A TALE OF TWO SCANDALS

FINANCIAL INCLUSION CENTRE COMMENTARY

Two financial scandals have dominated the news over the past few days. Concerns have been raised for some time now about a major pensions misselling involving defined benefit pension scheme transfers. These concerns have been highlighted by the publication of the Work and Pensions Committee report on the matter[1]. The other involved the treatment of small business clients (in distress following the financial crisis) by the infamous RBS GRG unit.

Central to both these scandals has been the role of the Financial Conduct Authority (FCA), which has been on the receiving end of fierce criticism. These scandals raise two core questions:

- Are the criticisms of the FCA justified in both cases; and
- Do these scandals point to the need to reform our system of financial regulation?

ARE THE CRITICISMS JUSTIFIED?

The FCA, as with any regulator, deserves to be criticised when this is justified (and we have been fierce critics of the FCA on a range of issues). But is the criticism deserved in these two high profile cases?

By definition, the issues involved in both scandals (especially the RBS scandal and the FCA's handling of it) are complex. Care must be taken not to oversimplify what can be important subtleties in legislation and regulation. But, to summarise the answer is:

- With regards to the pensions misselling issue, yes, the FCA clearly does have real questions to answer and has been criticised with some justification.
- The behaviour of the RBS GRG unit was appalling. It is hard to see how that can be disputed. But, as to the question of how the FCA handled the scandal, the regulator does not deserve the vitriol poured on it. The response by many external stakeholders (much of it seemingly based on misunderstanding of legislation and regulation) has been unfair. More worryingly, ultimately, it could potentially damage the ability of the regulator to operate effectively and in the interests of consumers[2].

The reasons are set out below.

[1] see https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/british-steel-report-17-19/

[2] We use a wide definition of consumer here to include retail consumers, micro-enterprises and SMEs, ad institutional clients

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Pensions misselling

In the first case, there are a number of parties[3] involved not least the advisers involved who, we shouldn't forget, are ultimately responsible for targeting the scheme members and providing the 'advice'.

Secondly, we would attribute much (if not most) of the blame to the decision by the government to introduce the pensions 'freedom and choice' reforms. We argued at the time that this was intrinsically a bad policy, and was being rushed and poorly implemented. 'Freedom and choice' has created the conditions and opportunities for misselling, frauds, and scams.

But the third party is the FCA itself. Why should the FCA share some blame for this?

One of the key issues relates to 'contingent charging' (where financial advisers receives a fee if a pensions transfer goes ahead). The fear is that it creates conflicts of interest between the adviser and the client and incentivises unscrupulous advisers to push unsuitable transfers to generate fees (the fees can be huge given the sums of money that can be involved in defined benefit pension scheme transfers).

Following the implementation of the Retail Distribution Review (RDR) at the end of 2012, commission payments to financial advisers *generally* were banned. Since then, advisers have been required to charge explicit fees.

Contingent charging is really just another form of payment by commission. But it wasn't banned as part of the RDR. The FCA has always recognised the conflicts of interest involved with contingent charging and has required firms who operate this business model to have measures in place to manage these risks. However, it is widely recognised that these measures have not been enough to stop misselling and the likelihood is that contingent charging will be banned, which we fully support[4].

The FCA cannot be expected to regulate to perfection. Mistakes will always happen. The UK's financial markets are just far too big and complex to be regulated in a way that meets the unrealistic expectations of politicians, media, *and* consumers. The resources required would just not be countenanced.

But, the FCA is meant to operate a risk-based approach to regulation. The history of financial services tells us that whenever large sums of money and conflicts of interest are involved, misselling is more likely to occur (the *follow the money* principle). The retention of contingent charging meant that conflicts of interest still existed. Critically, as mentioned, the pensions freedom and choice reforms heightened the risks of misselling.

The *follow the money* principle (and the numerous warnings provided by stakeholders) ought to have alerted the FCA to the need for intervention. Moreover, there are justified criticisms about the

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[3] of course, it is important to consider the role of sponsoring employer of a pension scheme and the trustees, along with The Pensions Regulator. But this blog relates specifically to the role of the FCA.

[4] Declaration: the author was a board member of the FSA/ FCA from November 2009 to January 2016. The banning of commission and the RDR has brought great improvements into the financial advice market. It is one of my great regrets that as a board member I didn't push for contingent charging to be banned as part of the RDR. Mea maxima culpa.

usefulness of the FCA's register of qualified and approved financial advisers. The FCA undoubtedly has questions to answer on this one.

The handling of the RBS GRG scandal

But, if criticisms regarding pensions misselling are unfair, why are criticisms regarding the handling of RBS GRG unfair? The answer basically lies in differences in the freedom the FCA had to operate in both those cases.

With the RBS GRG case, some of the criticisms levied at the FCA have been strange to say the least. It is not clear whether this is due to genuine misunderstanding of the relevant legislation and regulation or wilful disregard of the FCA's position in order to attack the regulator for other reasons.

At various times it has been criticised for: not protecting the SMEs in the first place; 'suppressing' the full report of the independent reviewer appointed to undertake the s166[5] report and having to be forced to publish by politicians; producing a dishonest summary[6] of the full report of the independent reviewer; being involved in a cover up; and allowing RBS to dictate the content and conclusions of the report.

This is a very large scale review and it is not possible to summarise the full scope and findings of the s166 report. The two key issues under consideration were:

- did RBS and GRG *deliberately* engineer defaults of SME businesses so that the bank would make a financial gain; and
- did the treatment of SMEs and behaviours of RBS staff give rise to wider concerns about the standards of governance within RBS?

The FCA's summaries of the s166 investigation reported that, while some isolated examples or poor practice were found, the independent reviewer did not find evidence of *deliberate* engineering of defaults to create financial gain for RBS.

But, the FCA summaries reported that the reviewer found evidence of widespread inappropriate treatment of SMEs such as failure to: communicate properly; undertake proper valuations; handle complaints fairly; and ensure controls were in place to ensure fair treatment of SMEs. Moreover, the FCA reported that the reviewer had concluded that some of these widespread problems were down to the failure of RBS to identify and manage conflicts of interest and ensure proper governance and accountability systems were in place.

The full report, which has now been leaked, is very much in line with the FCA's summaries – see paras XI and X of the report. It is very difficult, now that the report can be read, to understand how commentators can make the claim that the FCA had downplayed the findings of the report in its various summaries. Some commentators have been reduced to complaining about the order in

[5] The FCA appointed Promontory as the 'skilled person' under section 166 of the Financial Services and Markets Act (FSMA) 2000 to review how RBS GRG treated relevant SMEs in financial distress that were referred to it over the period 2008 to 2013. S166 reports are a tool used by the FCA to undertake more in depth investigations where it thinks these are needed

[6] The FCA has produced various updates and summaries over the course of the production of the s166 report (with names of individuals not included to preserve confidentiality)

which the FCA presented the summary of the report's findings claiming this was an attempt to downplay the second set of more critical findings.

Coming back to the point about whether the FSA/ FCA[7] could have done more to protect the SMEs affected, it is important to understand the legislative and regulatory framework the FCA/ FSA operates(d) within. Commercial lending (including to SMEs) was, apart from a few exceptions, not regulated by the FSA (the same still applies now with the FCA). The decision as to which financial activities are brought within the 'regulatory perimeter' is not made by the regulator – this is determined by legislation through Regulated Activities Orders[8]. Commercial lending was (and is) not covered by the same conduct of business standards that apply, say, to mortgage lending or consumer credit. Moreover, SMEs were, and still are, limited in their ability to use the independent Financial Ombudsman Service (FOS). This meant that SMEs were, and still are, not protected to anyway near the same extent as retail consumers.

The blame for the appalling treatment of these SMEs lies primarily with RBS. But, if commentators want to apportion blame to any authority for leaving SMEs unprotected and vulnerable, then this should be laid at the door of our legislators, not the regulators.

As to the point of 'suppressing' the report, it is difficult to see what reason the FCA would have to do this. As explained, the FSA/ FCA was/ is not responsible for regulating SME lending in the same way as consumer lending. It is not clear what supervisory failings of its own with respect to this financial activity, during the period under review, the FCA would now have an incentive to conceal.

The FCA has also been lambasted for dragging its feet and having to be forced to publish by politicians on the Treasury Select Committee. But, to publish the full, detailed report, the FCA needed the consent of RBS and individuals named who have the right to put their side of the story. Again, this is not the FCA deliberately 'suppressing' a report. Nor is it a matter of the FCA being afraid of being sued by the RBS or the FCA allowing the bank to dominate and control the regulator. It is actually a matter of the regulator quite rightly following legal processes. It is not difficult to imagine the huge outcry if the FCA did not comply with legal processes and risked breaching the human rights of those involved.

RBS announced that it would not object to publication at the end of January 2018. This was welcomed by the FCA and it said it was now happy to publish the report. But as the regulator pointed out it would have still needed the consent of individuals who provided information and those named in the report.

But this has since been overtaken by events. The Chair of the Treasury Select committee announced that she had demanded the FCA publish the s166 report by 16th February[9]. If the FCA could not meet the deadline, it was told it should provide the report to the Committee. Failing to do so would put the FCA at risk of being in breach of an order of the House of Commons and being found in contempt of Parliament. The Chair also stated that she would be asking the Committee, on its return from

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[7] The FCA came into existence in April 2013. So, technically speaking the FSA was the responsible authority during the period under review while the FCA has been the responsible authority for handling the subsequent review.
[8] See https://www.fca.org.uk/firms/authorisation/how-to-apply/activities for a list of FCA regulated activities
[9] http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2017/rbs-global-restructuring-group-fca-report-17-19/

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recess, to agree to publish the full, unredacted report under parliamentary privilege as soon as possible.

Now that the report has been leaked and the FCA ordered to provide the report to the Treasury Committee, this dealt with the legal barriers to publication of the full report. Some argue that this is a good development as it brings much needed transparency to what is an appalling episode in banking history.

But there could well be consequences for financial regulation and supervision. The fact that the protections given to people under investigation have been overridden could well make future investigations even more difficult. The current system was meant to allow the regulator to conduct in-depth investigations drawing on the co-operation of those involved to ease the process. The current system is clearly too prolonged and doesn't allow for victims to put their case properly (this is a wider issue with supervision and enforcement) and needs reforming (see below). However, we must be alert to the risk that, that in the absence of reforms, those under investigation in future under the current system will withdraw their co-operation and use their own legal representatives to stall the progress of investigations and publication of reports.

To conclude on this issue, it does seem that the FCA is being unjustifiably criticised for its handling of the RBS GRG scandal. It is not clear what is behind these criticisms – is it genuine misunderstanding of current legislation and regulation, or wilful disregard of the reality of the constraints facing the FCA so as to allow attacks on the regulator for other reasons?

Who knows? Whatever the reason, the response by various parties could have unintended consequences. Firstly, as mentioned, there is a risk that future investigations could be stifled as those under investigation fight every inch of the way to forestall publication. The second concern relates to the impact on consumer confidence. A free, well informed, critical media is a key part of the system of accountability that keeps markets and regulators in check. And to reiterate, regulators should be roundly criticised if that criticism is justified. But, unjustified coverage and criticism could damage consumer confidence.

IMPLICATIONS FOR REGULATORY REFORM

It is never a good idea to launch into reform as a knee jerk response to a crisis. Flaws need to be identified, reforms considered properly (including whether reforms are actually feasible), and unintended consequences understood.

But, we have been thinking about this for some time. The work we do on evaluating the economic and social utility of the financial system, our work on financial inclusion and discrimination, and the growth in fintech/ big data lead us to conclude that there are significant weaknesses and gaps in our system of financial regulation. With Brexit on the horizon it seems like an ideal time to give reform serious consideration (the form of Brexit will, of course, determine the nature of any reform).

The weaknesses exposed as a result of the RBS scandal (how activities are brought within the regulatory perimeter, the inconsistent approach to regulatory protection given to different

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‘consumers’[10], arrangements for conducting investigations, and constraints on transparency) reinforces the need for regulatory reform.

Based on our analysis, the areas that stand out for reform are:

- the objectives, duties and remit of financial regulators;
- regulatory tools and powers (including authorisations, supervision, enforcement and sanctions);
- improving transparency around ongoing supervision and important investigations (such as the RBS GRG scandal) – without compromising natural justice and human rights of market practitioners accused of wrongdoing;
- the capacity of regulators to respond more quickly and effectively to crises and emerging problems in markets;
- the relationship between Parliament and regulators; and
- regulatory governance and accountability, and stakeholder representation.

As mentioned, we will never have perfect regulation. The simple unchallengeable fact is that the UK’s financial markets and services are vast and complex. We can never design a regulatory system that meets the unrealistic expectations of some politicians and the media who tend to pay attention only when things go wrong – there is no glory or story when things are going well. But, the system of financial regulation can, and should, be improved.

CONCLUSION

With regards to the two financial scandals that have hogged the headlines recently we would conclude that:

- On the pensions misselling the FCA clearly does have real questions to answer and has been criticised with some justification.
- But the regulator does not deserve the vitriol poured on it for its handling of the RBS GRG scandal. The response by many external stakeholders (much of it seemingly based on misunderstanding of legislation and regulation) has been unfair.

Working on the principle that we should never let a good crisis go to waste, these scandals do create an additional reason and new impetus for a proper, considered debate on how to reform our system of financial regulation.

Finally, we should not forget that financial institutions (particularly the boards and senior managers) have a major role to play in improving the corporate governance and culture in their organisations. It is not all down to regulators.

We look forward to working with other stakeholders on these critical issues. If you have any questions please contact: **mick.mcateer@inclusioncentre.org.uk**

[10] The historic distinction between retail consumers, business customers (especially SMEs and micro-enterprises), and supposedly sophisticated clients such as pension fund trustees is actually quite daft when you think about it. The latter two categories can be just as vulnerable to misselling, exploitation of behavioural biases, and unfair practices as retail consumers. Indeed, given that the latter two groups tend to have to make decisions involving larger sums of money, the financial loss if things go wrong can be even greater.

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