Money Advice Liaison Group Conference - 28 November 2012

Credit – New World or Old Wine in New Bottles

Adam Phillips – Chair Financial Services Consumer Panel

Thank you for inviting me to talk to you today.

I think I should start by saying that the Panel welcomes the plan to transfer responsibility for the regulation of consumer credit to the new FCA. We see a single regime as a definite improvement. It has always struck us as odd that a bank account in credit has one regulator while if in debit it has another.

However, it is essential that consumer protections standards should be maintained, and ideally enhanced, under the transfer. We believe that this can be achieved through tackling existing market failures and effective enforcement of the conduct requirements.

However, before I get into detail, I probably need to explain what the Consumer Panel does, since many of you will not have come across it in your work. The FSA is required by law to set up two Panels, the Consumer Panel and the Practitioner Panel. It subsequently established a third panel to represent smaller businesses like independent financial advisers, stockbrokers, building societies and credit unions. It has a duty to consult these panels about its approach to regulation. It is also required to respond to representations made by the Panels. These requirements will be written across into the new Financial Conduct Authority with the addition of a fourth panel to represent the financial markets.

The definition of a consumer is anyone who is not an Authorised or Approved person. At the moment there are 17 members, because there has been an unusual amount of work with the Bill and the

break up of the FSA, but we usually operate with around 14. The Panel members are part time and are expected to give 2 or 3 days a month to Panel work. Panel members are paid and are appointed for a maximum of two terms of three years. We advertise for new members and they are chosen using an open process based on the Nolan principles.

We come from a broad range of backgrounds. These include consumer advice, consumer policy, law, economics, the civil service, journalism, management consultancy, and research. And, of course, we are all customers of the financial services industry ourselves. We meet monthly as a full Panel to discuss overall strategic issues and also two weeks later in three working groups to consider detailed responses to consultations from the FSA and other organisations. One of the working groups now focuses full time on the EU because of the amount of regulation coming out of Europe. We have an office of seven full-time staff based in the FSA, a budget for independent research and we publish our work on our website and in our annual report.

Roughly half our work is responding to consultations and queries from the FSA and other organisations involved in developing policy in the financial services sector. The other half of our work focuses on strategic priorities where we think there is a need to encourage debate.

This year our priorities are:

- The future shape of legislation on financial regulation
- The future effectiveness of the FCA
- Consumer credit regulation
- Poor practices in general insurance

- Decumulation, and
- Effective consumer representation at the EU Level

Deciding what to do is very difficult. This year we had an extensive discussion before deciding to focus on decumulation rather than pensions and saving for later life. But consumer credit regulation was an easy choice..... Which leads me neatly to the title of this conference - New world or old wine in new bottles? sounds a rather suspicious title. But it's an understandable question, given that the new Financial Conduct Authority will be largely composed of the staff from the FSA and will be sited in the FSA's current offices.

Seen from the consumer perspective, it would be an understatement to say that regulation of the financial services industry has not been very successful when compared with most other industries. Of course, the FSA stopped the life assurance industry collapsing in the dot com bust of 2001 and the Government stepped in to help the FSA and the Bank of England save the banks more recently. But there has been a succession of regulators over the last 30 years without much reduction in the ability of parts of the industry to damage the financial health and savings of significant numbers of its customers. So it's not an unreasonable assumption that not much is going to change, apart from one letter in the initials.

I think this is an unfair view, for the reasons I am going to explain. But, all of us need to watch developments closely and engage with the various consultations, round tables and workshops that are being run to guide the development of the new system if we are going to end up with regulation which is more effective than what have now and not something which is worse.

Six weeks ago John Griffith Jones and Martin Wheatley, the chairman and chief executive of the new Financial Conduct Authority, launched the FCA's approach to regulation. The FCA will replace the FSA at the beginning of April next year if the legislation, which is still working its way through Parliament at the moment, goes according to plan. The Approach document makes the FCA look a lot more impressive than the FSA, from the consumer protection point of view, but has worried the industry. They are afraid that the intrusive approach it describes will ultimately increase costs and reduce the availability of financial services for the public.

So, with all this as background, it's not surprising that there is some nervousness around transferring credit regulation from the OFT to the FSA.

The Panel thinks the move to twin peaks, with separate business conduct and prudential regulators, rather than the FSA covering both prudential and conduct regulation, is a good idea. It means that there will be a clearer focus on consumer protection than was ever possible with the FSA. Also, the FCA's clear focus on conduct makes it much easier to bring credit into the same regulator as deposit taking.

The fact that it is possible to do this does not mean that it is automatically a good idea, but here are a couple of examples about why it could be. First, many of you will be aware that the first letter sent by a bank to someone who becomes overdrawn is regulated by the FSA under the Financial Services and Markets Act. However, all subsequent letters and communications are the responsibility of the OFT working under the Consumer Credit Act. It's not surprising that banks discovered they could use this lack of "joining up" in regulation to make additional profit from unauthorised overdrafts. Second, the OFT has competition powers which the FSA does not have and these

were particularly relevant to the regulation of PPI – simply put, it was not obvious whether PPI was a problem of ineffective competition and subject to the OFT or a simple case of mis-selling and the responsibility of the FSA. While this was being decided, which took nearly five years, a lot more PPI was mis-sold.

It's not surprising that in the join between the FSA and the OFT a number of problems, not just these, have been caught in the regulatory overlaps and underlaps. These problems tend to drag on and become a lot more costly and detrimental while the responsibility and powers are sorted out. The twin peaks structure makes it possible to join up the regulation, to get the best of what is in the Consumer Credit Act and the extensive rule making powers in the Financial Services and Markets Act. Of course, that may not happen if things don't change, hence the title of the conference.

It is worth remembering that the consumer credit market is large – unsecured debt in the UK was £156.6Bn in August which is about £6000 for every household. Anyone offering credit has to be licensed under the CCA and there are currently just under 80,000 licence holders. Research conducted for the FSA earlier this year by Critical Research suggested that around 20% of these licence holders were no longer trading. The number of active licence holders is estimated to be just over 47,000. Of these licence holders, just under 13,000 were estimated to be lenders; with roughly two out of three lenders having outstanding loans of £100k or less. Of the remainder one in seven lenders had more than £1m in outstanding credit and 3% had more than £50m. So not only is the sector large, it is also very diverse and this is one of the concerns about the future structure of regulation. It will more than double the number of firms the FCA will need to regulate.

Change is always disruptive. This one is particularly problematic because of the need for new legislation. There is uncertainty about how rules will work, which means that accepted practice could change.

The opportunities created by the proposed change are that:

- first that we can create a more straightforward world for both consumers and industry where there is a consistent regulatory approach with no overlaps or underlaps between the FSA and OFT
- second that the FSMA principles based rule making regime is more flexible legislation than the CCA. This will make it possible to update or develop rules as new products and practices emerge.
- third that we will have a single regulator with a more engaged and proactive approach to supervision and more resources than the OFT

If this works well, the result will be that we get much more effective consumer protection..... That's the dream.

In order to prepare for a discussion about the impact of a change from laws under the CCA to rules under the FCA, the Panel commissioned two pieces of research this time last year. The objective was to look at how the OFT had regulated under the CCA; what worked well and should be preserved and what could be done better. The reports are on our website. We discussed our findings with the FSA and the Treasury and held a workshop in the early summer with consumer groups. The workshop resulted in a more comprehensive and detailed list of issues. A list of issues which we have since discussed with the FSA. BIS and the FSA have recently

been running workshops and discussions with industry and consumer bodies to discuss points of detail.

The challenges in making the change are primarily to ensure consumer protections provided by the CCA and established case law are not lost in transferring to the principles and rules based regime of FSMA. The key protections are repayment and voluntary termination rights, time orders, section 75, unenforceable credit agreements, reasons for refusal of credit, collection and recovery and unauthorised overdraft rules. The best way to do this will be to retain the relevant sections of the CCA, since rules under FSMA do not have the same powers or precedent as established law. There is a debate at the moment on which parts of the CCA to retain and we expect a consultation early next year.

There will be resistance to transferring all the requirements of the CCA to FSMA from some sectors of the industry and politicians, claiming it is gold plating the requirements of the CCD.

In addition to the legislative issues there are operational essentials that need to be sorted out:

- OFT experience needs to be transferred to the FCA. The two organisations are talking to each other and the plan is to move staff across once the FCA takes over responsibility.
- The transition has to be managed so that it is clear how existing agreements will operate and consumer confusion is kept to a minimum. The FCA will have to work with the industry to provide clear and relevant consumer focused guidance for consumer advisers. In this space there may be a role for existing self-regulatory codes to be written across into the new regime, although there is also a risk that this could create a

loophole which would weaken regulation. We saw this with the Banking Code which attempted to define fair treatment of customers in terms of what the Code required.

- We need to keep firms' administration and costs to a reasonable level. Credit licences are cheap. Better regulation will cost more, but it is essential that the increase in fees is kept as reasonable and fair as possible, given the number of small firms that need credit licences.
- There needs to be consistent and effective regulation and improving enforcement and no gaps during the transition. In this area the role of the FCA's consumer intelligence and Trading Standards are critical elements

Finally, there could be unintended consequences,. The most obvious consequence could be a reduction in access to consumer credit, less choice for borrowers, and poorer value due to less competition. This could be a particular problem for businesses and small traders who are already suffering.

The current proposed timetable is planned to be:

- **End Jan to end Apr 13:** consultation on general regime design (including fees and transition arrangements) plus draft high-level rules
- **Late spring 13:** consultation on guidance on perimeter and other issues relating to the interim regime
- **Summer 13:** a policy statement with final high-level rules, taking account of feedback received
- **Sept-Dec 13:** a consultation paper on detailed features of regime, including rest of draft rules and guidance
- **March 14:** a policy statement with final rules and guidance, taking account of feedback received

- **End 14**: transfer of responsibility to FCA under transitional regime
- **End 16**: new regime introduced

The challenges and risks I have described mean that it is important, above all, to allow sufficient time for the FCA to develop a regulatory philosophy and a regime specifically tailored to the needs of the credit market. There is concern that the FCA will rely on the larger organisations in the industry to regulate by proxy using Appointed Representatives, increasing their compliance risks and costs. The FCA could also impose unreasonable capital adequacy requirements. These may be risks, but the evidence so far is that the FSA staff involved have been very willing to engage in constructive discussions. At the FLA Conference last month the Treasury official involved said that they wanted to get the regime right and if that took a little longer than 2016, they would be prepared to take the extra time.

One of the issues that is concerning about the change is that the FSA has had very little experience of dealing with small businesses, apart from independent financial advisers, or with criminals apart from those running scams like boiler rooms. I recently talked to people at the OFT involved with Trading Standards and to Trading Standards and was reassured to hear that there is a relationship between all three organisations. They are talking to each other and trying to ensure that during the transition nothing goes wrong. In the short term, it is unlikely that much will seem to change at the operational level although no change happens without the occasional cock up.

Of course a huge problem is austerity and the lack of money at both local and national government level to support an effective Trading Standards operation. I don't think the transition will make it any

worse and the change means that there is an opportunity for good ideas to be put into practice.

The other issue about enforcement is the extent to which the FCA will be willing and able to deal with credit problems. The two most obvious examples are payday lending and unauthorised money lending.

I am very glad that the OFT has taken a clear stance on what it expects from payday lenders and I have no doubt that the FCA will continue this work when it takes over. Most people forget that the FSA only took over the regulation of mortgage lending in 2005 three years before the crash and retail banking regulation from the Banking Code Standards Board in November 2009. A lot of what went wrong in both areas was due to a light touch approach, but it was compounded by the fact that the FSA were taking over from another regulator and, in the case of retail banks, from self-regulation which was not working well. I think the FSA has learned from these experiences and, coupled with the change in the political climate as a result of the crisis, I have a lot more confidence that they will do better.

One of the things which gives me confidence that they have the will and the ability to deal effectively with smaller businesses is that when we began to see the sale and rent back market taking off, the FSA moved quickly to put in place an interim regime to give a minimum degree of protection to consumers while it developed and implemented a full regime, closing down most of the major providers in the process. The Panel was concerned that there were over a thousand small operators in this market, but the FSA's belief was that the effect of closing the main bad providers of finance

would be to effectively shut the market down. And this appears to have worked.

Illegal money lending is more of an issue. The centralisation of expertise is probably a good thing as long as the intelligence on the ground is not lost. Maintaining good up to date information about what is happening is not going to be easy with the pressure on local authorities' finances, but I hope that the people involved will think creatively about how information can be provided to the FCA and Trading Standards. Both organisations are clearly keen to build relationships with organisations that can help them.

The OFT regime had very limited resources to supervise licensees. This is not how the FSA is used to working and this is one of the areas where there could be a very significant improvement in the effectiveness of regulation. Cost is an issue, but it needs to be seen in the context of the detriment weak regulation can cause. The key will be getting the right balance between on the ground intelligence, collecting information from credit licensees, supervisory oversight and enforcement. This is an area where the industry , as well as consumer groups has a real interest in helping to get the balance right by responding to the consultations and remembering that ineffective regulation is not in the interests of anyone.

I would like to leave you with three thoughts:

- The proposed change is a once in a generation opportunity to bring about a real improvement for consumers and to rebuild trust in the industry
- Good change will only come about if consumer groups and industry co-operate to get the detail of the new rules right. I believe there is a lot of good will on both sides, but if we get

into competitive negotiation about the shape of the regulation, there is a real risk that consumer protections will be eroded and the opportunity we have will be lost.

- Everyone must engage with the consultations. As I hope I have made clear, there is a lot of working going on between the regulators, but they don't understand all the detail and there needs to be continuing attention by those who do.

To sum up. I think we should all work together to make sure that the result will be a good wine in a new bottle.

Thank you.