK retail and business bank pre-tax profit between 2001 and 2005, when almost 70 per cent of borrowers taking some loan products also bought a policy. See A Salz, *Salz Review: An Independent Review of Barclays' Business Practices*, Apr 2013, https://www.salzreview.co.uk/c/document_library/get_file?uuid=557994c9-9c7f-4037-887b-8b5623bed25e&groupId=4705611 (accessed 13 Dec 2013).

25 FCA, *FCA Risk Outlook 2013*, Financial Conduct Authority, 2013, www.fsa.gov.uk/static/pubs/other/fcarco.pdf (accessed 13 Dec 2013).

26 LCB Gower, *Review of Investor Protection: Report Part 1*, Cmnd 9125, Stationery Office, 1984.

27 For further detail see D Weinbren, 'Mutual aid and the big society' in A Ishkanian and S Szreter (eds), *The Big Society Debate: A new agenda for social welfare?*, Edward Elgar, 2012.

28 House of Commons Treasury Committee, *Competition and Choice in Retail Banking*.

29 CSJ Working Group, *Maxed Out: Serious personal debt in Britain*, Centre for Social Justice, Nov 2013, www.centreforsocialjustice.org.uk/UserStorage/pdf/Pdf%20reports/CSJ_Serious_Debt_report_WEB_final.pdf (accessed 13 Dec 2013).

30 See for instance, M Sandel, *What Money Can't Buy: The moral limits of markets*, Allen Lane, 2012.

31 The Office of Fair Trading has conducted a review of payday lending to examine these issues, taking action against a number of players in the consumer credit market, and referring the sector to the Competition Commission in June 2013.

32 The Post Office Card Account operates under a contract between the Department for Work and Pensions (DWP) and the Post Office, which is set to expire in April 2015. Discussions are taking place over how a future payment mechanism for benefit recipients might operate.

33 This new combined payment for people who are either out of work or in work on a low income will combine means-tested benefits such as tax credits, income support, Jobseeker's Allowance, Employment and Support Allowance and Housing Benefit. Claims will need to be made online and will generate one payment per family, so potentially covering more than one person's entitlements.

34 Citizens Advice, '9 our of 10 Citizens Advice clients are not ready for Universal Credit', nd, www.citizensadvice.org.uk/index/ policy/policy_publications/er_benefitsandtaxcredits/universal_credit_managing_migration.htm (accessed 13 Dec 2013).

35 M Dibben, 'My aunt was sold a risky investment – at the age of ninety-four', *Observer*, 8 Jun 2008, www.theguardian.com/money/2008/jun/08/consumeraffairs.moneyinvestments (accessed 13 Dec 2013).

36 FSA, *Financial Capability in the UK: Delivering change*, Financial Services Authority, 2006, www.fsa.gov.uk/pubs/other/fincap_delivering.pdf (accessed 15 Dec 2013).

37 Money Advice Service, *The Financial Capability of the UK*, 2013, https://www.moneyadviceservice.org.uk/en/static/the-financial-capability-of-the-uk (accessed 13 Dec 2013).

38 FCA, *Applying Behavioural Economics at the Financial Conduct Authority*, Financial Conduct Authority, Apr2013, www.fca.org.uk/your-fca/documents/occasional-papers/occasional-paper-1 (accessed 13 Dec 2013).

39 Money Advice Service, *The Financial Capability of the UK*.

40 Wheatley, 'My vision for the FCA'.

41 House of Lords and House of Commons, *Changing Banking for Good*.

42 FCA, *Business Plan 2013/14*, Financial Conduct Authority, 2013.

43 FSA, *Treating Customers Fairly*.

44 The PCBS report proposes going a step further to give the FCA a new power to use a 'special measures' tool to identify and tackle serious failings in standards and cultures. See House of Lords and House of Commons, *Changing Banking for Good*.

45 FSA, *Journey to the FCA*.

46 For instance the FCA is to review the practice of offering better interest rates on savings products to new customers for time-limited periods – so-called 'teaser' rates – leaving long-term customers on lower rates. The FCA considers the practice of subsidising new business from an existing low cost book a potential competition risk as it benefits incumbents at the expense of new entrants.

47 Bishop et al, *The Regulatory Challenge*.

48 FCA, *FCA Risk Outlook 2013*.

49 See for instance, Oxera, *A Framework for Assessing the Benefits of Financial Regulation: Report prepared for the Financial Services Authority*, 2006, www.oxera.com/Oxera/media/Oxera/Framework-for-assessing-benefits-of-financial-regulation.pdf?ext=.pdf (accessed 13 Dec 2013). A more recent piece of work by PricewaterhouseCoopers involves modelling of the potential economic costs of regulation, particularly where it inhibits innovation or affects business confidence, looking at a range of scenarios and assumptions about regulatory impact and how that might feed through into jobs and growth: PwC, *Where Next? Assessing the current and future contribution of the UK financial services sector*, PricewaterhouseCoopers, 2013, www.pwc.co.uk/financial-services/publications/where-next-assessing-the-current-and-future-contribution-of-the-uk-financial-services-sector.jhtml (accessed 13 Dec 2013).

50 The National Audit Office will publish a review of the FCA and PRA in early 2014, with two key objectives: to provide an early assessment of whether the new regulatory framework is likely to be delivered in a targeted, proportionate, consistent and transparent way, and whether the bodies are effectively working together; and to consider the impact of the changes through calculating the additional costs of the regulators and, where possible, through estimates of the additional costs and benefits to regulated firms and consumers. Although this may provide some further insights on proportionality it is likely to fall short of a full cost-benefit analysis.

51 The Treasury is also expected to take new powers to direct the PRA and FCA to levy the industry for the costs of engaging with international bodies such as the Financial Services Board on regulatory issues.

52 Deloitte, *The Cost of Regulation Study: Commissioned by the Financial Services Authority and the Financial Services Practitioner Panel*, 2006, www.fsa.gov.uk/pubs/other/deloitte_cost_of_regulation_ report.pdf (accessed 13 Dec 2013).

53 FSA, *Treating Customers Fairly*.

54 If generalised to the whole sector this would imply that with direct annual costs of regulation of roughly £500 million, the indirect costs might be in the order of £1.5 billion, and total costs £2 billion, although in practice much more detailed work would be needed to update a 2006 sample estimate to a fully robust figure applying to the whole sector in 2013. The report also cautions against such generalisations, given the methodological challenges faced in collecting and interpreting the data.

55 House of Commons Treasury Committee, *Financial Conduct Authority*, Minutes of evidence, 'How the FCA should approach its work', HC 1574, 13 Jan 2012, para 120, www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1574/157407.htm (accessed 13 Dec 2013).

56 FCA, *FCA Risk Outlook 2013*. An impact assessment by the Treasury of the cost of the change to dual regulation for those affected (around 2,500 large firms in banking, investment and insurance) estimated overall costs of £25–50 million per annum, with an additional £5–100 million in transitional costs as firms had to change IT systems and potentially internal process to cope with the changed requirement. It adds, though, that these are very much indicative figures: 'the small number of responses received and the fact that firms can be expected to adapt over time to the new regulatory arrangements mean that additional ongoing compliance costs cannot be precisely estimated'. See HM Treasury, *A New Approach to Financial Regulation: Securing stability, protecting consumers*, Cm 8268, 2012, Annex D.

57 Huntswood, *Banking On Change: The changing face of regulation: FSA to FCA*, 2012, www.huntswood.com/documents/banking-on-change-report.pdf (accessed 13 Dec 2013). Huntswood collected the data from 143 senior industry stakeholders in financial services between April and May 2012 via an online survey.

58 FCA, *FCA Risk Outlook 2013*.

59 Ibid.

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68 Citizens Advice is registering increasing problems in relation to credit – including a tenfold increase in the four years to 2013 in the proportion of clients receiving advice on debt that included a payday loan, reflecting the sharp rise in payday lending since the financial crisis.

69 Recent research by the Centre for Social Justice notes that an estimated 6.6 million people were charged more than £100 in overdraft and penalty fees in 2011 and that credit card debt trebled between 1998 and 2012 to reach £55.6 billion. See CSJ Working Group, *Maxed Out*.

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73 Clive Maxwell, OFT chief executive, speech to the RPI Annual Competition and Regulation Conference, 10 Sep 2012.

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75 House of Lords and House of Commons, *Changing Banking for Good*.

76 'Remarks by Andrew Haldane on accepting the International Financial Law Review's Regulatory Contribution Award', *The Economic Voice*, 25 Jun 2013.

77 Although Haldane was in practice particularly focused on prudential regulation his argument for simplicity and targeted judgement is no less pertinent when it comes to conduct regulation.

78 House of Lords and House of Commons, *Changing Banking for Good*.

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83 The FCA has responded to concerns on data collection by publishing a data collection strategy in September 2013 with proposals to minimise duplicate requests for data and to ensure that all data collected is available across the organisation, as well as establishing strong controls before new data requests are authorised. That said, the burden of ongoing regulatory returns and ad hoc data requests for specific purposes such as market reviews remains considerable and is not necessarily affected by an initiative largely focused on ensuring that the burden does not increase.

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103 The FCA is collecting evidence on the extent to which these new approaches are embedded, with a view to reporting on how far the industry has reformed sales incentives and performance assessment processes to align with the stated commitment to fairness and good consumer outcomes.

104 Shakespeare et al, 'Public trust in banking'.

105 House of Lords and House of Commons, *Changing Banking for Good*.

106 A Which? Banking Commission report in 2010 presented arguments for such a body, and in 2011 the UK's eight biggest banks set up the Professional Standards Board of the Chartered Banker Institute to be overseen by senior bankers. In September 2013, ex-CBI director general Sir Richard Lambert was charged by the largest banks with setting up a new body – with more broad-based governance – to ensure bank staff follow high professional standards, develop codes of conduct, assess training programmes and report each year to the boards of banks on whether ethical behaviour is embedded in their culture and practices.

107 Following the publication of the PCBS report in June 2013, a survey by Populus on behalf of Which? found that more than half of respondents thought that the Commission's recommendations would lead to positive improvements in banks, but the vast majority (84 per cent) also thought that a professional standards body, if established, would need to be independent of the sector. This may be linked to the fact that only 19 per cent thought that banks on their own would be effective in delivering a change in banking culture sufficient to prevent future scandals.

108 House of Lords and House of Commons, *Changing Banking for Good*.

109 House of Commons Business, Innovation and Skills Committee, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, HC 603, www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/603/603.pdf (accessed 13 Dec 2013); Mayer, *Firm Commitment*.

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Retail finance touches most of the UK population, many of whom have daily contact with it through bank transactions, direct debits and investments. Some of these interactions can have life-changing consequences. But for all its importance, retail finance and, crucially, its regulation, are poorly understood. Whether or not we have a regulatory regime that offers consumers an appropriate degree of protection (including from themselves) for an acceptable set of costs and trade-offs is wide open for debate.

Significant legislative and regulatory change is now underway, with several vital agencies, including the Financial Conduct Authority, in the process of finding their feet or simply being established. This report aims to explain their emerging responsibilities and mandates, and explore how to maintain an effective balance between protecting consumers and monitoring and disciplining providers of financial services.

Putting Customers First argues that adherence to a single principle – regulation shaped by consumer outcomes – would go a long way to securing regulation that is fair, efficient and proportionate. If instead regulators continue to focus in minute detail on each process and input, they are likely to impose an unnecessary burden on the industry and thereby actually harm consumers. The report concludes that it is of national importance that the emerging regime pays attention where it is genuinely needed rather than micro-managing every aspect of an industry that plays a key role in the economy.

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