Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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Financial Stability Group
HM Treasury
Horse Guards Road
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24 November 2023

By email: ringfencing_review@hmtreasury.gov.uk

Dear Sir / Madam,

Financial Services Consumer Panel response to HM Treasury's consultation on a smarter ring-fencing regime: near term reforms

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of policy and regulation of financial services in the UK.

Our focus is predominately on the work of the FCA, however, we also look at the impact on consumers of other bodies' activities and policies where relevant to the FCA's remit. We are responding to this consultation because the FCA has a role in supervising the ring-fencing regime. The ring-fencing regime impacts outcomes for financial services consumers in that it (rightly) addresses the conflict between commercial incentives and consumer interests and helps maintain financially stable market conditions that are generally conducive to better conduct standards. We wish to ensure that consumers' needs are considered in any review of the regime.

The Panel agrees with the conclusion of the Ring Fencing and Proprietary Trading Independent Review that *"Ring-fencing has contributed to improving UK financial stability, but the regime has been less successful in its key objectives of reducing the risk to public funds and addressing too-big-to-fail."*[1]

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1 https://assets.publishing.service.gov.uk/media/6230b687e90e070ed9432345/CCS0821108226-006_RFPT_Web_Accessible.pdf para 3.47

The Panel is supportive of the ring-fencing regime in principle, as a means to protect consumers' money and incentivise better conduct in the banking sector. In light of the Panel's remit concerning consumers and SMEs we would like to raise some overarching concerns, and some questions, to be taken into consideration:

1) **The consultation focusses too much on competitiveness and not enough on consumer protection** - The Panel is concerned about the operational application of the primary and secondary objectives of regulators. There is emphasis throughout this consultation on the proposals improving the international competitiveness of the UK banking sector, but comparatively little consideration of consumer protection. The Panel feels it must remind HM Treasury that international competitiveness and growth is, for both the FCA and PRA, a secondary objective. Therefore, their primary objectives - which in the case of the FCA includes consumer protection - must always come first and not be diluted in pursuit of competitiveness.

   With this in mind, and in light of the Consumer Duty, the Panel believes that due and explicit consideration should be given to how proposed changes could impact outcomes for consumers, including those who are most vulnerable. Before any changes are made there should be a solid evidence base that the changes advance the FCA's primary objective of consumer protection.

2) The proposals are made at a time of **heightened geopolitical and economic insecurity.** HM Treasury should ensure that consumers and SMEs are adequately protected during these times of change and be vigilant in assessing potential unintended consequences of their proposals. This is particularly important in relation to proposals where there is, in our view, an insufficient evidence base to warrant change (see our answers to questions 1 and 8 in Annex A). HM Treasury should also conduct ongoing monitoring of any change to ensure that any negative unintended consequences are identified and remedied as soon as possible, minimising any potential harm to consumers and SMEs.

3) **Some of the proposals aim to open up, or act as a stimulus to, markets where there are known prevailing conduct issues** – the Panel is concerned about the risks to consumers and SMEs as a result of poor conduct. Some of the proposals in this consultation intend to expand

banks’ access to markets where there are known conduct issues which remain unaddressed. For example:

- The consultation proposes opening up the equity release market to ring-fenced banks (RFBs) through hedging of mortality risk. Our research into equity release products found that consumers, especially vulnerable consumers, were not always given the information they needed to make fully informed decisions, which could have significant negative long-term implications. The FCA’s recent multi-firm work on later life lending also found evidence of poor advice and misleading promotions. Notably, the FCA stated that “we were disappointed to find evidence of firms not acting on our previous findings”.
- The consultation proposes allowing RFBs to provide financing for SMEs. Whilst we recognise the challenges caused by a shortage of funding, policy makers should not forget the significant harm that has been caused by banks in their relationships with SMEs. For example, during the Covid-19 pandemic, the CMA found that banks were using Covid-19 support schemes to force SMEs to open fee-paying business bank accounts[2]. Further, in 2022 the FCA found evidence of poor collections practices where banks agreed clearly unaffordable repayment plans with struggling SMEs[3].

4) **The proposals mean prudential and conduct regulation are pulling in different directions** – ring-fencing is at its heart a prudential regime, but it influences conduct too and therefore prudential and conduct regulation should work seamlessly together. We believe that making changes to the regime in the context of the conduct issues outlined above creates unhelpful divergence between conduct and prudential regulation. The overall regulatory framework needs to be coherent so that it is more adaptable and simpler for firms to understand (and therefore abide by). A joined-up approach therefore better serves the needs of customers – both individual consumers and SMEs – and reduces potential risks.

Our responses to specific questions, that we feel most relevant to consumers and SMEs, are set out in Annex A below.

Yours sincerely,

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[2] https://www.gov.uk/government/news/cma-stops-lloyds-bundling-business-accounts-with-loans

[3] https://www.fca.org.uk/news/press-releases/fca-tells-banks-improve-treatment-struggling-small-business-borrowers

Helen Charlton
Chair, Financial Services Consumer Panel

Annex A – answers to consultation questions

We have answered only the questions we feel are relevant to consumers and SMEs, in line with our remit.

[Proposal A.1] Deposit threshold

Question 1: Do you agree with the proposal to increase the ring-fencing deposit threshold to £35 billion of core deposits?

The Panel cannot see how the proposal to increase the deposit threshold will deliver meaningful benefits to consumers. This is consistent with the conclusions of the Ring Fencing and Proprietary Trading Review, which recommended keeping the limit at £25 billion as there were no clear benefits of increasing it but a potential risk of adverse impacts on competition[4]. It is our view that, for consumers and SMEs, the potential risks outweigh any potential benefits.

The Panel therefore does not support this proposal.

[Proposal A.3] De minimis threshold

Question 6: (i) Do you agree with the proposal to allow RFBs to incur exposures of up to £100,000 to a single RFI at any one time?
(ii) Do you agree that this proposal would alleviate the compliance burden of the ring-fencing regime on firms?

The Panel does not object to this proposal but would encourage HM Treasury to review activities and outcomes under this proposal on an ongoing basis.

Question 7: Do you agree that the Panel's de minimis threshold recommendation would not be easy to implement in practice? If you do not, please explain your rationale and any alternative options along with their benefits.

No comment.

[Proposal B.1] Geographical restrictions

Question 8: Do you agree with the proposal to allow RFBs to establish operations outside of the UK or EEA?

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[4] https://assets.publishing.service.gov.uk/media/6230b687e90e070ed9432345/CCS0821108226-006_RFPT_Web_Accessible.pdf Para 7.6-7.13

The Panel understands how this might benefit some UK consumers – for example, those living abroad - but would encourage the HM Treasury to give due consideration to how the proposed changes may affect outcomes for all consumers, including those who are most vulnerable.

[Proposal C.1] Equity investments

Question 10: Do you agree with the proposal to permit RFBs to (i) make direct minority equity investments in UK SMEs, (ii) make investments in funds that invest predominantly in UK SMEs and (iii) acquire equity warrants in UK SME borrowers, up to 10% of tier 1 capital?

The Panel does not object to this proposal on the basis that it should provide much-needed capital investment to SMEs. The Panel does question whether allowing such investments of up to 10% of Tier 1 capital from the outset may be too much too fast. The Panel would prefer to see a gradual increase (potentially eventually up to the proposed 10% limit) over a number of years. This would allow HM Treasury to monitor and review this activity, both in terms of its impact on SMEs and to understand its contribution to the RFB.

Question 11: To what extent do you think this proposal would help to unlock equity financing in the UK and address UK SMEs' financing needs? If responding as a ring-fenced group, would you undertake this type of activity?

No comment.

Question 12: Is the UK CRR definition of SME viable as a size limit for equity investments, both directly and indirectly through funds? If you believe it is not, please suggest an alternative definition. The government is open to considering alternative definitions that may better reflect current market practices and investment strategies, provided that this supports the overall policy objective.

No comment.

Question 13: On the proposal to permit investments in funds that invest predominantly in UK SMEs:
(i) what do you perceive as the risks and benefits of this proposal?
(ii) if responding as a ring-fenced group, can you provide further information on the type of funds you may consider investing in?

(iii) would you consider establishing a fund that meets the conditions set out in the draft secondary legislation?
(iv) do you consider that the proposed types of permitted funds capture those which are currently operating in UK SME markets?

The Panel supports measures that would increase flexibility and availability of finance options for SMEs.

The Panel urges HM Treasury and the FCA to ensure that, if RFBs are allowed to invest in SMEs, they should also be compelled to improve their product and service offering to SMEs as customers.

The Panel believes that current banking propositions to SMEs are uncompetitive and restricted in nature.

For example, at present, SMEs face challenges in terms of current account charges, availability of cash deposit services and bundling (many services available only to businesses with a current account). The FCA and CMA have also recently needed to write to banks requiring them to address harm they have caused to SMEs, as outlined in our covering letter.

The poor conduct, coupled with the lack of effective competition in the SME banking market, mean that capital from RFBs would be poorly allocated. Therefore, before RFBs are granted new powers to invest in SMEs there must be adequate protection measures in place to assure good conduct, in line with the Consumer Duty, so that risks can be mitigated and potential benefits realised. In addition, research should be conducted with SMEs to understand the potential demand for this type of finance and also surface the expectations and concerns that SMEs have about their potential new relationships with banks under the proposals. This would support the assessment of banks' conduct under the Consumer Duty.

[Proposal C.2] Exposures to certain small financial institutions

Question 14: Do you agree with the proposal to permit RFBs to have exposures to RFIs that qualify as SMEs?

The Panel does not object to this proposal.

[Proposal C.7] Mortality risk and lifetime mortgages

Question 26: Do you agree with the proposal to permit RFBs to hedge mortality risk?

No, we believe that RFBs should not be permitted to hedge mortality risk without adequate consumer protections in place first. The Panel's longstanding concerns about poor conduct in the later life lending market have been supported by several investigations by the FCA. Notably, there is a high risk of negative outcomes for consumers, particularly those in vulnerable circumstances.

In theory, increased competition can offer benefits for consumers. However, the Equity Release market is fraught with conduct issues, some of which are exacerbated by the prevailing regulations. For example, regulation permits commission-based sales and permission silos that allow firms to sell equity release even when it might not be the best solution for an individual consumer. Solutions are often narrow, and advice fails to be holistic, meaning that an individual's full financial position and personal circumstances are not taken into account. With so much at stake, poor outcomes can be catastrophic, particularly for later-life consumers making decisions from a position of vulnerability.

The current market conditions exacerbate the inherent conduct issues. While the cost-of-living crisis may lead more consumers, particularly those who are asset rich and cash poor, to consider equity release, the prevailing interest rates make these products particularly problematic at the moment. Negative outcomes for later life consumers are likely to have direct consequences for public finances, in terms of additional welfare costs.

We would like to draw the HMT's attention to the findings and recommendations from the Panel's recent research study into Equity Release. The FCA's recent multi-firm work on later life lending also recognises these risks, stating in the first paragraph *'These complex products are often sold to customers with a higher risk of being in vulnerable circumstances so it's essential they are fully informed and receive suitable advice.'*

If RFB's were allowed to offer equity release products to their customers, the Panel is concerned that the prevailing conduct issues would be magnified. Before the market is opened up, it is essential that the regulatory framework is sufficiently robust to the risks outlined in order to ensure adequate consumer protections are in place.

In summary, the Panel believes that there should be no attempts to open up this market until the FCA has acted on the findings of its multi-firm work in this market and implemented measures to address issues of poor conduct to ensure that good outcomes for consumers are being delivered.