The Financial Inclusion Centre

Financial markets that work for society

FINANCIAL INCLUSION CENTRE BRIEFING PAPER

DEALING WITH FINANCIAL VULNERABILITY

SUMMARY

The Financial Conduct Authority (FCA) has focused its attention recently on the issue of financial vulnerability and ensuring that financial providers treat vulnerable consumers fairly.[1] With this in mind, this briefing paper discusses:

- What is financial vulnerability, and what causes it; and
- What firms, regulators, and policymakers can do to tackle individual vulnerability, structural and systemic harm, and enhance consumers' rights.

The FCA's work is very important. If it is implemented and enforced properly, it could make a real difference to large numbers of vulnerable individuals. But, the FCA's work focuses primarily on the *personal* circumstances of consumers and an *individual's* relationship with an *individual* firm. This is not a criticism of the FCA. The regulator has to supervise and enforce against individual firms.

The FCA can, of course, launch market studies to investigate practices and features of markets that cause widespread detriment. However, interventions resulting from these market studies are about making the market work better, and do not confer rights on vulnerable consumers.

The FCA talks about fair treatment and fair risk pricing meaning consumers are not *unduly* excluded. It also talks about how in a market-based economy, consumers do not have an automatic right to receive products and services. There are some specific universal obligations in consumer markets - for example, with regards to postal services, and some telecoms services. In financial services, certain institutions must offer payment accounts with basic features. But, firms in the UK generally do not have an obligation to provide products and services.

Consumer vulnerability is inherent in market based provision of services. The FCA does not tackle systemic vulnerabilities and discrimination. For example, entire groups consumers can find themselves paying more for, or excluded from, essential financial services just because they are poor or because the market considers them to be a high risk. These are matters for government rather than regulatory policy. So, in any discussion of financial vulnerability and rights, we should not lose sight of the limits of the FCA's remit. Alternative interventions will be needed to address systemic discrimination and exclusion particularly in the aftermath of the Covid-19 pandemic.

[1] See for example: https://www.fca.org.uk/publications/guidance-consultations/gc20-3-guidance-firms-fair-treatment-vulnerable-customers

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WHAT IS FINANCIAL VULNERABILITY, AND WHAT CAUSES IT?

The FCA defines a vulnerable consumer as *'someone who, due to their personal circumstances, is especially susceptible to detriment, particularly when a firm is not acting with appropriate levels of care*'.

Some specific groups of consumers are more vulnerable than others. The FCA focuses on individual factors such as:

- physical or mental health conditions or illnesses that affect the ability to engage with financial services
- life shocks such as bereavement or relationship breakdown
- low levels of financial resilience (for example, being on a low income, having no or little savings to fall back on if experiencing a financial shock) and emotional resilience
- low levels of financial capability, low levels of literacy in other areas such as digital skills

It is surprising how many consumers can be vulnerable at different points of their lives. The FCA, in its Financial Lives Survey 2020, estimated that 46 percent of UK adults display one or more characteristics of being potentially vulnerable.[2]

But, it is just as (if not more) important to recognise the conditions and structural factors in markets which can increase the risk of potential vulnerability amongst individual consumers (or groups of consumers) manifesting in actual detriment.

We identify conditions and factors such as:

- aggressive competition
- business models focused on the acquisition of market share and churning
- remuneration practices which reward staff for volume of sales rather than quality of sales
- market inefficiencies
- market structures
- negative application of technology and data
- proliferation of choice
- product complexity
- poor culture, governance and ethical standards in firms and sectors

The detriments that consumers can experience include:

- being excluded from/ denied access to markets
- being ripped off/ overpaying for products and services
- being missold or scammed
- making the wrong financial decisions and choices
- inability to manage finances
- over or under-consumption of products (eg. overindebtedness or undersaving)
- experiencing emotional stress

When we see large numbers of consumers, or groups of consumers with shared characteristics, experiencing financial harm this means structural or systemic unfairness, or even outright discrimination, is present.

[2] See page 9, https://www.fca.org.uk/publication/research/financial-lives-experiences-of-vulnerable-consumers.pdf

We live in a market based society and most essential financial services are provided by the market. Indeed, there is a *presumption* that, as far as possible, essential financial services should be provided by the market. Where the market is failing, policymakers and regulators focus on changing the conditions in which markets and consumers operate, rather than challenge the fundamental wisdom of market provision and consider alternatives.

The presumption that markets should be the default for provision of essential services is based on the economic *theory* which holds that market forces and competition between providers will ensure that markets innovate and deliver value to consumers.

But, it is an often overlooked point that, rather than firms competing with each other to provide good value to consumers, market based provision is characterised by:

- Consumers competing against each other to get the best deal in what is a finite pool of value. So, where markets are a zero-sum game, if some consumers get the best deal, this by definition must be at the expense of others who get a worse deal. Sometimes competition and innovation works to increase the total pool of value available to the consumer population so that overall consumer welfare is enhanced – although some will see their welfare enhanced more than others. But, we know from history that, too often, fierce competition and innovation in complex markets such as financial services actually extracts or destroys value – so it is not even a zero-sum game.
- Consumers battling against providers (and, where relevant, shareholders) and intermediaries in supply chains to get value from commercial transactions. And much competition in financial services is actually for the custom of intermediaries rather than the consumer. Providers and intermediaries will generally have the upper hand over consumers in complex markets such as financial services. Unless constrained by effective competition (there are limited examples of this in financial services) or effective regulation, this will result in consumer detriment.

Markets are amoral. The 'hidden hand' of the market determines that the value, service, or treatment consumers receive generally depends on how much money they have or how capable they are when engaging with markets, rather than their needs or rights.[3] The essential nature of markets means that vulnerable consumers are more likely to fare badly and lose out to more capable 'consumer-competitors' or providers and intermediaries who seek to extract value in commercial transactions.

It is also important to remember that, unless mandated by the state, the market decides who is and who isn't provided with products and services, and on what terms those products and services are provided. Entire groups of consumers can find themselves paying more for, or excluded from, essential financial services just because they are poor or because the market considers them to be a high risk.

[3] Better off consumers tend to have more choices open to them, are less likely to face punitive terms and conditions etc. It is worth saying that many financially savvy lower income consumers can overcome the low income hurdle and get good deals. Nevertheless, there is a clear relationship between income/ vulnerability and value/ treatment received.

HOW DO WE TACKLE INDIVIDUAL, STRUCTURAL, AND SYSTEMIC VULNERABILITY IN FINANCIAL MARKETS?

So, we can see that some of the factors and conditions outlined above that create vulnerability relate to individual firm behaviour. Others relate to the dominant structures in markets which increase the risk of widespread and chronic exploitation of consumer vulnerabilities affecting larger groups of consumers. The third category relates to the essential nature of market based systems which mean that certain groups of consumers will not have their needs met.

It is important to distinguish between these different levels of vulnerability as it determines the type and scale of intervention needed to address the financial harms identified.

At the individual firm level, this can be addressed by the firm improving its own culture and practices or the FCA supervising and enforcing against those firms for failing to treat vulnerable consumers fairly.

At the next level, the conditions which cause harm are just so ingrained in the structure and functioning of markets that industry wide initiatives (eg. self-regulation codes of practice) or structural level interventions by regulators are needed.

Of course, we should not overlook the role consumer groups and wider civil society have to play in exposing harm and using public pressure to improve corporate culture and behaviours.

At the third level, even if structural regulatory interventions are effective, the market will still not be able/ want to serve large groups of consumers. Addressing this type of systemic harm requires social policy interventions by legislators to mandate provision by markets or alternatives to market-based provision created – see below.

Table 1: Summary of levels of harm and intervention needed

Level at which harm is created	Level of intervention needed
Individual firm level	• Firm addresses own culture and practices • Regulatory supervision and enforcement
Market structure level	• Industry led initiatives, self-regulation codes of practice • Structural regulatory interventions
System level	• Social policy interventions by legislators such as mandating provision or terms of provision • Alternatives to market-based provision

Remember, the FCA's interventions deal with consumers who are already engaging with the market (or who might be included in the market if the FCA's interventions make the market more efficient and responsive). The FCA does not address the needs of citizens who will never be viable for the market. Nor does the FCA address the possibility that consumers whose needs are currently being met by market-based provision might have those needs met even more efficiently by alternative solutions.

For example, the FCA would not advocate policy solutions such as NEST – the workplace pension scheme set up by the government. Millions of consumers already had a plentiful choice of individual

personal pensions provided by the market. But, even if the market was working at its optimum efficiency, it would not have been able to deliver the value created by a collective scheme such as NEST.

Similarly, when looking at ways of funding long term care costs, the FCA's role will be limited to regulating private sector products and services aimed at helping consumers meet long term care costs – eg. insurance products or equity release schemes. It would not consider or propose state backed solutions even though these solutions would be clearly more economically efficient and equitable to vulnerable consumers.

Therefore, it is very important in this debate to recognise the limits of the FCA's interventions. It can only partially tackle the range and scale of vulnerabilities facing citizens. So, with that in mind, next we look at the different levels of intervention in more detail.

How can firms treat vulnerable consumers fairly?

From the above, we can say a firm treats vulnerable customers fairly if it does enough to:

- identify which customers might be vulnerable;
- understand the conditions that might create vulnerability;
- understand what detriment might arise from exploiting vulnerability (deliberately or inadvertently); and
- ensure it has the proper culture, products, and systems in place to provide the right levels of care and to avoid detriment.

Firms can avoid detriment in a number of ways. This is not an exhaustive list, but firms can:

- Ensure they have fair and equitable pricing policies that do not take advantage of vulnerability. An obvious example is not exploiting customer inertia or misguided trust to hike up automatic renewal prices on insurance policies.
- Have remuneration policies which reward quality of sales and fair treatment, rather than volume of sales or targets.
- Stress test products and services against recognised vulnerability characteristics to assess capacity for causing harm (in the same way firms would financially stress test a mortgage book or a structured investment product). This is best done using external, independent experts who will provide objective insights.
- Stress test products and services with consumers in the target market to ensure they understand the product and important terms and conditions.
- Do more to make consumers aware of risks inherent in complex financial products or the costs involved. These should be more prominently displayed on marketing and promotional material. This is not easy for marketing departments who have an understandable preference for telling consumers how wonderful their products are and downplaying the costs and risks.
- For products and services sold on-line, there is plenty of scope for firms to test consumer understanding of products. Fintech can be used to test consumer understanding of product key features and costs before allowing the consumer to proceed with a purchase.[4] For

[4] We have been sceptical about the potential benefits of fintech. See: Financial Inclusion Centre, Fintech: beware of geeks bearing gifts? http://inclusioncentre.co.uk/wordpress29/our-work/publications/fintech-beware-of-geeks-bearing-gifts
But, there is potential for developing financial capability tools that allow consumers to undertake real time tests of their understanding of products before going ahead with the purchase.

example, consumers could be asked to confirm understanding of exclusions in insurance policies or renewal prices before being allowed to confirm purchase.
- Have clear policies on dealing with vulnerability and ensure staff at all levels (including boards) are trained to recognise the vulnerability characteristics of customers (existing and potential) in its target markets.
- Take time to explain the product features, costs, and terms and conditions. Importantly, where products are distributed by intermediaries, these critical links in the supply chain have an important role to play in explaining products.
- Use data and analytical tools in a positive way. For example, to identify individual customer behaviours – such as unusual spending patterns - which suggest that those customers are vulnerable. Or use data to identify patterns of detriment. For example, looking for evidence of a new product or distribution strategy creating detriment amongst a group of customers who share vulnerability characteristics.
- Engage and consult with external experts to better understand the specific needs of vulnerable groups.
- 'Level up' the experience of customers who may find it hard to engage with or use services. Vulnerable citizens don't want 'special' treatment – they just want to able to experience services in the same way as a typical customer. Many firms already do much to make services more accessible for disabled or visually-impaired customers. But, it is more than this. Vulnerability isn't always obvious. Many customers may just feel overawed or alienated by the surroundings associated with financial services. Access to a basic bank account is now a legal right. Before this, we had self-regulation. It was clear that certain banks and building societies went the extra mile to help excluded consumers, who may not have been used to formal financial services, open basic bank accounts. Others made it difficult for potential customers. Not surprisingly, the 'good guys' ended up with a disproportionately higher share of unprofitable accounts.
- Of course, it would be better if firms limited the manufacturing of complex or costly products in the first place. This is not always possible but there is a great deal of spurious complexity and 'innovation' in financial services. The majority of consumers have fairly basic, standard needs that are best met by simple, easy to understand products and services.

What more needs to be done by policymakers and regulators to protect vulnerable consumers?
As mentioned, we live in a market based society where the value, service, or treatment consumers receive generally depends on how much money they have or how capable they are when engaging with markets, rather than their needs or rights. By definition, vulnerable consumers are more likely to experience detriment. When we see an agglomeration of consumers experiencing financial harm, this means structural or systemic unfairness is present.

If we want to see fair treatment of vulnerable consumers become the norm in financial services, this will need to be embedded in the culture and structures of firms, business models, and markets. Question is: what interventions are needed to achieve this?

In addition to firms acting on their own initiative, there are basically three ways to motivate firms and drive up standards and behaviours in markets:

- industry led initiatives;
- market forces and competition; and
- regulation and legislation.

Industry led initiatives
As outlined above, there is much individual firms can do to ensure they treat vulnerable consumers fairly. But, there is also the potential for industry wide initiatives. This involves groups of firms or trade bodies taking the lead by developing enhanced ethical standards, self-regulated codes of practice, or cultural change programmes. These can have an impact if they are meaningful and not just superficial tick box exercises, if there is high levels of compliance, and are developed in collaboration with consumer representatives.

Self-regulation has limited impact. Most people who work in financial services want to do the right thing and treat people fairly. However, the system doesn't always encourage or reward fair treatment – see below. Doing the right thing can sometimes cost money especially if your competition is not – the case of basic bank accounts mentioned above is a case in point. Organisations that operate self-regulation schemes rarely sanction firms that fail to comply with standards by naming and shaming.

Market forces and competition
In theory, market forces would determine that firms would be penalised for treating vulnerable consumers unfairly, and rewarded for treating them well. Consumers would be motivated to switch to the best behaved firms, and poorly behaved firms would lose market share. Analysts and shareholders would recognise the reputational and financial risk of treating consumers badly and put pressure on boards and senior management to put the house in order. This would motivate firms to clean up their acts and treat all consumers well not just the better off or more active consumers.

But, with competition theory, the reality is often very different. Consumer switching has not been effective at constraining firm and market behaviours. There is not much competitive advantage in going the extra mile for vulnerable customers. On the contrary, there is a great deal of money to be made by exploiting customer vulnerabilities.

History shows us that firms which exercised self-restraint, by refusing to exploit vulnerable consumer or adopt aggressive business models, have found themselves being left behind and have had to 'follow the money'.

Analysts can be very good at estimating revenues and profits, and balance sheet risks. But, they put comparatively little effort into identifying potential reputational or regulatory risks. So, they provide very limited external market discipline on board and senior management behaviour.

Therefore, we would conclude that the operation of market forces provide little real motivation for firms to treat vulnerable consumers fairly.

Of course, with the 'social' element of ESG attracting more attention in other sectors – for example, the poor treatment of vulnerable workers in fashion industry supply chains – we may see the treatment of vulnerable consumers attracting more attention of the media and socially conscious consumers. This could act as a constraint on the way firms treat vulnerable consumers. So, there may be grounds for optimism.

Regulation and legislation
But the most effective means of motivating firms to treat consumers fairly is likely to be robust regulation which ensures boards of firms fear the consequences of treating consumers unfairly, and social policy legislation. As outlined above, the other two main types of intervention – self-regulation and market forces – provide limited discipline on firm and market behaviour.

Regulation and legislation play different, complementary roles here. Regulation deals with the fair treatment of customers who are economically viable for the market to serve. But, in some cases, it is clear that the market cannot *voluntarily* serve consumers on terms that make sense for providers and consumers. This requires legislation to require the market to provide services to underserved households or dictate the terms on which the market provides products and services to consumers. Sometimes this is referred to as the distinction between regulatory and social policy.

With regards to regulation, the FCA has done some very impressive work to establish the types of harm faced by vulnerable consumers and the root causes of that harm. But, the FCA now has to act on these insights.

The FCA will need to use its supervisory and enforcement powers to monitor markets for these types of harm, identify system and controls failures which allow these to happen, impose tough sanctions so that firms and shareholders know there is a price to pay for unfair treatment, and ensure that boards and senior managers are held to account for exploiting vulnerable consumers.

But, even if regulation was very effective, it still leaves the question of how to deal with the wider structural or systemic unfairness and discrimination inherent in market based provision.

The market can provide any service – at a price. However, sometimes that price is considered by society to be basically unjust. Or else, left to its own devices, the market will choose not to serve the needs of vulnerable consumers. This can be considered unacceptable when it comes to essential services such as transactional banking.

Examples of legislation needed to tackle unfairness include price caps on payday loans and EU legislation giving citizens a legal right of access to a low cost basic bank account.

In some cases, there is clear evidence of structural unfairness and discrimination in markets. An egregious example of this was the way overdraft pricing practices in the current account market were shown by FCA analysis to disproportionately harm BAME, disabled, and poorest households. In our view, this was not just a case of 'market failure', it was outright financial discrimination.

The FCA has tried to tackle the structural unfairness in the overdraft market. The regulator's recent reforms of the current account market does address much of the unfairness in pricing structures. But, this does not go far enough. It has refused to cap overdraft charges, which would have been the most direct, effective way to protect vulnerable banking customers. The poorest, vulnerable banking customers will still pay significantly more for overdrafts. As with the payday price cap, it may well require government intervention to legislate for an overdraft price cap.

Moreover, the FCA has refused to take action against our major banks for either deliberately using pricing models which discriminated against BAME, disabled, and the poorest households or failing to have systems and controls in place to prevent this.

As with many areas of life, BAME households face structural and systemic discrimination in financial services. We do not consider that the FCA is doing enough to investigate and tackle structural and systemic financial discrimination.

We would argue that the UK needs to adopt more social policy interventions if we want to seriously tackle financial exclusion, unfairness, and discrimination. The FCA can 'have regard' to how easy it is for consumers to access financial services when advancing its competition objective. As a public sector body, it also has obligations under section 149 of the Equality Act 2010.

But, the FCA does not have a specific responsibility to ensure access for all consumers, a general objective to promote financial inclusion, or a specific requirement to assess markets and report on their performance against financial inclusion objectives.

To address this, we argue for a UK version of the US Community Reinvestment Act (CRA)[5] and Home Mortgage Disclosure Act (HMDA)[6]. These acts require US financial institutions to play a more active role in promoting inclusion and access, and impose robust transparency and disclosure measures on firms which allow civil society to hold firms to account.

We also argue for the FCA to be given a more explicit financial inclusion objective, to be required to produce detailed financial inclusion performance reports, and for firms to produce annual financial inclusion reports.

We will not properly address financial discrimination unless we have full transparency and actively enforced legislation that protects households and communities against structural discrimination.

But, even with improvements to financial regulation, this is unlikely to be enough to deal with systemic and structural unfairness and discrimination inherent in market based provision. Serious consideration will need to be given to:

- The state and regulators imposing financial inclusion obligations on the market, and giving consumers *rights* to services. This involves the need for cross-subsidies and the application of the mutuality principle – something that is not that common in the market-centric UK economy.
- The state stepping in where the market (commercial and non-profit) cannot deliver. This is the least considered and most under-utilised option.

FIC's proposals for this type of intervention can be found in our recent paper - Extraordinary times need extraordinary measures: Proposals to deal with the immediate and longer term financial impacts of the Covid-19 pandemic.[7]

[5] See: https://www.federalreserve.gov/consumerscommunities/cra_about.htm
[6] See: https://www.consumerfinance.gov/data-research/hmda/
[7] See: http://inclusioncentre.co.uk/wordpress29/our-work/publications/dealing-with-the-immediate-and-long-term-financial-impacts-of-covid19

CONCLUSION

The FCA's work on financial vulnerability is very important. If it is implemented and enforced properly, it could make a real difference to large numbers of vulnerable individuals.

As we have outlined, there is much individual firms and industry trade bodies can, and want, to do to treat vulnerable consumers fairly and significantly enhance the experience they receive from the critically important financial services industry.

But, the FCA's work focuses primarily on the *personal* circumstances of consumers and an *individual's* relationship with an *individual* firm. The FCA's work, efforts by firms, and sector wide self-regulation initiatives do not address the types of structural and systemic detriment, and discrimination faced by the most vulnerable groups of consumers.

This will become a much bigger problem as we emerge from the Covid-19 pandemic. We will need an alternative approach. One which treats the provision of essential services as a right, not as a consumer good provided at the discretion of the market.

We hope that civil society and consumer organisations recognise the limitations of the FCA's approach (important as it is), and have the courage to push for alternative, bolder solutions.

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