Check against delivery

Why public scrutiny and accountability matter to financial services

Centre for Public Scrutiny – 19 March 2013

Adam Phillips – Chair, Financial Services Consumer Panel

Introduction

We all need financial services for everyday life.

Imagine how difficult it would be to function without a bank account to receive income and pay bills. Always having to pay with cash, rather than a card, when shopping.

- **Keeping your savings in cash has never been a safe or convenient option**, not forgetting the economic implications for society if savings were not available to be reinvested through the financial system.
- In virtually every aspect of the modern world **financial services have become an essential service for everyone**.
- People need to save to protect themselves against unforeseen events and to provide a pension for later life. **They need insurance to protect their families and possessions should the worst happen**.
- Nowadays everyone needs access to a range of essential financial services. **Access is not just about being able to find a convenient way to purchase and use essential financial services, but also about the cost of provision and affordability** - you cannot legally drive a vehicle on a public road if you cannot afford the insurance premiums. This is a challenge for young drivers, particularly in those living in rural areas and can severely restrict employment opportunities.

The problem with financial services is that unlike buying a car or a employing builder, it isn't obvious after a short time that the product or service is not suitable for your needs or that it is unreliable and not fit for purpose. You might wait for years, or even decades, before you realise that you have bought the wrong product or been mis-sold.

The public's confidence in financial services, the people who sell them, financial advisers and the products themselves is therefore even more crucial if people are going to place their trust in the companies that provide financial services. **Without such trust, many people will take the view that engaging with the industry is an expensive and risky business**. They will avoid it, either by not purchasing products like insurance or by using their house or cash deposits for long term saving rather than diversifying into a wider range of savings vehicles that are likely to produce a safer and better return in the long term

This brings us to the current challenge facing the financial services industry and its regulators.

- Just when people need to access financial services more than ever before, **the industry is beset by problems arising out of industry bad practice and regulatory failure**
- Consequently, **the public is less trusting of financial services products and providers. This is hardly surprising** with scandals like Libor manipulation, the miss-selling of payment protection insurance (PPI) or interest rate swaps
- **Huge bonuses for senior executives are seldom out of the headlines**. The dilemma facing regulators and government is that restoring the industry to health is essential for economic recovery. However, if consumer confidence is to return, the problems of the past must not be allowed to recur.

<u>Governance, scrutiny and accountability</u>

Public scrutiny and accountability matter because **the key to restoring public trust in the industry will be strengthening firms' governance, improving regulatory scrutiny and making firms and staff more accountable for their actions**. The history of the last 30 years has demonstrated that the industry is not capable of achieving this without strong and effective public oversight.

In financial services the bad can drive out the good unless there is effective regulation.

- PPI provides a particularly good example, but there are other examples of this behaviour.
- Recently we have seen a similar pattern with the provision of interest rate swaps to small businesses
- longer ago the mis-selling of endowment linked mortgages

In the case of PPI, **even more responsible providers appear to have felt compelled to sell complex PPI products with exclusions and limits that meant few people would be able to make a claim**, while employing sales targets for staff that were likely to encourage mis-selling. This is because the large profits PPI delivered would otherwise have allowed their competitors to put them at a disadvantage.

- It has been suggested by the FT that at the peak of the market **in the mid-2000s more than half bank's profits were derived from PPI alone**. In such circumstances, strong competition coupled with weak regulation creates conditions which allow a race to the bottom to occur where there is weak ethical leadership.
- If those retailing PPI had been **more concerned about the suitability for customers of the products they sold, the brakes would have been applied sooner**.
- **In the future there is a need not just for tougher regulation**, as advocated by Martin Wheatley the Chief Executive-Designate of the new Financial Conduct Authority (FCA). T**here is also a need to be stronger ethical standards for individuals,**

enforced by an effective code of conduct accountable to a professional body backed by statutory powers

Another unique characteristic of the financial services industry is that the need to maintain confidence leads to a lack of transparency and effective stakeholder oversight

- **For good reasons shareholders and the public cannot know how risky individual banks or insurance firms are**.
- This makes the task of those charged with the **supervision of financial institutions even more important than normal financial auditors**.
- **Regulatory capture is always a major risk in situations where there is little openness and potentially weak internal governance**

The complexity of financial products and services means that most consumers, even informed ones, do not understand how these products services will behave in changing circumstances

- **Product design is largely unregulated**, so the normal controls which operate in other retail markets do not moderate behaviour
- **Instead regulators have relied on regulating advice** as a way of providing consumer protection
- Even without the recent development of the online market, which has led to a rapid growth in unadvised sales, **it had become clear that this approach was unsuited and too expensive for the mass market**
- **PPI is a clear case where the reliance on regulating advice, rather than regulating product design using, for example, a British Standard or ISO approach**, has led to a huge amount of mis-selling
- Since **detriment in financial products can take a long time to emerge**, **the usual checks that consumer groups and oversight bodies apply in other sectors operate far too late**, long after hundreds of millions, if not billions, of pounds have been mis-sold, too late for thousands of consumers who have suffered losses from risks they were not aware that they were running

<u>Role of consumer organisations and the Consumer Panel in providing accountability</u>

Consumer groups, the Treasury Committee, consumer advocates and academics provide an additional source of scrutiny, helping the regulator and pointing out industry malpractice. **However, most of these groups lack the policy resources needed** to tackle all but the most serious cases and **the majority of consumer groups represent particular groups within the population** and therefore have quite a narrow area of focus.

- **The Consumer Panel was established in 1998** to advise the FSA's predecessor the Personal Investment Authority (PIA)

- It was given a statutory footing under the Financial Services and Markets Act 2000 (FSMA) alongside a practitioner Panel
- **The Consumer Panel exists to advise and challenge the FSA.** The Panel's terms of reference have allowed it to look wider than the limits imposed on the FSA by the original FSMA, but most attention has been given to the areas which the FSA has regulated. This has meant that, although it has engaged with the regulation of banking conduct, it has not given much attention to credit until recently, since this is regulated by the OFT. Credit regulation will only transfer to the FCA in 2014
- **Given the huge breadth of financial regulation, the Panel works closely with other consumer groups to channel advice and concerns in to the FSA** particularly with regard to emerging consumer risks.

The Panel represents a very British approach to stakeholder engagement. It benefits from a clear insight into the regulator's activity and its privileged access makes it possible to influence policy making at the development stage. **The resources provided for it by the FSA enable it to be sufficiently well-informed to provide effective evidence-based arguments to help counterbalance the lobbying power and market knowledge of the industry**. The Panel also responds to relevant questions and consultations by Parliament, HM Treasury and BIS. This does, however, mean that much of the Panel's work happens behind the scenes without publicity. **The FSA's Practitioner Panels operate in a similar way and the FCA's panels will continue to do so when the FCA replaces the FSA.**

The UK approach to providing stakeholder input can be contrasted with the European Supervisory Authorities (ESAs). The European Securities and Markets Authority (ESMA), European Insurance and Occupational Pensions Authority (EIOPA) and the European Banking Authority (EBA)

- **all have stakeholder groups** that exist to provide feedback and advice from consumer, industry and academic views
- **The ESA's also have various consultative and expert groups** to advise them on specific issues. Several Consumer Panel members are involved with these groups
- **The structure of these groups is that all sectors sit in the same meeting**, as opposed to the UK approach where industry and consumer panels meet separately and have their own resources
- **We believe the UK approach is more effective in addressing the resource imbalance between industry and consumers** and, if well managed, provides more helpful advice to the regulator and a better opportunity for reaching constructive consensus.

In the United States the Dodd Frank Act established the Consumer Protection Bureau. This has consumer protection at the heart of its remit, just as the new Financial Conduct Authority is charged with making markets work well so that consumers get a fair deal

- **The US regulator is responsible for financial education, enforcement and research into financial services**
- **Like the FCA, it has a Consumer Advisory Board** with a remit to advise and consult the Bureau and provide information on emerging practices
- **The UK and US approach has the advantage that the consumer perspective is better resourced and can be more effectively represented in the rule making process than in the EU equivalents**.

The key objective of all these stakeholder groups is to try to ensure that the regulation is proportionate and provides regulation that delivers products and services which are good value, meet customers' needs and are sufficiently profitable to be sustainable in the long term.

Examples of how the Consumer Panel works are difficult to extract given its role in questioning and providing advice, rather than administering policy. However, there is one recent example worth mentioning to illustrate how the Panels work with the regulator

- **The Panel has promoted the elimination of the conflict of interest caused by commission since the early 2000's.** Following the launch of the FSA's Retail Distribution Review in 2006, the Panel actively engaged with the development of policy, including commissioning independent research to help shape the structure of the regulation. The FSA's reforms have raised professional standards and tackle the potential biases created by provider commission payments to advisers
- **The Panel's work included evidence based advice on the risk created by platforms to the RDR reforms** delivering value to the consumer
- **The Consumer Panel was the only consumer body to respond to the FSA's consultations on this topic** in a market which has the potential to grow to more than £1,000Bn of retail customers' assets under management.
- **The platforms lobby is powerful, but the arguments for ensuring the principles of the RDR were applied to platforms were strong.** The result as likely to be a profitable market for platforms and, with continuing attention from the regulator, one which will deliver better value to the customer than would have been the case if action had not been taken.

Concerns for the future

The global character of large financial firms and the relative weakness of most governments mean that it will be difficult to guarantee a responsible culture and ethical behaviour without international consensus

The new Consumer Protection Bureau in the US, coupled with the ESAs in the EU, is slowly leading to a more international approach to regulation, although there are likely to remain huge opportunities for regulatory arbitrage between jurisdictions and a continuing risk of over-regulation, because of an uncooperative approach by the industry.

The rather complex structure of the FPC, PRA and FCA, coupled with the role of the Payments Council in managing transactions, is an improvement on its predecessor, by providing independent organisations with more straightforward objectives, **but does little to encourage cooperation to achieve less onerous regulation or to introduce much more effective public scrutiny or accountability than before**

New structures create novel problems. The changes made in Britain and around the world should mean that some of the worst mistakes of the past will not be repeated. However, **it is not clear that the new structure that has been created will be more effective overall than the old one, unless steps are taken to ensure that there is a permanent change of culture in the management** of financial firms. In this respect **a professional and ethical code of conduct for Authorised Persons enforced by statute provides the best long term guarantee** that individuals will behave responsibly and can be held accountable for their actions.