UK FINANCIAL SERVICES

POLICY AND RISK OUTLOOK

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INTRODUCTION

The resilience, efficiency and conduct of the UK financial services industry is critical to the economic well-being of UK households, the 'real economy', current and future generations.

Retail financial services is one of the big six[1] consumer sectors that have historically been the focus of consumer group, civil society and media scrutiny. This is understandable given the widespread market failure seen over the years. A litany of financial misselling scandals (now costing £50bn according to the latest tally) has left a legacy of mistrust and low levels of confidence in the industry. Consumers have been exploited by unfair products and practices. Serious concerns remain about the dominant culture in the financial services industry. All this is bad enough in its own right but a wider cause for concern given how much consumers are expected to rely on retail financial services in the future.

Sitting behind retail financial services are the huge wholesale and institutional financial markets and financial infrastructures. Our analysis suggests that market failure in these sectors have a greater impact on the economic welfare of households and the real economy than retail financial services. The root cause of much of the welfare loss and detriment borne by ordinary households and SMEs can be traced to wholesale or institutional market failures transmitted through the supply chain. There is a direct, but not well-understood, link between market failure on the supply side and financial exclusion and underprovision.

Behaviour and activities in financial markets continue to create systemic risks and threaten economic resilience. Financial market activities can generate asset price bubbles such as in the property market which exacerbate intergenerational inequality. Over the longer term, greater financialisation in an economy contributes to economic inequality. Despite their importance, wholesale and institutional financial markets receive comparatively little scrutiny from civil society.

The financial services industry is of national economic interest. Market failure doesn't just harm consumers, it can harm the interests of firms – for example, if high charges on investment funds extract value from consumers' savings *and* reduce the amount of investment capital that reaches firms. Market short-termism affects the ability of firms to invest for the long term.

Financial services isn't just a pure *consumer* issue. Financial services already play a significant role in meeting *public policy* needs such as housing, retirement incomes, long term care, and social security replacement. This role is expected to increase over the years as policymakers attempt to transfer risk and responsibility for meeting these needs to citizens.

Households are expected to use financial products and services to build financial resilience and long term financial security. But, much of the industry has not adapted to the new economic and financial reality forged by low returns, technological change, more realistic regulation, changing labour markets, and squeezed household finances. The industry is becoming less relevant for growing numbers of economically vulnerable households.

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[1] Along with food and retail, pharmaceuticals, utilities, telecoms, and transport.- Other sectors such as retail consumer goods, electronics and increasingly internet service provision are also important. But the Big Six tend to attract more attention with specific regulators and dedicated consumer protection regimes reflecting the historical view that consumer sovereignty is weaker in these sectors.

Identifying major risks and policy issues

That is the state of play now. Financial markets and services are not working well for society. There is much to be done to remedy existing failures. But, more challenges lie ahead. The environment in which financial services operates is being reshaped by a range of powerful external forces creating a range of risks and challenges for the industry *and* its customers.

It is important that consumer groups, civil society, policymakers, regulators and, of course, the industry itself understand the current and emerging risks and policy issues. This policy and risk outlook is intended to contribute to that debate. To identify the major risks and policy issues we used a two stage process:

- We analysed the forces shaping the environment for the financial services industry ie. socio-economic, demographic, technological, commercial, and political factors; and
- Applied four tests to assess how well financial services will respond to these challenges and identify which sectors and activities create the greatest risks for consumers and the real economy.

In total, we identified nearly 30 major risks and issues. To provide some structure, we have grouped these issues and risks into the following areas:

- Retail financial services including financial inclusion.
- Wholesale/ institutional markets, and financial infrastructures.
- Major areas of public policy in which financial services has a role.
- How regulatory and public policy is developed.

Note that some of the risks and policy issues are 'vertical' and cover specific product sectors such as banking, consumer credit, and pensions. Others are more 'thematic' and cover issues which are common to a number of product sectors such as the need for new business models, the treatment of captive consumers, dealing with legacy business models, consumer confidence and trust, conduct and culture in financial services, and so on.

The other main category of risk covers behaviours and activities in the financial markets which have a wider impact on the real economy and society – for example, economic inequality, the economic and social utility of the financial system, and the role financial services play in meeting public policy needs.

Structure of the report

Section 1 describes the new environment for financial services with a focus on five of the major external forces forging this environment – the new economic reality; transition risks; big data and fintech; consumer confidence, conduct and culture in the industry; and attitudes towards the role of the state.

Section 2 outlines the four tests we used to identify the major risks and policy issues in financial services.

Section 3 describes in more detail those risks and policy issues grouped according to: retail financial services including financial inclusion; wholesale/ institutional markets, and financial infrastructures; public policy; and the development of regulatory and public policy.

A word about Brexit

This paper was prepared before the announcement that the UK had voted to leave the EU. Brexit will, of course, have a major impact on the UK financial services industry and consumers. But, it will take some time before we can establish with any degree of certainty what that impact will be.

All the risks identified in this paper will still be there and need to be dealt with. In some cases, the risks will be exacerbated – particularly financial stability, prudential and market behaviour risks.

In the very near term, not much is likely to change with regards to consumer protection unless the UK Parliament acts to amend existing legislation derived from EU legislation or decides not to implement legislation in the pipeline. But the long term future of financial regulation is a major concern. This is covered in more detail in Section 3.1.

Next steps

We hope this paper will be useful to consumer campaigners, the media, financial regulators and, of course, the industry itself. We have identified many policy issues and risks which need to be dealt with to protect consumers and make financial markets work for society. Each of the risks and policy issues would need a full report to do them justice. We can only provide a synopsis of each in this report. Much more work is needed to develop the appropriate policies to deal with all the challenges identified and campaign for reform. As a small non-profit group, we would welcome the opportunity to work with other civil society groups.

If you have any comments or would like further information on the approach to identifying risk please contact mick.mcateer@inclusioncentre.org.uk or gareth.evans@inclusioncentre.org.uk.

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1. THE NEW ENVIRONMENT FOR FINANCIAL MARKETS AND SERVICES

A range of major socio-economic, demographic, commercial, and technological forces, and political attitudes will shape the behaviours of consumers, the financial services sector, *and* the state over the next decade. These forces will exacerbate existing or create new risks in financial services. In this section, we focus on five of those:

- The impact of the new economic and financial reality on households and financial markets.
- The risks associated with financial firms trying to transition from legacy business models to new business models.
- The potential impact of 'big data' and fintech.
- Consumer confidence and trust, conduct and culture in the financial services industry.
- Attitudes towards the role of the state.

The relevant risks that will emerge in specific areas of financial services such as banking, pensions, insurance and so on are covered in more detail in the following sections.

The impact of the new economic and financial reality

One of our key concerns is that the financial services industry, policymakers and civil society organisations have not fully grasped the new economic and financial reality facing millions of households and the industry.

The UK labour market is undergoing significant changes. Taking into account the self-employed, workers on zero-hours contracts, non-guaranteed hours jobs, temporary and part-time jobs, we estimate that nearly 40% of the workforce is now in non-permanent/ non-full time work. There are also concerns that the UK is also developing an 'hour glass' labour market with an increase in higher skill and lower skill jobs but a fall in middle skill jobs.

In the post financial crisis era, household incomes have been squeezed – indeed, for many households real disposable incomes are still below their pre-crisis peak[2]. While some on more 'flexible' work will benefit from greater freedom and flexibility, many other households face much greater economic uncertainty and insecurity. The development of this hour glass labour market suggests that we could see a widening disparity in incomes and capacity for amassing financial assets. These trends will limit the ability of households to build financial resilience and long term financial security.

So, these challenging economic conditions will clearly have an impact on the demand side – that is, more and more households will be unable to afford to buy (financially excluded) or will have to cut back on financial services (underserved consumers), while others will be forced to buy poor value or 'sub-prime' financial products.

But there are supply side issues too. Established financial institutions will be under commercial pressure from the combination of squeezed household finances, more challenging economic

[2] Recent analysis by the ONS found that median equivalised disposable household income was £25,683 in 2007/08 and £25,660 in 2014/15 see http://visual.ons.gov.uk/uk-perspectives-2016-personal-and-household-finances-in-the-uk/

conditions, lower financial returns in the future, technological innovations, dealing with legacy systems and redress, and more realistic financial regulation.

The business models of established financial services firms have tended to be based on assumptions that customers look forward to secure employment and steady earnings growth, and are able to pay down debts and build up assets over time. This will not be the case for the millions of households who face greater economic uncertainty and insecurity. But we do not see much evidence that the mainstream financial services industry has responded to the structural changes in the economy by developing more efficient, flexible, consumer orientated business models.

The obvious fear is that the mainstream financial services industry will focus even more on better-off households using data and technology to segment households in more granular detail, resulting in even greater financial exclusion.

But what about the new challengers who talk about 'disrupting and transforming' the market? For now, even they seem to be more intent on just providing products and services to the same target market as the established providers – just in a different form. We see little evidence yet that these new providers have found a way to 'monetise' the provision of financial services to households with volatile earnings or who offer low lifetime economic value to product and service providers.

The other major concern here is that, in a period of low expected returns, financial institutions may well be tempted to exploit consumers to satisfy shareholder and management expectations. In other words, they may try to squeeze more out of a smaller pool of profit.

The final point to mention here is the role of financial regulation. There have been complaints from many in the financial services industry that regulation has gone too far and that it stifles innovation and competition and so on.

This is not the case. Yes, we have much tougher prudential and conduct of business regulations. But this was needed as financial markets were not properly pricing in the cost of doing business fairly and sustainably. The 'externality' costs were transferred to consumers and the rest of society. In other words, the rewards were privatised, the risks socialised.

Regulation is now just factoring those costs back into the financial system so they are borne by financial institutions and their shareholders. We now have a more realistic approach to regulation which no longer ignores the true cost of doing business well. More realistic regulation has also exposed the fact that the financial services industry could not provide fair value products and services to large parts of the consumer population on commercially viable terms. Financial institutions which became used to operating in a less well regulated market will struggle to make decent returns on investment.

Of course, it all depends on whether tougher regulation is here to stay. This remains to be seen – after all the industry lobby is very powerful and lessons are quickly forgotten. But tough regulation is needed to restore and maintain consumer confidence and trust and campaigners will fight hard to prevent deregulation.

Transition risks and legacy business models

The business models of many financial institutions such as banks, life insurance companies, and investment/ asset managers were structured to operate in a very different economic climate with high returns on equity, strong economic growth, easy credit, increasing household incomes and, of course, light touch regulation.

The new economic and financial reality will expose major structural weaknesses in these business models. In addition to lower returns on investment, larger financial institutions face additional pressures dealing with legacy problems, managing transitional risks, major restructuring[3], *and* trying to plan for the future. Key challenges include:

- Fixing or phasing out legacy IT systems and business models while at the same time trying to improve operational efficiency and transition to new business models to compete against new, lean, more efficient rivals; and
- Dealing with uncrystallised redress costs while trying to avoid new regulatory sanctions and censure by treating existing and potential customers fairly.

Firms will have to triangulate the demands and needs of shareholders, customers and regulators.

Significant efficiency gains will be needed. In certain sectors, oversupply of providers and proliferation of products is as much a problem as the overconcentration of providers seen in the banking sector. So, as well as improvements in operational efficiency, a major streamlining of products and services is needed.

In theory, periods of disruption should lead to innovation and better functioning markets as competition rewards the best providers and drives bad practice out of the market. But experienced consumer advocates know that competition theory doesn't often translate into practice in financial services.

The search for greater efficiency is likely to lead to an increase in financial exclusion. Efficiency gains (if actually realised) could result in a reduction in unit costs which, in turn, should extend access to hitherto underserved groups. But, in our judgment, this will be more than offset by the need for firms to chase after more profitable, better off consumers to restore and maintain profit margins in the new economic and financial reality.

Consumer groups should also be alert to major conduct risks. Periods of transition provide fertile grounds for misselling. The dislocation effects on financial institutions and, therefore, consumers could be huge. In inefficient markets with high degrees of oversupply and lower returns there is a risk that financial institutions will seek to maintain revenues and profit margins through exploitative practices and behaviours such as price gouging and hidden costs.

Similarly, lower income, financially vulnerable households also represent a greater reputational and regulatory risk for established financial institutions making these households even more unattractive as a commercial proposition. The shift up the income scale/ down the risk scale clears the way for less scrupulous providers who do not worry so much about reputational risk.

[3] Particularly for the major banks who are required to protect their retail operations by 'ring-fencing' them from the 'casino' banking operations (investment banking etc) by 2019 and by creating a special capital buffer

Of course, it maybe that alternative, better value providers try to fill the gaps created by established financial providers as they try to transition to more profitable business models and customer segments. But, as of yet, we have not seen that much evidence that non-profit providers (such as credit unions) or innovative fintech companies (see below) are making anything more than a marginal difference to the challenge of meeting the needs of excluded or underserved consumers.

Financial policymakers and regulators also face difficult challenges. Periods of disruption may cause tensions between prudential regulation and conduct of business/ consumer protection objectives. As mentioned, these are fertile periods for misselling as firms try to restore and maintain profit margins. Senior management will be dealing with many competing priorities, and may take their eye off the ball and fail to control poor conduct in their organisations.

Regulators will need to pay close attention to, and take action against, system and control failures in firms whose business models are under pressure in the new economic reality and/ or trying to transition to new business models. But, there may be a reluctance to be too tough on firms which are struggling for fear of tipping them over the edge and putting them out of business.

The regulators are often at pains to emphasise that the UK does not have a zero failure policy and that firms will be allowed to fail. That may be fine when it comes to small-medium size firms. The challenge will come if evidence emerges that a major financial institution is struggling in the new economic reality and is unable to transition to sustainability. In an ideal world, regulators should enforce against conduct breaches and not worry about potential consequences even if the sustainability of a firm is jeopardised. But, civil society has to be realistic. A failure of a major firm would knock already fragile consumer confidence and trust in financial services, or could pose a systemic risk to the UK's financial system. Until we address the 'too-big-to-fail' problem and/ or are confident that resolution schemes for major financial institutions work, prudential and conduct of business regulators may end up facing some very big judgment calls. The key issues are discussed in more detail in section 3.1.

'Big data' and fintech

Information plays a central role in all sectors of a modern economy. But, it is particularly important in the financial services industry – at its core it is an information business. Information, if used properly, can lead to more efficient, well-functioning, flexible and responsive markets that meet consumers' needs and preferences.

However, information is power and power can be abused. If financial and personal information is not used within a proper social justice, regulatory and corporate governance framework, it can result in dysfunctional markets, market abuse, and serious consumer detriment including financial exclusion, price and service discrimination (red-lining) and abuse of fundamental consumer rights.

There has been much hype about so called 'big data'. The full value to financial institutions and consumers remains to be seen. Nevertheless, there have been rapid developments in information science, technological innovation and an increase in the sheer volume of data and information being accumulated in the hands of powerful financial institutions and associated services providers such as credit reference agencies.

This provides mainstream financial services institutions (who are seeing business models squeezed in a low return environment) with the imperative and opportunity to undertake more granular segmentation to target better-off households. Greater segmentation in markets is generally associated with greater exclusion and outright discrimination in markets.

It is not even certain that 'innovation' in this field will lead to better value for consumers who are not excluded – at the *aggregate* level. We could see better value emerge if markets are disintermediated (that is, with fewer more efficient intermediaries in the supply chain) or if more efficient fintech providers are able to match products and services much more closely to consumers' needs and preferences.

But, given the inherent complexity, we may just see new forms of intermediation emerge and we may lose scale economies if individualisation is taken too far. So, if we don't see greater market efficiency at the aggregate level, then this will be a zero sum game and the net result will be a small number of consumers confident and skilled at using technology benefiting at the expense of other consumers. In other words, consumers who are already well served by the market will end up being even better served with more flexible, convenient products and services.

Greater individualisation will have a significant impact on the insurance industry and other sectors which still operate to some degree according to the principles of risk-sharing and cross-subsidisation. By definition, this will result in greater financial exclusion or more costly access for groups who are considered higher risk and/ or less profitable (as measured by lifetime value of customer relationship).

The risk of greater financial exclusion is not the only concern. There are consumer protection issues to consider. Combining big data, fintech and social media allows providers to grow and harvest new pools of consumers. It also then provides more opportunities to use sophisticated data mining and analysis tecnhiques to target consumers and exploit their behavioural biases.

Financial regulators face their own challenges finding new ways to supervise fast moving developments in fintech and social media markets. Supervision and enforcement is made all the more difficult when firms may operate in multiple jurisdictions. The jurisdiction problem is also critical with regards to protecting financial systems and consumers against cybercrime.

But, there are more fundamental questions for regulators. Winners and losers are a feature of market based systems. How far should regulators go in protecting consumers from firms who use sophisticated techniques to target consumers? How should regulators respond to the potential for fintech/ big data to create more financial exclusion? How far should regulators go in protecting consumers against cybercrime and scams originating in other jurisdictions?

The truth is it is too early to say what the impact of fintech and big data will be on the industry, consumers, and regulation. The relevance for retail financial services and wholesale/ institutional markets are discussed in more detail in sections 3.1 and 3.2.

Consumer confidence and trust, conduct and culture in financial services

If households are to make greater use of financial services then restoring and maintaining consumer confidence and trust is a prerequisite. Financial services is starting from a long way back on this issue. Many of the other major consumer sectors have been beset by crises and scandals. But, surveys have found that financial services is one of the least trusted[4]. Within the broader financial services industry certain sectors score particularly badly in terms of customer satisfaction and trust. In large scale studies, banking, pensions and investments score very badly when ranked against other consumer industries[5].

But the low level of confidence and trust has wider implications. If consumers do not trust the pensions and investment industry they will not save for the future and may need greater support from the state; this will have consequences for future generations of taxpayers. Real economy firms also suffer as less resource is invested in the real economy. It even impacts on housing inequality and financial stability[6].

This legacy of mistrust has been created by a litany of misselling scandals and market failures. In turn, these were caused by poor conduct of business standards, aggressive corporate cultures, and weak regulation.

Poor conduct and aggressive cultures not only harms consumers, it encourages reckless behaviours which create market and systemic risks.

So, restoring and maintaining confidence and trust, and discouraging reckless behaviours requires a sustained improvement in the governance, ethics and culture of the financial services industry. This, in turn, can only happen by applying the 'holy trinity' of reforms:

- tough, targeted regulation;
- more effective market forces in the form of institutional investors, analysts and consumer groups improving due diligence, exerting pressure on financial services firms to improve behaviours; and
- boards of financial institutions (and trade bodies) understanding the conduct risks in their organisations and focusing on changing corporate cultures and behaviours.

On the face of it, there is evidence of improvements in culture and behaviours in retail financial services. But, will this last? In our experience, the boards and senior management of many financial institutions struggle to understand the root causes of conduct risk. The new economic and financial reality described above will make it more difficult for boards and senior management to prioritise improving corporate cultures.

In the wholesale and institutional financial markets, we have only just begun to understand the scale of conduct failures. The more come to light, the more damage to trust and confidence will result.

An important recent development is the introduction of the Senior Managers and Certification Regime (SM&CR). The SM&CR requires firms to identify clearly the responsibilities of senior management within the firm, and those who perform functions that could cause significant harm to

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[4] Financial services is one of least trusted industries globally (Edelman Insights 2015), % trusting: Technology; 78%; Consumer electronics 75%; Car industry 71%; Food 67%; Telecoms 63%; Pharma 61%; Energy 60%; Fin Services 54% amongst 'informed public', 48% general pop; Media 51%

[5] For example, see the EU Consumer Market Scoreboard, http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/10_edition/docs/consumer_market_brochure_141027_en.pdf

[6] investors favour property investments such as buy-to-let which contributes to rising rents, the property bubble and overindebtedness

the firm or its customers. It also imposes a statutory requirement on senior managers to take reasonable steps to prevent regulatory breaches in their areas of responsibility.

The SM&CR is overseen by the FCA and PRA. It is hoped that this new regime will enhance the personal responsibility of senior managers, deter aggressive behaviours and encourage good conduct.

But the success of the SM&CR and other regulatory interventions depends on regulators being able to identify, supervise and enforce against breaches. Consumer groups are concerned that the industry is pushing back on regulation at EU and UK level.

Current market conditions provide fertile ground for new misselling scandals and poor conduct which will surely happen if regulatory standards are lowered. Corporate conduct and cultures in financial services have not been reformed sufficiently (and given the nature of financial services markets probably never will be) to risk a reduction in regulatory standards. We hope regulators will resist pressure to deregulate as this will be self-defeating. We also hope the more progressive firms in the industry who do understand the importance of improving cultures and restoring confidence recognise the dangers of deregulation.

In the banking sector, much attention will be focused on how successful banks are at ring-fencing their retail operations. This is primarily a financial stability and prudential regulation measure. But, consumer groups will need to monitor this too from a conduct and culture perspective. Ring-fencing is not the same as a complete separation of retail and wholesale operations. There will still be plenty of scope for conflicts of interest to emerge between retail and wholesale operations. Robust corporate governance and rules to manage conflicts of interest will be critical for protecting clients.

Attitudes towards the role of the state

The last factor we considered is the changing attitude towards the role of the state in meeting households' needs in areas such as pensions, long term care, and social security replacement.

Currently, the dominant view amongst policymakers and some experts seems to be that demographic trends and pressures on public finances mean that an increased share of meeting essential needs *must* be borne by the individual and less by the state. There is an attempt to transfer greater risk and responsibility from the state to the individual and/ or from state funded to private sector funding mechanisms. Moreover, there are fears that cuts to state schemes such as the social fund push more and more vulnerable consumers into the high cost credit market.

Looking at the comparative costs of state versus individualised, private sector provision, this attempt to transfer risk and responsibility does not seem to be based on objective economic analysis. As we explain in 3.3 and 3.4, the perceived cost savings achieved by transferring responsibility from the state to private provision would seem to be illusory or a false economy. Nevertheless, it seems that policymakers are determined to continue with this approach. Therefore, we need to understand the consequences for consumers and wider society.

The first issue to consider is the capacity of different groups of consumers to handle these greater risks. Individualised, market based systems by definition create winners and losers[7]. How do we

[7] This is not a criticism of markets per se. Markets are amoral and allocate value according to economic power, not needs. It's what markets do.

ensure that consumers can access to necessary advice to make effective choices and decisions in this more complex, risky environment?

Secondly, there is the very big question of whether the financial services industry is 'fit-for-purpose', can be trusted, and can produce the products and services consumers need. Expecting households to use financial services to meet their core needs, with consumer confidence and trust in financial services so low, is a risk in itself.

For example, if households are to be *encouraged* to use individual insurance products to provide income security, the lack of confidence and trust may cause them to underprovide. If consumers are compelled to use insurance products at a time when confidence and trust is so low, they may resent this. This is another reason why attempts to lower standards of regulation would be counterproductive. Moreover, individualised insurance based provision is not as economically efficient as collective provision – so households at the aggregate level end up paying more to meet the same core financial needs.

Finally, the role of the state and regulators requires special consideration. If the state stops meeting some of these core needs directly, how will it protect vulnerable consumers who will lose out in a market based system? How far should regulators go to ensure that products and services are safe, fair, and value for money? It is only reasonable to expect higher standards when it comes to products which meet core public policy needs such as pensions, long term care, and social security replacement.

2. THE FOUR MARKET TESTS

So, those are some of the main forces we think will shape the environment for financial services over the next decade or so. But, if we want to act on these insights, we need to understand how these forces will act on specific sectors of the financial services industry and different groups of consumers.

To do this, we applied four key tests to identify the emerging risks and policy issues in each of the main sectors. These four tests are derived from the established consumer outcomes that consumer advocates use to assess whether markets are working[8].

1. **Financial markets should be safe, stable and resilient and not threaten wider economic resilience.**

There has certainly been a great deal of macro and micro prudential developed post financial crisis to promote financial stability and make financial institutions safer. We won't know whether this regulation is effective unless it is tested by a new financial crisis. Of course, we must hope we don't see a recurrence of the 2008 crisis but many commentators are worried that the global financial system is still vulnerable to systemic crises. The decision by the UK to leave the EU creates new financial stability and resilience risks.

Closer to home, UK households are building up serious levels of debt again and there are fears that risks in the main banking system have just been transferred to the 'shadow' banking system rather than properly mitigated.

The UK is at the centre of the global financial system and on some measures the leading global financial centre. This makes it unusually exposed to risks in financial markets. Ultimately, alongside good financial stability and prudential regulation, the most effective way to create a resilient financial system is to ensure greater institutional diversity and plurality in that system.

But, the UK is considered to be one of the least resilient financial systems partly due to the scale and nature of activities undertaken here but also due to the lack of institutional diversity and plurality in the financial system. So far, we see little sign of sufficient diversity and plurality emerging *organically*[9] so the financial system remains vulnerable.

The sustained low interest rate period (needed to bolster the economy and financial system) creates serious problems for the insurance and pensions industries – including the defined benefit employers' pension sector which still faces huge scheme deficits. Worryingly, we do not detect much evidence that the long term challenges in the insurance and pensions industries are being faced up to.

This low interest rate environment is also having a major displacement effect on financial markets encouraging new asset bubbles and causing investors to 'search for yield'. It is not clear that investors understand the risks involved.

Moreover, the vulnerability of our financial networks and infrastructures to cyber attacks has emerged as a real concern recently. The global, interconnected nature of the UK's financial system leaves it particular attractive to cyber attacks. Individual consumers are increasingly becoming

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[8] Access, fairness, choice, information and transparency, value for money, socially useful innovation, sustainability, safety, and redress

[9] That is, market forces enabling innovative – or to use the trendy phrase, 'disruptive' – new providers to take market share off established providers

victims of cybercrime as the use of fintech/ internet based distribution of financial products gathers pace.

Key risks to watch out for:

- Vulnerability in the banking system due to lack of institutional diversity and plurality.
- Impact of Brexit.
- Re-emergence of high levels of household debt.
- The long term sustainability of pension schemes and insurance industry.
- Irrational financial market behaviours in response to low interest rate environment.
- The impact of cyber attacks crime on the financial system and households.

2. Financial markets should operate to high standards of conduct and integrity, customers should be treated fairly

The litany of misselling scandals over the past 25 years has left a legacy of mistrust in financial services. The total direct financial cost in terms of consumer redress is now around £50bn. But as we explain elsewhere the legacy of mistrust creates wider public policy costs.

In sectors such as financial services, with so much market failure and poor conduct evident, a strategy of *storming, norming, and performing* is needed. This involves tough regulatory interventions to stop market abuse (the *storming* phase), followed by sustained regulatory interventions to *normalise* good behaviour. Only then can we expect to see firms competing using good conduct as a competitive advantage – the *performing* phase. This is the norm in better run, more consumer-focused industries.

It must be said that on the face of it, some progress has been made on improving the conduct and culture in parts of the retail financial services industry driven by tough conduct of business regulation.

Of course, there is no room for complacency. We are a long way from even *normalising* good conduct in retail financial services, never mind reaching the *performing* phase where financial firms use good conduct as a competitive advantage. Legacy problems will continue to emerge, further knocking trust and confidence in the sector.

It remains to be seen whether these improvements signal a permanent improvement in culture or are a temporary response to much tougher regulation. Our experience is that boards and senior management of many financial institutions struggle to understand the root causes of conduct risk. Embedding and normalising good conduct remains a major challenge.

The challenge now is to build on the progress made through tough regulation and embed a strong consumer culture, good conduct standards, and high ethical standards in the industry.

Moreover, it is not clear that the same improvements in culture and conduct have occurred in the critical wholesale/ institutional financial markets. Regulators have only begun to look at behaviours in these markets. Some of the early findings give real cause for concern. The sheer scale of the size

of the wholesale and institutional markets, means that misconduct can have a much greater impact on consumer welfare and economic well-being than retail markets.

The new economic and financial reality outlined above will make all the more difficult for boards and senior management to ensure good conduct within their firms. Now boards and senior management in many firms will have the impact of Brexit to contend with. Good conduct and treating customers fairly may not be high on the agenda for the next few years.

One of the most important recent initiatives is the introduction of the Senior Managers and Certification Regime (SM&CR) which is intended to improve conduct in the wholesale and retail markets and ensure greater personal responsibility amongst senior personnel in firms (see page 12 for more detail). This is a welcome initiative but if this to work, it must be robustly enforced by the FCA and PRA.

But the industry can play a role, too. There is much to be done not just to improve conduct in the industry but to protect hard won gains. The Centre is keen to work with progressive firms on embedding good conduct in the industry.

In the banking sector, implementing the new ring-fences between retail and wholesale operations in major banks will be a priority to manage conflicts of interest.

Key issues here are:

- Investigating conduct and culture in wholesale and institutional markets, maintaining and building on progress in the retail financial services industry.
- Persuading other agents (such as analysts and institutional fund managers) to exercise due diligence and influence behaviour of firms in the financial system.
- Improving confidence and trust in financial services.
- Ensuring consumers are treated fairly – particularly 'captive consumers' – in the new economic and financial reality.
- Preventing deregulation especially in light of the Brexit vote.
- Ensuring the SM&CR is robustly supervised and enforced.
- In the banking sector, ensuring the ring-fence between retail and wholesale operations promotes good conduct, as well as enhancing financial stability and prudential regulation.

3. Financial markets/ system should be economically and socially useful

Consumer groups have been very effective at exposing misselling scandals and holding retail financial services to account, leading to much tougher regulation. As a result, we think there has on the face of it been an improvement in the conduct and culture in retail financial services – even if there is no guarantee that this is permanent. But this is not enough. Financial markets have to be judged according to the contribution they make to the wider economy and society, not just how they treat retail customers.

To be judged economically and socially useful, financial markets and the financial system should:

- Be efficient, inclusive and accessible.

- Produce innovative, socially useful products and services.
- Promote positive financial behaviours amongst households.
- Contribute to the real economy by allocating resources to the most productive economic uses.
- Not create major negative externalities or social costs (this is covered in more detail, below).

Looking at each of those tests in turn, the financial sector performs badly. There has been some progress on financial inclusion in banking (see below). But in other areas progress has been slow. Significant reform is needed to improve the economic and social utility of the sector.

Key points to note are:

- There have been numerous reviews and inquiries into competition in banking with few obvious signs of progress. The latest report from the CMA reinforces this view[10].
- The asset management industry – which is supposed to channel capital to real economy firms while helping people save for the future – stands accused of costly value extraction, outright value destruction and short termism.
- Banks and the wider financial intermediation sector have been criticised for not allocating resources to the most productive uses, lending more to other financial institutions and the property market than to real economy firms.
- The financial sector has not been good at promoting positive financial behaviours amongst households – for example, encouraging households to take on too much debt while being ineffective at persuading consumers to save for the future or insure themselves against risk.
- More generally, there has been a huge amount of product development with thousands of products on the market, and furious competitive activity. But this is very different to true, socially useful innovation and competition that works in the interest of consumers.
- The financial sector has a poor track record at developing innovative, inclusive products and services which meet the needs of households affected by the new economic and financial reality. As a consequence, we expect financial exclusion and underprovision to deteriorate.
- The City of London is one of the most active, innovative financial centres in the world. But, it has a poor track record in developing financial products and instruments to meet social needs – the social finance function.

As with test 2 above, we are a long way from normalising effective competition and consumer focused, socially useful innovation in large parts of the financial services industry. The key challenges which need to be addressed are:

- Improving the effectiveness of the banking system – competition style interventions do not work, more direct regulatory interventions are needed to reconfigure the banking system.
- The financial sector has to become better at promoting positive financial behaviours amongst consumers.
- Improving the effectiveness of the asset management industry is critical – not just from the perspective of investors but real economy firms.
- The financial system needs to be reconfigured so that it allocates resources more effectively to the real economy.

[10] https://www.gov.uk/government/publications/retail-banking-market-investigation-overview

- A major streamlining of products is needed, with more emphasis on designing truly innovative products which suit consumers' needs, business models need to evolve to meet the needs of consumers hit by greater economic and financial uncertainty and insecurity.
- The City needs to deploy is skills and resources to developing social finance.

4. Financial markets should not create negative externalities or social costs

Financial markets should also be judged on the negative externalities and social costs created, not just benefits. Like most critical industries of national importance (food and retail, utilities, transport, pharmaceutical sector and so on) behaviours in the financial services industry don't just affect its own customers and shareholders. Market failure in financial services affects employees, tax payers, future generations, the wider economy, and public finances.

The financial crisis provided a painful lesson on how the negative effects of financial market activities are not necessarily contained within the sector. As has been said many times, the risks were socialised, the rewards privatised. Negative externalities can include damage to the real economy due to short termism, creation of asset price bubbles, exacerbating economic inequality and financial exclusion, harming public finances, damage to the environment, and so on.

The main concerns here are:

- The financial sector still represents a major risk to the resilience of the UK economy.
- The success of the UK economy is still too reliant on the financial sector.
- Financial sector activities distort the real economy and housing market.
- The level of financialisation in the UK exacerbates regional, income and wealth inequality.
- Fund managers (who are meant to act as stewards of our assets) do not properly factor in the long term costs of environmental damage or social costs such as widening income inequality.

Tackling these problems requires carefully calibrated policy interventions to ensure that financial markets internalise these costs and do not pass them onto the rest of society. But, despite the UK having a comparatively sophisticated and well-resourced financial regulatory system, we do not have the necessary institutional structures to deal with these externality risks.

We have a number of institutions – HM Treasury, Bank of England, Financial Policy Committee, Prudential Regulation Authority, and Financial Conduct Authority – which play critical roles in maintaining financial stability, ensuring good conduct and promoting competition in financial markets. However, none of these institutions have statutory objectives to understand and deal with externality risks. As a result, these issues do not get priority. Change rarely happens unless authorities are mandated to make change happen. Thinking about the institutional reform needed to address these externalities will be a priority for the Centre over the next year.

3. KEY POLICY ISSUES AND RISKS

Taking into account the new environment for financial services, and using the four tests described above, we have identified what we think are the main policy issues and risks in financial services.

We have identified nearly 30 key risks and policy issues so to provide some structure these are grouped into:

- Retail financial services and financial inclusion.
- Wholesale/ institutional markets, and financial infrastructures.
- Public policy issues.
- The way regulatory and public policy is developed.

Note that some of the risks and policy issues are 'vertical' – that is, they relate to specific product sectors such as banking, consumer credit, pensions, and so on.

Others are more 'thematic' – that is, they relate to themes which range across a number of product sectors such as the need for new business models, the treatment of captive consumers and dealing with legacy business models, consumer confidence and trust, conduct and culture in financial services, and so on.

The other main category of risk covers behaviours and activities in the financial markets which have a wider impact on the real economy and society. This can include the failure of the financial system to allocate resources efficiently to the real economy, the impact of financial market risks on economic resilience, the impact of financial markets on inequality and so on.

We have also included a separate category on public policy. This is because failures in public policy can create risks. For example, if regulators continue to deploy flawed competition interventions or regulatory models, this can prolong market failure or create new market risks.

3.1 RETAIL FINANCIAL SERVICES AND FINANCIAL INCLUSION

In this section we summarise the issues we think are the most important in retail financial services including:

- The future of retail banking.
- Access to fair, affordable banking.
- Consumer credit.
- The need for new, flexible, efficient business models.
- The role of 'fintech' and big data.
- Transition risks and legacy problems.
- The treatment of 'captive' consumers.
- Conduct and culture in the financial services industry.
- Deregulation.
- EU regulatory issues and EU referendum.
- Financial Advice Market Review (FAMR) and financial advice.

The future of retail banking

One of the biggest issues in retail financial services that needs to be confronted head on by consumer groups, policymakers and regulators is the future of retail banking.

The retail banking industry has to deal with a range of major challenges including: operating in a tougher prudential regulatory regime; new requirements giving consumers a legal right of access to basic bank accounts; dealing with inefficient legacy systems and infrastructures (such as the branch network); major restructuring as a result the new ring-fencing requirements; dealing with legacy conduct costs; facing demands from media and consumer advocates to retain the 'free-if-in-credit' (FIIC) banking model; incorporating fintech innovations into their operations; and fighting off the competition from the fintech 'disruptors' and challenger banks who don't carry the same baggage in terms of high legacy costs. And, of course, they still have to meet the expectations of their shareholders.

All this is being done in a period of low economic growth and financial returns (see the new economic and financial reality, above). The challenge for the big retail banks is stark. Recent comparative analysis suggests that in 2015 the return on equity for the largest five UK banks was just 4.6% compared to 9.5% for larger challenger banks, and 17% for the smaller challenger banks. The cost-to-income ratio for the big five was 80.6% compared to 59.2% for larger challenger banks, and 48.5% for smaller challengers[11].

It is difficult to see how retail banks can meet consumer group and media expectations on FIIC banking, maintain a large branch network in the era of fintech, *and* keep shareholders happy. Something has to give.

We need to have a proper, open and honest debate about the future of banking in the UK covering how banking services should be paid for, what we expect from retail banking, and whether banks should be seen as utilities (with the associated lower return on capital). Despite the recent

[11] KPMG, A new landscape, Challenger Banks Annual Results, May 2016

Competition and Markets Authority (CMA) report on the current account market, these questions remain unanswered.

Access to fair, affordable banking

Improved access to fair, affordable banking has been a focus of our work for some time. We have seen some real progress on this. Late in 2015, it was announced that nine major banks will offer fee-free basic bank accounts from the start of 2016 for people who don't already have a bank account. This is good news but it is not clear whether people with fee-charging basic bank accounts will be able to switch to a new, fee-free account.

The announcement on fee-free accounts was made in advance of the forthcoming implementation in the UK of the EU Payment Accounts Directive (PAD). The PAD must be implemented by the UK Government and FCA by 18th September 2016. One of the key measures in the PAD is that EU citizens will have a legal right of access to a basic bank account. This legal right of access represents real progress in the fight to promote financial inclusion. The Centre, along with EU consumer representative groups such as the FSUG[12], fought very hard to counter the UK Government and banking industry lobbies who wanted to keep the failed self-regulation approach. This will be one of the most important developments in financial inclusion in 2016.

But, there is still work to be done. Fears about money laundering and terrorism finance means that many people will be denied, sometimes unreasonably, the right to a basic bank account.

The priorities now will be to ensure that:

- The Brexit vote does not affect the implementation of the PAD.
- Consumers trying to open a basic bank account are not unfairly rejected.
- Rights to appeal and access to redress are established.
- A transparent allocation system is established to ensure all major banks take on their fair share of basic bank accounts.

We intend to work to ensure that consumers with older, poorer value basic bank accounts can switch to the newer basic bank accounts.

Consumer credit

We also saw some real progress in the consumer credit market. We had campaigned for some time for a price cap on payday loans arguing that this was the most effective way to protect vulnerable borrowers and create a level playing field for credit unions and other alternative non-profit lenders.

A price cap was introduced by the FCA in early 2015 and has already had a major effect in constraining the business models of payday lenders and cleaning up the industry. The price cap has been shown to be a very effective consumer protection measure. The price cap will be reviewed in the first half of 2017.

But, again, there is still much work to be done. Alternative lenders have not yet responded to meet the unmet need for affordable short term credit so we intend to explore new ideas to develop

[12] http://ec.europa.eu/finance/finservices-retail/docs/fsug/opinions/140305-letter-mep-klute-payment-accounts_en.pdf

capacity in the alternative lending sector and develop viable new business models and loan products.

Moreover, as the FCA's report on the credit card market show[13], there are serious problems affecting millions of vulnerable credit card borrowers who will face an uphill struggle trying to manage overindebtedness. Consumers in the high risk credit card market are at risk of unfair practices and high charges from four providers who dominate this market. The credit card market is not working well for financially vulnerable households.

Furthermore, the application of high unauthorised overdraft charges continues to harm vulnerable consumers struggling to make ends meet. Unfortunately, the CMA decided not to recommend a regulated charge cap on overdraft charges[14]. This leaves consumers vulnerable and may hinder the ability of the FCA to apply tougher regulatory interventions – the banking industry will now be able to cite the CMA recommendations to argue that further interventions would be disproportionate.

As our recent report on the rent-to-own (RTO) sector shows[15], the market for this form of borrowing has grown significantly since the financial crisis and is expected to grow further over the next five years. There is much consumer detriment in the RTO market with consumers paying a high cost to own basic consumer goods.

The priorities here are[16]:

- Ensuring the effective payday price cap regulations are not diluted.
- Improving the support available to overindebted households.
- Improving consumer protection for vulnerable consumers in the overdraft and credit card market including protecting consumers from the impact of high charges. The FCA should toughen up the responsible lending regulations. But we fear that it is relying too much on information solutions to protect vulnerable borrowers. Information is important but it is not effective in controlling provider behaviour. The best way in our view to do this is to constrain the opportunities providers have to apply unfair charges by introducing a payday lending style cap (but as mentioned, the FCA's room for manoeuvre is now limited by the CMA's report).
- Developing viable, alternative sources of credit with community lenders and other important 'trusted intermediary' organisations such as social housing providers and local authorities.

The longer term goal should be to help financially vulnerable households build financial resilience so that they do not have to turn to costly credit when hit by unexpected financial shocks (see Major Public Policy Issues).

The need for flexible, innovative, efficient business models

One of our key cross-cutting, or thematic, concerns we have is that the mainstream retail financial services industry may be losing relevance for many households. The business models of mainstream financial services firms have tended to be built on the premise that consumers over their working

[13] https://www.fca.org.uk/news/final-findings-credit-card-market-study
[14] https://www.gov.uk/government/publications/retail-banking-market-investigation-overview
[15] See http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2016/03/Better-and-Brighter-Responsible-RTO-Alternatives-Full-Report-150316-1.pdf
[16] For more detail, see our report commissioned by the ACCA called 'Britain's Debt: how much is too much?' Which sets out measures to support overindebted consumers and encourage savings http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2016/04/britains-debt-final-report.pdf

lifetime can look forward to earnings growth, paying down debts, building up assets, and can afford regular payments into bank and savings accounts, mortgages, pensions and insurance products.

Moreover, financial institutions got used to high returns on investment. But, the financial services industry and its consumers face a new economic and financial reality of low economic growth, low financial returns, greater economic insecurity, squeezed household incomes, and dealing with the legacy of overindebtedness.

More efficient business models and innovative, flexible products and services are needed to provide better value for consumers and prevent an increase in financial exclusion. Cutting distribution costs are critical to offer better value, more affordable products and services to excluded and underserved households. Parts of the financial services industry will find the transition more difficult because of legacy business models, IT systems and uncrystallised redress costs – see below.

We are keen to work with progressive thinkers in the financial services industry and civil society to develop innovative business models, appropriate products, and financial infrastructures to reduce distribution costs and improve access.

The role of 'fintech', big data, and algorithms

Linked to the above, is the role of technology and information in promoting fair and efficient, accessible and inclusive financial services.

Numerous inquiries and subsequent policy intervention have failed to produce much meaningful change to competition dynamics in the UK banking sector. But 'fintech' evangelists seem confident that developments in technology and data science will introduce some real competition for the big banks and allow 'disruptive' innovators to transform the financial services industry (including the critical payments infrastructure). They argue that this will lead to more innovative, accessible and inclusive, more convenient products and services.

It is also suggested that fintech in the form of 'robo-advice' could help close the so-called 'financial advice gap' by reducing distribution and advice unit costs and by helping consumers make better financial decisions.

Furthermore, fintech evangelists also argue that new technology and big data should allow more innovative firms to offer better value, flexible products and services in the consumer credit and insurance markets and, more generally, provide apps to help consumers manage their household finances better.

We think fintech has the potential to benefit by facilitating the development of products, services and distribution channels more suited to the changing needs of consumers. But, it is by no means clear that this potential will be realised. It all depends on how effective policymakers and regulators are at clearing space for innovative providers.

We see three possible 'pathways' for fintech and big data:

- New entrants will - to use the trendy term - 'disrupt' established financial services providers.

- Established providers will 'adopt and adapt' fintech and big data for their own purposes.
- Non-bank providers particularly the infotech giants (Google, Facebook, Amazon etc) enter the financial services industry in a big way.

Whether fintech developments will just lead to a re-ordering of existing ways of providing services or a genuine transformation in the efficiency, value, and social utility of financial services remains to be seen. There is certainly plenty of activity in this field. But the financial services industry does not have a great track record on socially useful financial innovation. Fintech could well be another false dawn and we need to take care that it is not seen as a panacea for closing the advice gap or used as yet another excuse to *not* intervene to make financial services work for consumers.

It is not clear if the basic economics of fintech work. Is there sufficient revenue potential to make the new fintech start-ups viable? Will consumers be willing to pay for these new services (note the reluctance of UK consumers to pay explicit charges for transactional banking) or can some other way to 'monetise' fintech services be found? The obvious way to do this is for consumers to allow their personal data to be used in return for free fintech services – but this brings its own set of issues.

There is potential for new entrants to play an important role as interfaces (using apps) between consumers and product providers. For example, helping consumers manage their finances better, 'nudging' consumers to take action. But it is not clear how these apps can be monetised in a way that is sustainable.

In terms of product provision, although there may be some exceptions, we do not think that the new, smaller fintech providers will be that successful in taking market share off established financial institutions. We will not see that much *organic* growth. Established providers are just too dominant. If policymakers and regulators want to see real change, they will have to actively create space for new fintech providers to emerge and thrive.

Of course, fintech doesn't just have to be utilised by exciting, new fintech businesses. Established providers could also harness the potential of fintech to make services more responsive and flexible – what we call the 'adopt and adapt' model. But, even under this scenario, established providers will face a real challenge developing new fintech based services while trying to deal with their inefficient legacy business models and systems.

The great unknown, so far, is the role of the infotech giants. They do have the firepower and technical ability to intervene in the financial services supply chain in a way that could herald a significant change in the relationship between the financial infrastructures, banks/ financial services providers and the 'end-user'.

But this has its own set of problems. The infotech giants would also have to find a way to monetise these relationships. These organisations certainly know how to monetise data. The financial services industry has been criticised in the past for confusion marketing and exploiting behaviour biases. But, the infotech giants could take this to a whole new level.

If the potential benefits are as of yet unclear, what seems more certain is that the combination of fintech and big data will certainly create new risks or exacerbate existing problems. We are likely to

see even greater use of confusion marketing, exploitative pricing and widespread abuse of personal data.

More sophisticated risk based pricing, customer segmentation and acquisition techniques is likely to result in greater financial exclusion. More granular segmentation is usually associated with greater exclusion as cross-subsidies are unwound. Indeed, some fear that if taken to its logical extent, fintech and big data could destroy the underlying risk sharing basis of insurance.

In the investment sector, sophisticated 'robo-advice' systems are being developed which can guide consumers towards an investment decision (whether on a course of action or recommendation on specific product). But, there are concerns that the industry is trying to exclude this form of advice from the full definition of regulated advice thereby limiting consumer protection and access to redress. In our view, robo-advice should be treated on a par with regulated advice provided by a human. Robo-advice still involves gathering information about an individual, assessing that information, diagnosing problems and needs, and recommending a course of action. That is advice.

More generally, our system of financial regulation and data protection has not evolved to protect vulnerable consumers in this new environment. Information is now an asset in its own right – it can almost be thought of as a form of money. We have strict conduct of business regulations governing how firms treat our money when we hand it over to them. There are, of course, laws relating to use of data[17]. However, we do not have a system of *conduct of business* rules which govern how firms acquire, manipulate, and monetise our data.

The table below summarises what we see as the potential benefits and risks of fintech/ big data.

Table 1: Fintech and big data – potential benefits and risks

Potential benefits	Potential risks
Greater empowerment/ better decisions Greater access/ inclusion Better value products and services More efficient markets Greater consumer/ citizen engagement in markets/ democratic process Access to information Constant innovation Exploration Enhanced knowledge and education	System resilience Information security Consolidation of corporate power Exaggeration of consumer empowerment/ weakening of regulation Greater confusion/ disempowerment Greater abuse of behavioural insights Firms circumventing definitions of advice, reducing consumer protection Less efficient markets/ higher search costs/ spurious innovation Greater financial exclusion/ discrimination Exacerbating economic inequality/ social exclusion Invasion of privacy/ abuse of personal data Civil/ human rights abuses Increase in scams/ frauds Regulatory arbitrage Jurisdictional issues Regulatory capacity

The truth is, no one yet knows what the impact of fintech and big data will be. Serious thought will need to be given to whether we really are on the cusp of real change and whether fintech can address some of the financial exclusion challenges, and improve the efficiency and utility of financial

[17] A new EU General Data Protection Regulation came into force in May 2016 but does not apply until May 2018. It is not clear how Brexit will affect the application of this in the UK. See comments by UK minister responsible http://www.out-law.com/en/articles/2016/july/brexit-minister-admits-the-general-data-protection-regulation-might-not-apply-in-the-uk/ Moreover, this Regulation does not provide for financial regulatory style conduct of business rules. See http://ec.europa.eu/justice/data-protection/reform/index_en.htm

services? Our approach to consumer protection must be updated to protect consumers from the downsides of fintech/ big data. To inform the debate, the following questions relating to access and exclusion, choice, consumer sovereignty, fairness, efficiency, and security need to be addressed:

- What are the practical applications and implications of big data/ fintech/ algorithms? Despite the hype, there are surprisingly few good, objective analyses which try to assess the practical applications from the consumer perspective?
- Specifically, what would the impact be on different groups of consumers including implications for access/ exclusion, on consumer behaviours and decision-making abilities - and therefore on markets?
- How fit-for-purpose is our system of regulation in this new environment? What are the implications for data protection, conduct, competition, prudential/ financial stability regulation? Does financial regulation and data protection regulation interact properly to protect consumers?
- What measures need to be taken to promote effective competition and innovation?
- What is the appropriate policy response to these developments? Do we have the right policy framework to allow us to identify the positive aspects of these developments whilst protecting consumers against the very obvious risks?

We look forward to working with civil society groups and industry on developing thinking on this critical issue.

Transition risks and legacy problems

Another major cross-cutting issue facing the financial services industry is how to manage the transition to more flexible, efficient business models in the face of the more challenging new economic and financial reality.

In certain sectors, oversupply of providers and proliferation of products is as much a problem as overconcentration in key sectors. Streamlining product ranges will present a difficult challenge and will create new problems relating to back books and captive consumers (see below).

Parts of the industry may find it very difficult to transition to this new environment because of legacy business models, unstable and creaking IT systems, the need to restructure, and potentially large unresolved redress claims yet to crystallise. Dealing with these unresolved redress claims may create further opportunities for claims management companies causing disruption for firms and detriment for consumers.

This period of transition could be very disruptive (in a bad way) for many financial institutions. It may be difficult for some financial institutions to offer real value and make profits fairly. Some may face existential threats especially if the tech giants decide to get involved in a serious way in providing banking and financial services.

Transitional periods are fertile conditions for poor decision making and misconduct, and present a real challenge for senior management in financial institutions, policymakers and regulators, and consumer advocates.

The treatment of captive or 'back-book' customers

The treatment of captive or 'back-book' customers is a very difficult issue to resolve. The main product areas to worry about are: borrowers with interest only mortgages, older borrowers, closed with profits funds and older style pension contracts[18].

The combination of more difficult economic conditions, squeezed financial returns, and competition for new customers creates a very real risk that more established financial institutions will try to aggressively – or even unfairly – extract more value from existing customers (the back book). The increased use of technology and big data could facilitate this as this enables firms to use sophisticated behavioural insights and marketing techniques to target consumers.

Even if consumers are aware that they have a poor value product, and that better value options are available elsewhere, they can be tied into contracts through the application of very high redemption or penalty charges. This limits their ability to move to another provider – in effect they are 'captive' consumers – and makes them vulnerable to exploitative pricing strategies.

Similarly, in credit markets, borrowers may find themselves trapped in poor value mortgage or loan contracts because they are unable to find a new lender willing to lend – for example, if the lender's risk tolerance has changed since the original loan was taken out.

The reason why this is a particularly difficult issue to resolve is that fixing the problem could create a real tension between conduct of business/ consumer protection regulation and prudential regulation. Releasing captive consumers from poor value or exploitative products would be right in the interests of consumer protection. But, this will affect the product provider who will have modelled customer profitability on the old terms. If sufficiently large numbers of consumers are released from old contracts this could affect the sustainability of the provider – which then becomes a prudential issue.

Resolving the tensions between consumer protection and prudential regulation could become a very difficult challenge for regulators and consumer advocates if the current economic and financial conditions continue.

Confidence and trust, conduct and culture in retail financial services

Not surprisingly, the litany of misselling scandals (personal pensions, mortgage endowments, PPI and so on) has left a legacy of consumer mistrust in financial services.

Low levels of confidence and trust deters consumers from saving for future needs such as retirement. This is a problem in its own right. But, this in turn has wider public policy effects. Real economy firms are denied access to long term investment capital. Consumers are encouraged to put money into property - for example in the form of buy-to-let – which contributes to property price bubbles. The result is misallocation of resources within the economy and an increase in systemic risk.

Changing the culture in the industry and improving confidence and trust has been a priority for regulators and consumer groups for some time now. There is still much to be done. New examples

[18] The problems with old or dormant savings accounts is a separate issue. Interest rates on these accounts may be very low and banks and building societies may be exploiting consumer inertia but aside from poor information, there are few real barriers to switching. Captive consumers face much greater problems if they want to escape from a poor value, exploitative product.

of poor conduct in retail financial services will continue to come to light as legacy problems are uncovered. Bringing the PPI scandal to a close will expose new failings in the industry further denting confidence and trust[19]. An increase in claims management company activities will affect consumer confidence and trust in financial services.

The new economic and financial reality described above will make it difficult for some firms with costly legacy business models to make profits fairly. There will be a temptation to cut corners or put sales targets above consumer needs. Regulators have also begun to subject wholesale and institutional financial markets to the same type of scrutiny as retail financial services and are likely to uncover examples of misselling/ poor conduct of business.

But, it has to be said that on the face of it, there have been improvements in conduct and culture in retail financial services driven by tougher, more interventionist conduct of business regulation. We hope that policymakers and regulators resist the pressure from industry to deregulate (see below). The question now of course is: can this improvement be maintained and built on?

Markets can be made to work using three levers:

- Firstly, tough regulators target the root causes of market failure and proactively make markets work for consumers rather than try to create the conditions for markets to work.
- Secondly, the right culture and ethics are internalised and embedded within firms and across the industry.
- Thirdly, market forces are aligned to produce the right outcomes for consumers – this is very different to the illusion of competitive activity.

In other consumer markets, market forces work well to ensure that firms look after the consumer interest. But market forces are not effective at making key financial markets work. Contrary to competition theory, consumers exercise very little influence over the behaviour of financial providers (and probably never will). But, market forces can become more effective if institutional investors, analysts and credit rating agencies, and consumer organisations exercise due diligence more responsibly and use their influence and financial clout to discipline market behaviours.

Therefore, internalising and embedding good conduct, culture and ethics into firms' operations will be necessary to build on regulatory successes. But, in our experience, the boards and senior management of many firms struggle to understand the root causes of conduct risk. If they do not understand the root causes, they cannot fix the problems.

The challenges outlined above – dealing with the new economic reality, transition problems, restructuring, legacy issues etc – means there is a risk that changing corporate culture will fall down the list of priorities.

Robust supervision and enforcement of the SM&CR will be critical, as will hard-wiring tough rules on conflicts of interest into the new bank ring-fencing requirements.

To be fair, there has been a recognition on the part of some of the more forward looking leaders in the industry that things have to change. With this in mind, the Centre intends to work with

[19] The FCA is planning to introduce a two year deadline for PPI claims to be made

progressive financial services firms to help them develop good conduct standards, a consumer focused culture and fairer products and services. We take the view that campaigners can improve consumer outcomes by working with industry as well as continue to campaign for better, appropriate regulation.

Deregulation

Due to a combination of financial services lobbying and a change in political direction, we may see a reversal of some important regulatory gains made since the financial crisis – both in terms of prudential and conduct of business regulations, and at EU and UK level.

Over-regulation and 'red-tape' has been blamed recently for causing the financial advice gap, stifling innovation and competition, restricting lending to households and the real economy, and preventing the development of an effective EU single market.

This, of course, is not the case. The advice gap can be explained by the economics of distribution, not over-regulation. Realistic prudential regulation has promoted more responsible lending. Good regulation promotes socially useful innovation and competition that works in the interests of consumers. It is hard to think of a genuinely socially useful innovation that would have been prevented by the tougher regulation we have now.

More generally, regulation codifies the corporate standards we would expect from a well-run business that had the interests of consumers at heart. In other consumer industries, building quality and safety into product design and development is seen as positive, and compliance is not seen as a burden or a drag on innovation.

Deregulation could be very counterproductive. There are the direct concerns about weakening consumer protection. But there could be wider effects on consumer confidence and trust – which in turn could undermine public policy goals such as encouraging households to save for a pension (see above).

Consumer groups will need to continue to monitor regulatory developments and be alert to attempts to reverse hard won gains.

EU regulatory issues and EU referendum

This paper was prepared before the announcement that the UK had voted to leave the EU. Brexit will, of course, have a major impact on the UK financial services industry and consumers. But, it will take some time before we can establish with any degree of certainty what that impact will be.

All the risks identified in this paper will still be there and need to be dealt with. However, in some cases, the risks will be exacerbated – particularly in relation to financial stability, prudential and market behaviour risks.

In the near term, not much is likely to change with regards to consumer protection unless the UK Parliament acts to amend existing legislation derived from EU legislation or decides not to implement legislation in the pipeline. But the long term future of financial regulation is a major concern.

UK firms could lose valuable 'passporting' rights to sell products and services to the EU. The temptation now will be for policymakers to reduce regulatory standards in the hope that this will improve the competitiveness of the UK financial services sector when trying to attract business from other parts of the world. If this happens, the conduct risks we identify here will be exacerbated.

But, while the Brexit vote is not necessarily a short term risk for consumer protection and conduct of business, the same cannot be said for financial stability and prudential regulatory risks. Brexit certainly heightens those risks immediately.

In the meantime, the UK remains part of the EU and financial consumers will be affected by the development of EU regulation as well as UK regulation. If the industry is successful in lobbying for deregulation, this could be set in stone by the time the UK finally leaves.

There are a number of very important EU related initiatives underway this year. The main issues are the Capital Markets Union (CMU) project, the retail market integration initiative, deregulatory initiatives and, of course, the negotiations in advance of the referendum on whether the UK should leave the EU.

As we explained elsewhere[20], we are very concerned that the powerful industry lobbies are using the CMU and retail market integration initiatives as an excuse to try to persuade the European Commission to reduce the level of consumer protection. The industry claims that regulation and 'red-tape' is stifling the single market and holding back innovation.

This is a very dangerous game to play. We agree that inconsistent regulation or duplication does not help consumers or the real economy. But, reducing the level of regulatory protection would be a false economy and would undermine trust and confidence in the financial sector which already scores very badly in the EU Consumer Market Scoreboard[21]. The idea that we need to deregulate to promote competition and expansion of the single market is based on flawed economic analysis.

We urge civil society organisations to be alert to the finance lobby's efforts and campaign to ensure that hard won gains are not lost whether at UK or EU level.

Financial Advice Market Review (FAMR) and financial advice

HM Treasury and the Financial Conduct Authority (FCA) recently launched the Financial Advice Market Review (FAMR)[22] to address the so-called 'financial advice gap' in the UK – concerns that large numbers of consumers are unable (or unwilling) to access good quality, appropriate financial advice. Our submission can be found here[23].

Good advice is critical for promoting financial inclusion, financial resilience and security amongst households – particularly lower-medium income households which are the focus of our work at the Centre. So, we welcome the FAMR. But, it is important that we understand the real causes of the advice gap. Claims that the advice gap is caused by or has *emerged* because of over-regulation are wrong - or disingenuous and used to try to reduce much needed consumer protection. Remedies based on false analysis would exacerbate rather than improve the situation.

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[20] http://inclusioncentre.co.uk/wordpress29/?page_id=542
[21] This is a major pan-EU study which rates consumer sectors according to consumer trust and satisfaction – the main financial sectors regulatory score near or at the very bottom of the rankings. See http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/index_en.htm
[22] https://www.fca.org.uk/firms/firm-types/financial-adviser/financial-advice-market-review
[23]http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2011/04/financial-inclusion-centre-FCA-FAMR-submission-publication-final.pdf

A more accurate assessment is that robust, better regulation has *exposed* a long established advice gap. When thinking about the concept of an advice gap, it is important not just to think of access to advice *per se* but whether it produces the right outcomes for consumers. It would be easy to close the advice gap if we just allowed the industry to go back to advising on and selling poor value, unsuitable products. But, of course, that would be unacceptable.

The real reasons for the advice gap in our view are: growing numbers of consumers simply cannot afford to save and invest, or pay for for-profit advice; and large numbers of consumers are 'underserved' by the financial services industry because the industry is still too inefficient to meet their needs. In other words, it's all about the economics of access and distribution.

Reducing consumer protection to encourage the industry to serve more consumers is not the way forward. Instead the industry would continue to serve medium-higher income consumers but with weaker constraints on its behaviours. The overall effect would be to just transfer the risk of misselling to consumers thereby undermining confidence and trust in financial services. Closing the advice gap, therefore, means focusing on making the financial services industry more efficient so it can extend its reach to more consumers and providing alternative provision for consumers who are not commercially viable for the for-profit advice sector.

3.2 WHOLESALE/ INSTITUTIONAL FINANCIAL MARKETS, FINANCIAL INFRASTRUCTURES

In this section, we look at: major risks in the wholesale and institutional financial markets and infrastructures; and the relationship between the financial sector and the real economy and wider society.

Specifically, the key issues we cover in this section are:

- The financial sector and economic resilience.
- The future of defined benefit pensions.
- Financial market behaviours in the new economic climate.
- Corporate conduct and cultures in wholesale and institutional financial markets.
- Fintech and the financial system.
- Financial infrastructures.
- The economic and social utility of the 'City'.
- The impact of the financial sector on economic inequality.
- Asset management and pensions.

The financial sector and economic resilience

Compared to previous financial market crises[24] the crisis of 2007/08 was unusual in:

- the nearly catastrophic effects it had on our core financial system (the first phase *financial* crisis);
- the way it spread out from the financial system to damage the wider economy in the form of a major recession and prolonged slowdown (the second phase *economic* crisis); and
- the serious damage done to the economy which subsequently harmed household incomes and public finances (the third phase *political* and *social* crisis).

Therefore, in the aftermath of the financial crisis, there are three very important questions to consider:

1. Has the risk of new financial crisis been mitigated?
2. In the event of a new crisis, has the risk of contagion from the financial system to the wider economy been reduced?
3. Linked to this, is the economy more resilient to financial shocks and more able to continue to function in the event of the financial system seizing up (for example, would firms and households be able to transact and have access to finance)?

In terms of the first two questions, there has certainly been a great deal of macro and micro prudential developed post crisis designed to promote financial stability and make financial institutions safer. Banks have been required to increase the amount of capital they hold and will also have to ring-fence their retail operations from wholesale operations. Ring fencing is a step forward but this is not as strong as a full separation of retail and wholesale operations. We won't know whether this regulation is effective unless it is tested by a new financial crisis.

[24] (such as Black Monday in September 1987 or the bursting of the Dotcom bubble in 2000/01),

Of course, we must hope we don't see a recurrence of the 2008 crisis. But there are fears that:

- the UK is building up serious levels of debt again;
- major risks have not actually disappeared but been transferred to the shadow banking system;
- financial 'innovation' is again making markets vulnerable to sudden shocks;
- markets are vulnerable to liquidity crises; and
- irrational financial market behaviours are creating new systemic risks.

More generally, there are concerns that the UK banking and financial sectors are still just too big for the economy - indeed, the sector is expected to grow in size[25].

The UK is considered by some to have the least resilient financial system in the G7[26]. The position of the UK as one the two leading global financial centres and our economy's over-reliance on financial services makes it unusually exposed to international capital market risks. Financial stability and resilience needs to be continually monitored. Moreover, the vulnerability of our financial networks and infrastructures to cyber-attacks has emerged as a real concern recently.

At least some progress has been made on macro and micro prudential regulation. We cannot say the same for the third challenge of making our system more diverse. It is encouraging that we are seeing the development of new forms of financial institution such as P2P lenders and payment system providers. But, *as it stands*, we do not believe that these new institutions will take sufficient market share from dominant providers in financial system to ensure real diversity and make the economy more resilient. A key barrier are the doubts consumers have about the sustainability of new financial institutions.

The absence of alternatives leaves society vulnerable to the 'too-big-to-fail' syndrome. Big banks and financial institutions will always be in a strong position to repel attempts at reform given our reliance on these institutions to organise the financial system.

We face a real dilemma. We need greater diversity to reduce our reliance on to-big-to-fail financial institutions. But, without major policy interventions to create space for growth, and promote consumer confidence in these smaller institutions, they will not achieve enough 'organic' growth to provide a real alternative to the big banks and financial institutions. However, the fact that these institutions *are* too big to fail, means that policymakers may lack the will to force through real change.

Therefore, one of the big policy questions we need to address over the next few years is:

- Which policy interventions are needed to promote economic resilience; and
- How do we build a viable case and consensus for reform?

We are keen to encourage debate on this.

[25] Mark Carney, Governor of the Bank of England has said that the size of the UK-based market-based financial system could increase from six times now to nearly 15 times UK GDP by 2050. See: http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech865.pdf
[26] See http://www.neweconomics.org/publications/entry/financial-system-resilience-index

The future of defined benefit (DB) pensions

The future of employers pension schemes – particularly defined benefit (or 'final salary') schemes – has been a major concern for regulators, employers and, of course, workers and pensioners who rely on these schemes to provide an income in retirement.

A recent report from the Pensions Institute makes clear the sheer scale of the potential risks facing these schemes[27]. There are over 6,000 pension schemes in the Pension Protection Fund (PPF)[28] Index of private sector DB schemes. Together, these schemes are responsible for paying the current and future pensions of around 11 million members and their dependants.

The assets of these schemes are valued at around £1.2 trillion. But, the liabilities are estimated to be valued at £1.5 trillion using the PPF valuation measure[29]. This equates to an aggregate deficit of 20%. But, this conceals a wide range of situations. Over 1,000 schemes are in surplus and if these schemes are excluded the aggregate deficit is actually closer to 25%. However, the true position may be even worse. Experts suggest that if the full value of the pension benefits is included, the liabilities are closer to £2 trillion – an aggregate deficit of 40%.

It is important to note that underfunded schemes are effectively an unsecured creditor to the company providing the pension which may have a poor credit rating.

The PPF's view is that 10% of employers that sponsor schemes in its index are unlikely 'ever' to pay off their pension scheme debts - around 600 schemes. But the Pensions Institute experts estimate that 1,000 schemes are very unlikely to pay future pensions in full. Many of these are expected to become insolvent in the next five to ten years including some which will face insolvency due to the pension scheme deficit.

This presents us with a very difficult dilemma about what to do to safeguard these pension entitlements. If action isn't taken, many scheme members (and dependants) will not get the pension they expect. But, if employers are required to put more money into the pension scheme to close deficits, some claim that this could affect the economic viability of sponsoring firms.

Of course, scheme trustees could hope that the fund managers who invest the assets on the scheme behalf will produce better investment returns to close the deficit. However, there is a risk that, to generate these better returns, trustees will be advised by financial intermediaries to adopt much higher risk investment strategies. The problem is that fund managers and intermediaries do not have a good investment track record – see Asset Management and Pensions, below.

So, we do not have confidence that professional advice would produce the necessary returns to close these deficits. Indeed, higher risk investment strategies could exacerbate the problem with deficits. Trustees may put off taking more direct action in the hope that these high risk strategies will deliver. At a future point, the scheme would still have the same liabilities. But if the hoped-for

[27] The greatest good for the greatest number, A Pensions Institute discussion paper for DB trustees, sponsoring employers, advisers, policy-makers and regulators, Debbie Harrison, David Blake, December 2015, http://www.pensions-institute.org/reports/GreatestGood.pdf - note, Debbie Harrison is a trustee of the Centre

[28] The Pension Protection Fund pays compensation to members of eligible defined benefit pension schemes, when the employer goes bust and there are not enough assets in the pension scheme to cover Pension Protection Fund levels of compensation.

[29] As at September 2015, based on cost of paying out pensions at PPF levels. The actual liabilities are even higher

investment returns do not materialise, the scheme's assets could be worth even less – increasing the deficit.

The problem is exacerbated by the behaviour of some sponsoring firms who have been accused of using dubious techniques to get rid of or sidestep their scheme's deficits or exploit surpluses – what is known as 'milking and dumping'[30].

It is not at all clear how the problem with scheme deficits can be resolved. But, something has to be done even if none of the escape routes look particularly attractive. Waiting and hoping that this will resolve itself over time is not a sensible option and creates its own risks. Better prudential regulation and much tougher conduct of business regulation is needed in the employers pension scheme sector. The question now is: will someone take the lead to try to map a way out of this dilemma?

Financial market behaviours in the new economic and financial reality

Financial markets are again fearful about the slowdown in the global economy and risks in the global financial system. No one really knows if we are at risk of another financial crisis similar to 2007/08 or if the macro and micro prudential measures put in place in the aftermath of the last crisis will be sufficient to protect the real economy this time around.

But, even if we do avoid the worst-case scenario, prospects for economic growth are not promising. This low growth along with the continuation of the ultra low interest rate policies must feed through and affect the expected returns for the main investment asset classes – equities, bonds, cash, property and so on.

The overall question we are concerned with here is whether financial markets and financial market participants have factored in this new economic and financial reality into their expectations and adjusted their behaviours accordingly.

The specific questions which need to be addressed are:

- What evidence has there been of investors 'searching for yield' in this new low return environment? What form has this taken, which type of investments and financial instruments have investors sought?
- How have different investor profile groups reacted (pension funds, local authorities, retail investors, insurers etc)?
- Looking to the future, what are investor expectations in this new environment, have they now adjusted future expectations?
- If they have adjusted expectations, have they also adjusted behaviours (for example, have pension funds/ savers increased contributions or taken a bigger risk on high risk/ high return asset classes)?
- Do different investors understand the risks involved with higher yield investments (for example, with 'coco' bonds, catastrophe bonds, swaps strategies)?
- How have regulators responded? Have they revised prudential regulation requirements, reduced investment projections to be used in marketing and promotional material?

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[30] The Pensions Institute, Milking and Dumping: The Devices Businesses use to Exploit Surpluses and Shed Deficits in Their Pension Schemes, August 2016 http://www.pensions-institute.org/reports/MilkingAndDumping.pdf

- What explains investors behaviour – is it presentation of information, actions of financial intermediaries and advisers, consequences of regulatory interventions, or more fundamental behavioural problems?
- Which interventions are most effective at discouraging potentially reckless behaviours in the low yield environment?
- If interest rates do begin to rise (as some believe is inevitable), how will investors respond?

Despite awareness of the search-for-yield phenomenon being fairly high, there is surprisingly little substantive research and analysis on what drives investor behaviour and which interventions may work. Crucially, it is important that we understand how investors might respond if there is a change in sentiment – for example, if investor attitudes toward benchmark assets hitherto considered safe change. We are keen to do more work on this.

Corporate conduct and cultures in wholesale and institutional financial markets

Understandably, consumer groups and media have tended to focus on the retail financial services industry. This has been driven by the need to restore confidence and trust following a litany of high profile misselling scandals. As a result, on the face of it, there have been improvements in conduct and culture in retail financial services driven by tougher, more interventionist conduct of business regulation.

But, it is not clear that the same progress has been made in improving conduct and culture in the wholesale and institutional financial markets. Scandals in these markets are still coming to light. In some ways, conduct and cultures in the wholesale and institutional markets are more critical than in retail financial services. The structure of incentives and conflicts of interest in these markets not only cause misselling, but can undermine the economic utility of financial markets and undermine financial and economic resilience.

As with retail financial services, wholesale and institutional financial markets can be made to work using three levers:

- Firstly, tough regulators target the root causes of market failure and proactively make markets work.
- Secondly, the right culture and ethics are internalised and embedded within firms and across the industry.
- Thirdly, market forces are aligned to produce the right outcomes for clients – this is very different to the illusion of competitive activity.

In other markets, competition works well to ensure that firms look after the interest of clients. But the evidence of history suggests that competition *per se* and the commercial self-interest of major investment banks and financial institutions is not effective at making wholesale and institutional financial markets work.

Until recently, this has not been recognised by financial regulators. The dominant belief has been that participants in the wholesale and institutional markets are 'sophisticated' and able to look after

themselves. The theory held that the power of clients in the market would cause those selling services to treat clients fairly and sell good value products and services or risk losing business. Markets would then self-correct in the event of market failure.

But, these clients are not as sophisticated as previously assumed by regulators and can be just as vulnerable to unfair treatment as retail investors. Pension fund trustees, local authorities, SMEs, and even other financial institutions have been victims. If these agents were risking their own money, that is one thing. But these agents are often representing other investors or managing other people's money, or have employees who depend on the solvency of a firm in the real economy.

Therefore, internalising and embedding good conduct, culture and ethics into wholesale and institutional market operations must be a priority. The high stakes involved in these markets, and the failure of competition to police behaviours means that it is unlikely that self-regulation will be effective at improving conduct and culture.

Tough regulatory interventions will be needed to improve conduct and culture and make these critical markets work. The wholesale and institutional financial markets are perceived to be a huge economic asset for the UK (the 'golden goose'). But, this perception must not be allowed to prevent financial regulators from taking tough action to improve conduct in these markets for fear of killing the golden goose. The net value of these financial markets to the UK economy is much lower when the various externalities and social costs are factored in (see, the economic and social utility of the City, below).

Fintech and the financial system

As we explain in the section on retail financial services, there is much debate underway about the potential for fintech and 'big data' to help new entrants introduce some real competition for the big banks and transform the retail financial services industry to the benefit of consumers.

But, the potential for fintech is not limited to retail financial services. Just like the fintech evangelists in retail financial services, there are claims that fintech could transform the wider financial markets, financial systems and infrastructures.

For example, blockchain technology is being heralded as way to greatly improve the efficiency and flexibility of our core financial infrastructures, the efficiency of clearing and settlement of trades and back office functions leading to lower costs for investors, cross-border payments, and reduce compliance costs. Some analysts have predicted that it could reduce infrastructure, transaction, and compliance costs by $15-$20bn a year from 2022[31]. If the market is working effectively, these savings should be passed onto investors in the form of lower end-to-end costs.

In addition to improving the efficiency of critical processes, in theory, blockchain technology should enable banks to hold less regulatory capital against the risk of transactions failing to settle. If this is the case, this should free up some additional capital for lending to the real economy and households.

[31] See FT, Technology: Banks seek the key to blockchain, November 1, 2015, http://www.ft.com/cms/s/2/eb1f8256-7b4b-11e5-a1fe-567b37f80b64.html#axzz3zrPJpp1r

The potential isn't limited to the financial sector itself. Similar technology can help 'real economy' firms manage treasury functions, invoicing, and fraud.

Promoters of blockchain technology also maintain that there could be a significant regulatory dividend allowing for real-time monitoring of financial positions and defaults. Moreover, it is claimed that the potential for checking the identities of different parties involved in complex transactions should help regulators mitigate the risk of money laundering and fraudulent transactions, ultimately making markets safer and more trustworthy. In theory, blockchain technology could even have an impact on the role of auditors who would not face the same challenges pulling together and auditing relevant financial data.

Taking to its limit, these technologies could fundamentally transform the nature of transactional banking. One of the key reasons given for the hesitation of the tech giants such as Google, Facebook and Amazon moving into the banking market in a serious way, is the capital intensive nature of banking – it ties up a lot of capital. As explained, blockchain technology allows financial institutions to hold less risk capital so, in theory, this should be less of a barrier. However, it is not clear whether the tech giants are interested in infrastructure banking and may focus their efforts on retail financial services.

The role of fintech is not limited to improving back office processes. Algorithmic trading has been a feature of financial markets for some time now used to exploit tiny discrepancies in prices on financial markets and execute trades in incredibly quick time – when it comes to these functions, computers are much more efficient than humans. But, algorithms are now increasingly being used to try to add more value by making more complex investment decisions such as asset allocation and managing risk exposures.

However, as with retail financial services, the truth is, no one yet knows what the impact of fintech will be on the wholesale and institutional markets, and financial infrastructures. These innovations may be impressive. But, what matters is whether these innovations actually lead to a more efficient financial system from the perspective of investors and the real economy. Serious thought will need to be given to establish whether we are on the cusp of real change and to establish whether fintech can make the financial system more efficient. So far, we see little evidence to suggest that resources are allocated more effectively or risks better managed as a result of this cutting edge innovation.

Equally importantly, we are still trying to understand what the risks associated with these new technologies. There are difficult questions to address with regards to how regulators might safeguard money in such a decentralised financial system. There are also concerns about the ability of regulators to supervise approaches such as algorithmic trading. It also not clear whether regulators have the necessary capacity and skills to keep up with developments, or appropriate risk management approaches.

Again, this is another area which needs a great deal further work and input from civil society to ensure the potential benefits materialise and risks mitigated.

Financial infrastructures

We often take for granted the financial infrastructures (the payment systems, ATM networks, the IT infrastructure, clearing and settlement systems, and exchanges) which supports the financial services we interact with regularly – until it goes wrong.

Technology plays an increasingly important role. Major concerns have emerged about the resilience and stability of our major financial networks and systems, and cybercrime and bank fraud. Bank IT failures seem to be becoming more frequent.

Retail consumers and businesses are also increasingly falling victim to cybercrime and fraud. Recent research suggests that there were 5.8 million fraud and computer misuse cases in England and Wales in 2015[32].

Innovations such as blockchain technology are expected to be used more to undertake many of less exciting but critically important activities such as making payments or settling trades on the financial markets.

The key challenge here will be to make sure that policymakers and regulators have the necessary resources to identify potential risks to the financial infrastructures from increasing use of innovative technology. But, given the nature of financial infrastructures (the interconnectivity of financial systems, the sheer number of transactions that go through the UK infrastructures, the central role UK infrastructures play in the global financial system, the vulnerability of fragmented legacy systems) mitigating these risks may prove very difficult.

There are also concerns about the impact of dominant suppliers in the payment systems market on access and competition. To be able to transfer funds for end-users, payment services providers (PSPs) need access to the interbank payment systems. While there are around 2,500 payment services providers, the main payment systems (CHAPS, BACS, Faster Payments, and the ATM network) are dominated by a handful of powerful institutions. These critical infrastructures need to be carefully monitored to ensure these dominant positions are not abused.

The economic and social utility of the 'City'

Perhaps understandably, consumer groups and media tend to focus on retail financial services[33] but have largely ignored the role of the wholesale and institutional financial markets (the 'City'). This is unfortunate given the importance of the City to ordinary households and the real economy.

The availability of retail financial services depends on the wholesale and institutional financial markets. For example, the City undertakes the critical process of financial intermediation and credit creation so that households can get the mortgages they want. Market failure in the City is transmitted through the supply chain to affect retail consumers. The City is also supposed to meet

[32] ONS, Crime in England and Wales: year ending March 2016
http://www.ons.gov.uk/peoplepopulationandcommunity/crimeandjustice/bulletins/crimeinenglandandwales/yearendingmar2016#new-estimate-of-58-million-csew-fraud-and-computer-misuse-offences

[33] the provision of banking, insurance, mortgages and consumer credit, personal pensions, financial advice and so on

the needs of the real economy and help firms manage economic risk (such as volatile currency fluctuations which can make it difficult for firms to forward plan).

One of the primary economic roles of capital markets (and various intermediaries) is to channel capital from where it is, to where it's needed in the real economy. There are two main ways for this to happen. Firms and households can borrow money in form of loans (secured and unsecured) or bonds. Firms can also attract investment from investors[34].

To help the real economy, financial markets should channel this capital in the most economically and socially useful way possible. But, the City has been criticised for misallocating resources to unproductive activities and creating risks rather than help manage risks. For example:, banks have lent too much to other banks rather than to firms in the real economy; the credit creation process has pumped up asset price bubbles in the housing market risking another financial crisis and pushed home ownership beyond the reach of more and more younger people; and asset managers have failed to deliver decent returns for investors, and become too short-termist in their outlook depriving firms of long term investment capital.

The role of asset managers is critical. High charges, poor investment performance, and short term thinking not only harms the financial well-being of households saving for a pension, it means less capital gets to real economy firms and harms long term, sustainable economic growth.

Furthermore, there are concerns that the very measures that had to be deployed to rescue the economy (such as QE[35]) from the financial crisis are causing distortions in the financial system and the economy– for example, contributing to wealth inequality, resource misallocation that undermines economic productivity, and starting a new boom and bust cycle.

Assessing the economic and social utility of the financial sector and externalities created will be a key area of work for us over the next few years. These are discussed in more detail in our forthcoming economic and social audit of the City.

The impact of the financial sector on economic inequality

Although there has some work published on the relationship between the financial sector and inequality, it is still a largely unexplored area. The sector can contribute to inequality in a number of ways.

- The role the financial sector has played in creating housing market bubbles has exacerbated the intergenerational wealth gap and made it more difficult for younger generations to get on the housing ladder. Similarly, the growth in buy-to-let loans has contributed to a high price-high rent-high price spiral.
- Furthermore, it is worth noting the concerns that the same measures[36] deployed to rescue the economy in the aftermath of the financial crisis – albeit much needed at the time – may now be exacerbating wealth inequality and contributing to social exclusion by creating property price bubbles.

[34] This is of course is a simplification. There are many hybrid financial products and instruments which exhibit characteristics of debt and equity.
[35] Quantitative easing
[36] For example, quantitative easing and sustained, ultra-low benchmark interest rates

- Consumer credit can be helpful for some households needing to smooth consumption, but the growth in debt caused/ contributed to the financial problems faced by vulnerable households as high debt and interest repayments accounted for a rising share of disposable income and restricted the ability of households to save.
- At the macro level, an expansion in consumer credit results in a transfer of income in the form of debt interest payments from the lowest income decile households to the highest income decile households.
- Moreover, market failure in the wholesale markets has been transmitted through the supply chain pushing up the cost of retail products sold to households.
- Finally, there is evidence to suggest that the high salaries available in the City directly contributed to income inequality while investment decisions made by London-centric investment community exacerbates regional imbalances.

Failure to take into account these wider externality impacts means that policy interventions have not gone far enough to align the interests of the City with wider economic and public policy goals.

One of the key problems is the absence of an appropriate institutional framework for identifying and dealing with these externalities. The UK's major financial policy and regulatory institutions[37] have clear but limited statutory objectives – for example, relating to financial stability, prudential regulation, competition and consumer protection.

But we do not have an equivalent institutional framework for identifying and proposing policy to deal with the types of externality caused by financial market behaviours outlined above. Of course, it could be argued that HM Treasury has overarching responsibility for financial services policy and ensuring the sector supports the economy. But, this is too narrow and does not explicitly address the problems identified here.

Understanding the impact of financial markets on inequality and other externalities and developing the appropriate institutional policy framework and mechanisms is an area which needs further work by civil society and consideration by policymakers.

Asset management and pensions

UK pension fund assets are the second largest in the OECD and worth more than 100% of UK GDP. The powerful institutional investors who manage these assets play an important role in not only looking after the pensions and long term savings of households, but channelling and allocating resources to the real economy. So, it is critical that asset management industry performs an economically and socially useful role.

We previously published research showing the sustained underperformance of UK pension funds against OECD rivals over the medium-long term[38]. Investment underperformance affects the retirement incomes of households. Underperformance also creates wider externality costs for the real economy and society given the importance of private pension schemes in overall pension provision in the UK. The worse the performance, the more households, employers (where relevant), and, ultimately, the state have to contribute to ensure a decent income in retirement for individuals.

[37] Bank of England, FPC, PRA, FCA
[38] http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2011/04/OECD-Pension-fund-performance-Financial-Inclusion-Centre-briefing.pdf

This can lead to reduced disposable incomes, higher employment costs and/ or lower wages, and higher public spending in the long term.

But, in addition, the greater value the various intermediaries in the asset management industry extract in fees and costs, the less resource gets channelled into the real economy. Market short termism and poor investment decisions result in inefficient resource allocation within and undermine long term investment in the real economy. The role of powerful investment consultants who have such an influence on pension fund trustees who oversee a large part of pension fund assets has been called into question.

Making sure these powerful institutional investors provide good value, support the real economy and are held to account must a priority for anyone in civil society interested in campaigning for a better financial system.

Greater transparency and disclosure is desirable in this market. But, we know from experience that transparency and information disclosure have limited effect on controlling behaviours in financial services. In other words, information is necessary but not sufficient.

There are a number of more direct interventions which would be much more effective at aligning the interests of asset managers, intermediaries in the supply chain and the ultimate end-user including:

- Fund managers should bear all the transaction costs associated with running funds and charge clean prices.
- Fund managers should disclose past performance of all funds against objective benchmarks (and specific time periods) agreed by regulators.
- Fund managers (and custodians/ trustees/ fiduciaries) should be required to explain in detail: why funds have underperformed against benchmarks, what actions have been taken to address this poor performance, and justify why they are not cutting investor charges to compensate for poor value.
- Fund managers prohibited from changing a benchmark unless approved by regulators/ supervisors.
- It should be made clear that selective use of past performance data and benchmarks for reporting and marketing/ promotions are breaches of regulation and can be enforced against.
- Regulations toughened up to ensure that custodians/ fund trustees or similar fiduciaries act more responsibly and clearly in the interests of fundholders by monitoring the behaviour of fund managers and disclosure to investors, reporting to regulators, and dismissing fund managers.
- Financial reporting standards should be reformed so that asset managers are required to report properly on environmental, social and governance (ESG) performance and risks.

The asset management sector will continue to be a focus of our campaign work given its importance to households and the real economy and the scale of market failure.

3.3 MAJOR PUBLIC POLICY ISSUES

The UK faces public policy crises in many important areas. Access to affordable, good quality housing – whether to buy or rent – is at the top of the list of priorities. Similarly, making sure people can look forward to a dignified retirement free from poverty and anxiety about being able to pay for decent long term care, if needed, remains a major concern for households.

The legacy of overindebtedness and historically low savings ratios means that we need to promote financial inclusion and build financial resilience to protect against financial shocks and long term financial security. Linked to this, helping the millions who face economic insecurity (the self-employed and others in 'non-standard' employment such as zero hours contracts, temporary and part time work) build financial security and save for retirement has emerged as a priority.

The financial services industry has a major role to play in tackling major public challenges facing the UK. But, the scale and nature of these public policy challenges[39] means that these cannot be solved by the financial sector and its regulators but need concerted action from government and third sector.

Below, we summarise the key priorities covering:

- Tackling the housing crisis.
- Pensions and retirement incomes.
- Funding long term care costs.
- Financial security in an age of economic uncertainty.
- Helping vulnerable households build financial resilience.
- The role of housing equity.

Sadly, little progress has been made on these priorities. Policymaking in the UK seems to be particularly susceptible to the blight of short-termism. We have neither the mindset nor institutions in place to face up to major long term challenges such as affordable housing, creating new economic safety nets, paying for decent pensions and long term care, and funding much needed social and economic infrastructure. More data on these issues can be found here[40].

The housing crisis

The housing crisis seems to be deteriorating, certainly in terms of affordability for first time buyers in certain areas of the country. The number of houses built each year in the last parliament (2010-2015) was the lowest since 1923[41]. Moreover, we have seen nothing meaningful to protect renters in the private sector from exploitation. The contrast between the comprehensive consumer protection regime available to well-off financial consumers and the lack of protection available to vulnerable renters is striking.

If we want to seriously tackle the housing crisis, the radical measures will be needed in the following areas:

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[39] Economic or financial theory alone cannot provide the answers to these problems as the responses involve difficult ethical questions about the use of public resources, fairness and redistribution
[40] Major public policy issues- http://inclusioncentre.co.uk/wordpress29/?page_id=880
[41] See http://www.independent.co.uk/news/uk/politics/david-cameron-housing-housebuilding-prime-minister-england-john-healey-a7144646.html

- Efficient funding mechanisms to fund the necessary increase in supply of housing – see our proposal for a London Social Housing Bond[42].
- Targeted rent controls to protect renters, reduce the amount spent by taxpayers on housing benefit, and to address the high rent/ buy-to-let/ high house price spiral (this could also be addressed through prudential regulation of buy-to-let mortgages).
- A decent consumer protection regime for renters with similar rights and protection available to financial consumers encompassing a proper landlord registration scheme, quality standards for homes, and rights of redress – see our pamphlet setting out a framework for a new renters protection scheme[43].
- Reforms to property and land taxes, and the planning system.

Pensions and retirement incomes

The creation of NEST and auto-enrolment into pensions continues to be one of the real success stories in public policy. But challenges lie ahead as the scheme is rolled out to smaller employers who do not have the same resources as larger employers.

Moreover, the pensions 'freedoms' create a whole new set of risks for consumers when they come to 'decumulate' their pension pot to provide an income in retirement. The pension freedom reforms threaten to reverse the progress made through the introduction of NEST and autoenrolment. With pensions policy, it's a case of one step forward, two steps back.

The types of risks emerging include:

- An increased risk of misselling as products become even more complex.
- Consumers being exposed to outright scams.
- Consumers paying higher charges and greater inefficiencies introduced into the pensions market as a result of new layers of products and costs.
- Consumers being exposed to greater market and longevity risk.

Robust consumer protection and access to the right financial guidance/ advice are short term priorities to protect consumers from the risks of misselling and from the wrong decisions. But, as well as presenting immediate risks, there are longer term concerns. If experience from other countries is to go by, the reforms will also introduce inefficiencies into the retirement planning process. Consumers will have to save more for retirement to offset higher costs[44]. This will need to be monitored very closely by regulators.

To address these risks, one solution would be to introduce a NEST style default decumulation option to act as a beacon of good value for consumers to help them make better decisions and promote some real competition in the market. Another potential solution would be to explore whether the state can play a bigger role in providing a low risk, good value alternative. Currently, people can 'buy' extra state pension through additional national insurance contributions or receive a higher state

[42] See http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2015/10/London-Social-Housing-Bond-051015.pdf
[43] http://inclusioncentre.co.uk/wordpress29/
[44] See http://inclusioncentre.co.uk/wordpress29/2015-and-beyond-financial-services-priorities/major-public-policy-issues for a more detailed explanation as to why the pension freedoms are a huge risk

pension by deferring the point at which it is received. These options can offer good value for many people.

But given the upheaval and new risks created by the annuity reforms, we think it is worth exploring whether these options can be improved – especially for households on low and/ or uncertain incomes, and the self-employed.

Furthermore, there is a case for exploring whether the current system of pensions tax relief could be used in a different way to further public policy goals. For example, what would the effect be of capping pensions tax relief at a flat rate and using the savings to boost low income/ self-employed pensions through a pension top up?

Long term care costs

It is important that we find the fairest and most efficient way of meeting the combined costs of long term demographic related challenges. The pension problems facing the UK have been well documented (see above). But with one in three women and one in four men aged 65 now expected to need long term care, working out how we fund this care presents another, potentially more difficult, challenge. Despite the recognition of the scale of the long term care funding crisis, the UK seems to have made little progress. If anything, the crisis is getting worse as local authority cuts begin to bite.

Care costs can either be paid for on a pay-as-you-go basis (out of current taxes), pre-funded in some way – or some combination. There are a number of options for pre-funding costs including:

- Through the state/local government (that is the state could require citizens to pay into what would be a hypothecated national insurance fund/ council tax).
- Other forms of collective provision (similar to the NEST pension scheme).
- Individual private sector financial services products (long term care insurance, pension/ LTC hybrids, and private sector equity release schemes).

In setting a cap on the amount people would pay towards certain aspects of care, the government had hoped that this would mean the insurance industry would be more willing to develop and offer new long term care insurance products. The theory is that people could insure themselves against that part of the costs which are predictable and insurers' costs would be limited.

However, this does not strike us as a very efficient method of prefunding long term care costs. This arrangement would mean the state still taking on the 'catastrophic' risk and picking up a large part of the care costs.

Moreover, despite urging by the government, the insurance industry does not seem very keen to develop the sort of insurance products to cover care costs. For now, industry representatives appear to see no business case in the new long term care products and think it would be even harder to persuade consumers to take out insurance products than it has been to provide for a pension[45].

Some have suggested that tax incentives are needed to persuade consumers to take out sufficient long term care insurance. But, the incentive approach wasn't successful in encouraging consumers

[45] See, Insurers shun call to reduce burden of care cost in old age, Financial Times, p2, 20th January 2015

to make sufficient provision for retirement through personal pensions. Moreover, much of the tax incentives provided by the taxpayer was eaten up in high charges on private pension products. It is difficult to see why the incentive approach would be any more successful with individual long term care insurance products.

This all highlights the difficulties involved in persuading the private sector and, of course, consumers to use private sector products. But if the private sector isn't suitable, what are the alternatives?

Drawing on the lessons from pensions reform, which led to the establishment of the NEST pension scheme, some form of collective provision (whether insurance based or prefunding) is likely to be the most efficient way of protecting the maximum number of people from unpredictable costs.

As with boosting retirement incomes, equity release may play a role in funding long term care costs. But as described below, the potential role is probably well overstated and much work needs to be done before equity release has a wider application for long term care costs.

With local authorities cutting spending on long term care, and the private sector so far unable to produce solutions to allow society to prefund care costs in an efficient way, it seems the long term care crisis can only get worse.

Specifically, the gap between the need for care and funds available (the funding gap) seems certain to grow. At some stage, civil society will have to return to this issue and develop new policies to fund long term care costs in the most efficient, fairest and equitable manner.

Helping economically vulnerable households build financial resilience

Many debt advice charities and social housing providers continue to do great work on providing support to overindebted and financially vulnerable households. But, we see very little evidence of improvements in overall financial resilience amongst financially vulnerable households.

Indeed, on some measures things are getting worse. Debt levels are rising again and the household savings ratio looks set to fall even further. Too many households are using consumer credit to manage cash-flow problems and to deal with financial shocks leaving them vulnerable to high cost credit providers.

Recent research suggests that one in three families in England could not pay their mortgage or rent in the event of losing their job[46]. High housing costs and low levels of savings are blamed.

The table below describes the characteristics of households who are financially vulnerable and financially resilient, and illustrates the 'journey' to financial resilience and longer term financial security.

[46] Shelter, see http://www.bbc.co.uk/news/uk-england-37017254

Table 2: The journey to financial resilience and financial security

Stage	Financial vulnerability/ insecurity	'Square one'	Financial resilience	Financial security
Definition	Consumers in a 'negative' position, vulnerable and exposed to shocks/ detriment	Consumers back to a 'neutral' position – still vulnerable, but with a platform to build on	Ability to withstand financial shocks/meet short-term financial needs	Sufficient means to meet medium to long-term financial needs
Main factors	Restricted access to transactional bank account Over-indebted/ vulnerable to subprime lending/trapped in vicious cycle No savings Exposed to risk, no/little insurance cover No pension/ underpensioned Housing problems, mortgage/rent arrears Low/unstable incomes, poverty Poverty 'premium'/paying more for basic goods and services	Effective budgeting/'making ends meet' (if possible, as may be outside control) In the financial system (functional bank account) Paid off unmanageable/ unproductive debt Still underinsured/ underpensioned	Income surplus Effective use of banking system Emergency savings (three months' income) Access to fair, affordable credit Basic insurance cover Some form of 'safety net' Beginnings of pension provision, but still underprovided for	Proper insurance cover, not just for contents but income replacement Paying off/paid mortgage Significant pension provision Long-term savings/asset accumulation Debt/assets lifecycle model positive position

Concerted interventions by government, regulators, civil society and financial services industry are needed to support households on this journey. The interventions needed include:

- Ensuring consumers can access a proper, functioning transactional bank account without high penalty charges, with easy accessibility (in terms of access to networks), and a reasonable overdraft buffer.
- Greater access to fair, affordable credit provided by viable alternative providers (see above for more detail).
- Greater access to fair, affordable insurance products.
- More effective use of technology and behavioural insights to help consumers budget better, to remove the barriers to saving, and to 'nudge' consumers into positive financial behaviours. For example, establishing web-based and physical savings access points, or working with debt advice charities to help clients coming off debt repayment plans start regular savings plans.
- Measures to tackle housing affordability.
- Measures to tackle pension underprovision.

More details can be found in our report on helping the overindebted and encouraging savings[47].

As we explained above when discussing the impact of the City on economic inequality, one of the key problems is the absence of an appropriate institutional framework for identifying and dealing with major public policy issues. The UK's major financial policy and regulatory institutions[48] have clear but limited statutory objectives – for example, relating to financial stability, prudential regulation, competition and consumer protection. But, we lack an equivalent institutional framework for implementing policy to build financial resilience.

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[47] http://inclusioncentre.co.uk/wordpress29/wp-content/uploads/2016/04/britains-debt-final-report.pdf
[48] Bank of England, FPC, PRA, FCA

Longer term financial security in an age of economic uncertainty

We estimate that nearly 40% of the workforce is now in non-full time/ non-permanent work[49]. In addition to low earnings, the uncertain and insecure nature of this work means that many of these households will find it hard to build up financial resilience and long term financial security.

The self-employed are a particular concern. Fewer than one in five of the self-employed participate in a pension scheme compared to 48% for employees. Pension participation rates have seen steep falls. In 1996/97, 62% of self-employed men were contributing to a pension compared to 21% in 2012/13. Just 12% of self-employed women participate in a pension scheme. Younger self-employed groups appear to woefully underprovided. Just 10% of the self-employed in the 25-34 age group are in a pension scheme compared to 44% of employee counterparts; 22% of the 35-44 age group are in pension compared to 60% of employees.

Another key indicator of financial resilience and security is having insurance to fall back on in the event of a financial shock. The self-employed are significantly less likely to have key insurances such as mortgage protection and life insurance than employees in equivalent occupation categories.

The self-employed do not benefit from an employers' sick pay schemes so they are particularly vulnerable to economic shocks. The self-employed rely more on state support than full time employees. More than half of households with one or more full time self-employed people receive state support which makes them very vulnerable to benefits changes.

The self-employed have much to fear from the new reforms introducing the Universal Credit system – 37% are potentially adversely affected[50]. Moreover, research suggests that 40% of the self-employed do not claim Tax Credits to which they are entitled[51].

Obviously, there are many success stories but generally the self-employed take greater financial risks than those in permanent employment but the rewards for the self-employed are not higher (certainly in overall financial terms). State benefits can provide only a small amount of replacement income but very few have private sector income protection insurance as a substitute.

However, it is important to note that other economically vulnerable employees are affected by many of these problems, too.

The priorities now are to:

- Tackle the seriously low levels of pension underprovision amongst economically vulnerable households; and
- Create a decent safety net to protect economically vulnerable households against economic shocks.

To address pension underprovision amongst the most vulnerable groups, the most obvious solution is for the state to step in and play the role of the employer by topping up pension contributions and make greater use of the existing NEST pension scheme. Alternatively, the state pension system could

[49] Self-employed, part-time, temporary, and zero-hours
[50] Why the self-employed need to wake up to the threat posed by Universal Credit, RSA, September 2014 http://www.rsablogs.org.uk/2014/uncategorized/selfemployed-wake-threat-posed-universal-credit/
[51] Boosting protection for the self-employed is a priority. But so too is raising awareness of existing entitlements, RSA, December 2014

be reformed so it provides a low risk, cost effective option for the self-employed and others with low or uncertain incomes.

In the meantime, the Government should urgently address the flaws in the Universal Credit system highlighted above to ensure it does not adversely affect the self-employed and is better structured to meet the reality of self-employment. Moreover, a public information campaign is needed to raise awareness amongst the self-employed do not claim Tax Credits.

The market is struggling to provide good value income protection products. We need to explore collective mechanisms for providing a decent, inclusive safety net for the self-employed and other vulnerable workers.

In summary, taking all this into consideration, we think there are two areas where further work is needed:

- Firstly, we need a frank and open debate about the respective roles of the state and financial services industry in helping individuals deal with economic insecurity; and
- Secondly, we need to develop alternative mechanisms for providing a safety net and meeting the pension needs of people in non-permanent/ non-full-time work and in other insecure employment.

The role of housing equity

An assessment of how to fund retirement incomes, long term care costs, and mitigate the effects of low household savings would not be complete without considering the role of housing equity. It is difficult to get precise values but around 60% of the total £6.5 trillion wealth in the UK is in property – the over 65s have £1.1 trillion of unmortgaged equity.

For many consumers, property is the single biggest asset they have and they may be expecting to rely on home equity to boost income or provide dignity and security in old age. Indeed, for many who need to fund a decent retirement and/ or long term care, there may be no other realistic option. Yet the home equity market has so far not produced sufficiently good value, effective solutions for the wider population.

A range of contributory factors mean that significant numbers of consumers do not, or are unlikely to ever, have access to viable home equity products. Preliminary analysis has identified two main groups of consumers who are excluded from the market.

The first group refers to those consumers who commercially viable for the market but the market has not yet developed home equity products with wide appeal – these are *underserved* consumers.

The second group refers to consumers who excluded in the conventional sense because they do not have sufficient home equity to be commercially viable for the retail market – there are obvious regional differences to consider.

Moreover, there are other constraints. For now, the limited use of home equity plans means that there are not yet major prudential regulation concerns. But, if we do see a significant growth in the use of home equity, this could change.

Much of the supposed equity which appears to exist in the property market is an illusion – it exists on paper. A property market crash (there must be a reasonable probability of at least a correction in some areas of the country) would reduce the available equity which currently makes home equity plans a viable proposition for financial firms.

The greater use of home equity plans is also predicated to a degree on property prices continuing to rise. Even if we don't see a major correction/ crash, it is only prudent to assume that the UK property market in certain areas simply cannot sustain the rises seen recently. If this is the case, home equity providers will demand a higher risk premium (in the form of higher charges) to provide the risk capital to finance home equity plans. More generally, there will be a limit on risk capital available to finance home equity plans.

We conclude that these constraints mean that there is a limit to which home equity will be viable as a means to meet the retirement income and long term care needs of large numbers of consumers.

If home equity is to play a bigger, albeit limited, role there are two key priorities:

- New research and development is needed to develop innovative, affordable home equity plans for consumers with low amounts of home equity. One of the key problems, as ever, is the lack of economies of scale and unattractive profit margins for commercial home equity providers. The way forward here may be to create partnerships between financial markets and third sector organisations such as housing associations and local authorities.
- Home equity products have improved recently with the introduction of features such as no-negative equity guarantees. But there is still much to be done to increase confidence and trust in schemes, and improve transparency.

3.4 DEVELOPING REGULATORY AND PUBLIC POLICY

It may be stating the obvious, but the way policy is developed affects how well consumers' core financial needs are met. If policymakers and regulators adopt the wrong policy models this leads to the wrong outcomes for consumers.

During the preparation of this paper, two key issues emerged:

- The need to rethink the approach to regulation followed by policymakers and financial regulators (particularly, competition policy); and
- How the comparative costs of public and private provision are assessed and presented.

Rethinking regulation and competition policy

If we want to make financial markets work for consumers, we must change the way we think about regulation and competition policy.

In the UK, the *permissive* approach to regulation has been dominant. This is based on the premise that:

- Allowing loads of choice and competition, combined with information disclosure and financial education, will create the conditions to allow the market to meet consumers' needs[52].
- Markets shouldn't face too many constraints on their activities with regulators only intervening to create the conditions for competition (when competition appears not to be working) or intervening *ex-post* to clean up when there is compelling evidence of market failure.

But this approach has not been effective at protecting consumers and promoting efficient markets. It has allowed thousands of products of questionable social utility to come to market at a huge cost to consumers (in the form of higher costs, product proliferation, confusion marketing, and misselling) and the industry (in the form of huge redress costs).

It may sound heretical but consumer campaigners should stop worrying about the number of products and providers on the market and levels of switching between competing providers. Conventional competition indicators (numbers of providers and products, price disparities, entrants and exits etc) don't actually tell us whether markets are working. What matters is whether the market produces the right *outcomes* and consumers' *needs* are met.

With thousands of products and firms, consumers are certainly not short of choice in financial services. But too many products can be just as damaging to consumers' interests as too few products. In certain cases, reducing choice leads to more efficient markets and better value – the NEST pension scheme is a case in point.

Over the years, there has been a great deal of new product development, 'innovation' and furious competitive activity. But this is very different to true innovation and competition that works in the

[52] This information approach has been continued in the Competition and Markets Authority (CMA) recent Retail Banking Market Investigation published in May 2016
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/523755/retail_banking_market_pdr.pdf

interests of consumers. Financial providers have competed fiercely to acquire market share but that is not the same as competing to meet the needs of consumers.

Product proliferation is associated with higher product development and marketing costs. It also increases search, distribution and advice costs. This results in poor value and reduced access and greater financial exclusion as products are more costly to distribute to consumers. Product proliferation goes hand-in-hand with confusion marketing which undermines the ability of consumers to understand product risks and make effective financial choices and decisions. This increases the risk of misselling.

Many of the arguments against tougher regulation are based on claims that regulation stifles innovation to the detriment of consumers. Of course, we don't want regulation to inhibit true innovation. But the question is: how do we judge real, socially useful innovation?

We use six tests to judge whether a financial innovation is socially useful (or competition is working well to produce markets that work in the interests of financial users). The tests are – does competition and innovation:

- Reduce costs/ enhance value for consumers?
- Make markets safer/ reduce risk/ help manage risk better?
- Improve access for consumers?
- Result in consumers making better choices and decisions including appropriate usage of products?
- Meet a hitherto unmet need for consumers?
- Result in more efficient allocation of resources within the financial system to the benefit of the real economy?

Much of the 'innovation' and product development we have seen in financial markets over the past few decades would not have passed those tests. We cannot think of a major, truly socially-useful financial innovation which passes those tests that would have been prevented from coming to market by the tougher, more effective regulation we have now.

Making financial markets work requires a change in regulatory philosophy and approach. The permissive, *ex-post* approach to regulation needs to be replaced with a more precautionary, *ex-ante* approach with policymakers having the confidence to consciously shape markets to ensure consumer needs are met.

Instead of unfettered competition, a *bounded competition* or *managed markets* approach is more appropriate for complex markets such as financial services. This means changing the default position on regulation and competition policy to a more sceptical, precautionary approach with:

- Product governance interventions to ensure products meet minimum standards and are designed and sold to the right target audience.

- Constraining (or even prohibiting) detrimental behaviours and business models and shepherding firms into adopting good practices (that is 'bounding' market behaviours).
- Positively encouraging financial innovations that pass the six tests outlined above.
- Over time, the aim should be to streamline the number of products on the market, get rid of the socially useless products, and end up with fewer, simpler, safer, better value, well designed products that meet consumers' needs.

This, of course, would have implications for the financial services industry. It would mean employing fewer staff in marketing and associated activities and more 'compliance' staff whose job is to ensure that products are safe. Compliance is often seen as a burden by the financial services industry or a drag on corporate performance. This is the wrong attitude. In other industries – airlines, nuclear industry etc – they would called safety engineers and be seen as an integral part of getting the product right and protecting the reputation of the firm. We are confident that, in the long term, this new approach would be better for well-run, progressive firms in the industry, not just consumers.

We are keen to encourage debate with consumer groups, academics, policymakers and regulators on how best to regulate financial markets.

Public policy – comparative cost analysis

We also raised concerns last year about how the costs to society of meeting critical public policy needs through state/ collective provision or market based/ private sector are compared and presented. Currently, the dominant view amongst policymakers and some experts seems to be that demographic trends and pressures on public finances mean that an increased share of meeting essential needs *must* be borne by the individual and less by the state. There is an attempt to transfer greater risk and responsibility from the state to the individual and/ or from state funded to private sector funding mechanisms.

But, the cost savings claimed by capping or reducing state spending and moving funding costs to private or market based funding are often illusory and, therefore, can be a false economy. Collectively, society can end up paying more to provide the same 'unit' of pension, healthcare, housing, social security, and infrastructure due to the inherently higher costs associated with some market based replacement mechanisms.

Why is this transfer of risk and responsibility from the state allowed to happen unchallenged? One reason is the way we account for public spending and the cost of replacement provision. If politicians manage to get the costs of funding core needs (such as pensions, social security, infrastructure etc) off the state balance sheet into the private sphere, this is presented as the prudent thing to do. But, national accounts or other official analysis (never mind politicians) do not show the higher replacement costs of funding equivalent social and economic needs through private/ market based mechanisms.

This is leading to poor public policy decisions being made with costs being transferred from taxpayers to other citizens (including future generations). If we are to make the right public policy decisions, we need present and account for costs in a more transparent and honest way.

A good example of this are the current attempts at EU and UK level to encourage pension funds and other private sector long term investors to fund critical infrastructure (including housing). The excuse for this is that public finances are under pressure and nations must turn to the private sector for funding. But, this infrastructure could be funded much more cost-effectively using government funding (in the UK through the gilts market). Private sector investors demand a premium over gilts in return for providing capital. This means, by definition, society pays more for funding the same infrastructure. This is a false economy but the public is not made aware of this because of the failure to present the true comparative costs. It also represents a transfer of wealth and risk from one group of citizens to another group (younger households and taxpayers effectively subsidise higher returns paid to pension scheme members) and creates a whole new set of fees for financial intermediaries.

However, it isn’t just comparative costs we should be concerned about. We do not have an effective policy framework which allows us to assess the impact of transferring risk and responsibility for core financial needs such as pensions and social security on different groups of consumers. Markets are amoral and allocate value to consumers with economic clout and/ or greater financial capability. This is not a criticism – it is just the inherent nature of market based systems. In a more individualised market based system vulnerable consumers lose out. Financial education is not an effective means of protecting or empowering consumers. So, we would need to develop alternative mechanisms for making markets for all consumers if policymakers insist on going ahead with this transfer of risk and responsibility. This creates additional costs.

We are keen to promote a debate on important questions of public policy such as outlined here.

NEXT STEPS
The work we have undertaken in preparation for this paper has led us to the following conclusions.

- The new economic and financial reality means that retail financial services faces profound challenges producing and distributing the products and services consumers need. This new environment will create major new risks which need to be pre-empted and mitigated. At the same time, a range of legacy issues still need to be resolved.
- There is clearly much that can be done to ensure retail financial services works in the interests of underserved consumers, not just better-off consumers. But, it is difficult to see how the industry – even if major efficiencies are made - can meet the needs of financially excluded consumers. Alternative provision is sorely needed for this group.
- The impact of the critical wholesale and institutional financial markets on the wider economy and society is now starting to be recognised. But, unlike retail financial services (where consumer groups have long been active in reform), civil society groups have not yet developed robust policies for wholesale and institutional market reform.
- Socio-economic, demographic, and technological forces are creating major long term public policy crises in the UK (pensions, housing, social security replacement, long term care costs). We have made little progress in developing effective policies not least because the UK political system seems particularly susceptible to the blight of short-termism.
- One of the main problems we have identified is the absence of an appropriate institutional policy framework to allow us to deal with public policy crises and the social costs created by financial market activities.

As a result, our main activities will be built around:

- Undertaking new research and policy development on issues not covered well by consumer groups and civil society organisations, especially in the wholesale and institutional markets.
- Developing new policies and alternative ideas to tackle the problems faced by financially excluded and underserved consumers including collaborating with consumer groups and third sector organisations.
- Campaigning for financial market reform including the creation of a new institutional policy and regulatory framework to deal with public policy crises and social costs created by financial market activities.
- Collaborating with and providing technical support to like-minded campaigning groups to maximise their influence with policymakers and regulators.
- Promoting better public understanding of the importance of financial markets to society and the real economy.
- Working with progressive financial services firms to help them improve their products and services and improve levels of consumer confidence and trust in financial services.

But, the range and scale of the issues we identify here means there is a limit on how much we can achieve on our own as a small non-profit organisation. Therefore, we are keen to work with other civil society groups and funders on these priorities.

Financial Inclusion Centre
August 2016