

Financial Conduct Authority



FCA Risk Outlook 2013



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Foreword

Martin Wheatley, Chief Executive Designate



“This risk outlook provides an opportunity for us at the start of our journey to take stock of the issues we face as a new conduct regulator which we can build on over the coming years”

This is the first Risk Outlook to be published by the FCA and so sets expectations for the type of risks the FCA will focus on.

A ‘Risk Outlook’ inevitably will focus on what could go wrong – firms or products failing; misalignment of the risk appetite of individuals with the products they are sold and consumer detriment when lives are affected through failings or misconduct in the financial sector.

But there is another side to the risks we are concerned with: firms not investing in innovating new products to meet the changing needs of society; withdrawal of sales forces; and too few new entrants in the industry to allow competition to flourish. So there are two sides to the risk equation – consumer detriment arising from the wrong products ending up in the wrong hands, and the detriment to society of people not being able to get access to the right products.

The FCA must recognise that these are both risks and will need to navigate a careful path between them.

This document provides an opportunity for us at the start of our journey to take stock of the issues we face as a new conduct regulator which we can build on over the coming years. It sets out our current thinking on conduct in financial markets by analysing the root causes and emergence of conduct risk. We will complement our approach to retail conduct with a strong focus on wholesale conduct. We recognise that wholesale conduct in some respects sets the tone for the conduct of the wider financial industry; the risks in transactions where conflicts of interest are poorly managed or counterparts do not act with integrity can undermine overall market integrity, and may eventually feed through to the retail consumer.

Our approach to risk will enable us to become more proactive and intervene earlier, focusing on the sources of detriment such as product design, governance and incentives. In this document we set out those forward-

looking risks that we deem pose the greatest risk to our objectives. While the FCA also has prudential responsibilities this document focuses solely on the conduct responsibilities for the organisation and how these link to our regulatory objectives. For the first time we are publishing our Business Plan alongside the Risk Outlook; in subsequent years we will expect these links to be even clearer and to develop our approach as we gain experience in the new regulatory environment.

From insurance contracts for ships negotiated in the coffee shop of Mr Edward Lloyd, to goldsmiths acting as safe depositors of money for merchants, the financial services industry was built on the needs of its customers and functioned in order to meet those needs. In the first speech I gave as CEO designate of the FCA, I set out the lifecycle of a typical customer and their interaction with and expectations of the financial services industry. With the financial services landscape becoming increasingly complex, it is important to keep revisiting this story to remind ourselves of the needs and expectations of the society we are here to serve today.

The first need for most consumers is for a bank account – somewhere to put money from a first job, or a loan, or maybe even pocket money which they use to save or to buy goods and services. The majority of consumers remain with their first bank for the remainder of their lifetime, making that first choice all the more important.

With our new competition power, we have a role in promoting choice and ensuring that regulation does not act as an unnecessary barrier to new firms entering the industry and does not discourage innovation. Our new focus on supply-side issues associated with competition problems is a real departure from the FSA regime and will enable us to better intervene in the factors that affect the functioning of markets and in the market failures that often lie at the root of poor conduct outcomes in financial markets.

“Achieving the FCA vision is in all of our interests, not only socially but also financially.”

The next time our consumer may encounter financial services products is when they make payments for goods or services, perhaps their first car, mobile phone, concert tickets or book their first holiday. They may need access to their savings or credit if there is a shortfall; they may need insurance to protect their new assets. Our consumer may be faced with the option of a general insurance add-on product, which is available for just about every product being sold. However as the consumer is focussed on the primary sale, they do not always assess the cost or utility of the add-on product.

The FCA will focus on inherent factors that interact to produce poor choices and outcomes in financial markets. We will carry out market studies to identify features that weaken competition and drive poor consumer outcomes – the first of these will focus on problems in the add-on market).

Going back to our typical customer, after they've been with their bank a while and built up some savings, they may want to take out a mortgage to help them buy their own home. Figures show that since 2002 the average age of first-time buyers has been fairly stable, at around 31 years old. In recent years, an increasing number of people buying their first home have had parental help.

Lastly our typical customer will perhaps start looking to invest or save for their retirement. Part of our role as the FCA means encouraging a financially inclusive society where firms do not focus only on those with significant wealth to invest, but also on encouraging saving amongst those on lower incomes.

When our typical customer visits their bank, building society or IFA in search of investment advice, they need to be confident that an advisor will look at their personal circumstances, their goals and aspirations and how much they're prepared to risk and then come up with something that is appropriate for them – not just see it as an opportunity to earn a little more sales commission.

Poor incentive structures that reward high-risk, short-term strategies are a clear indicator of a culture where the customer is not at the centre of how the business is run. Culture change within firms is essential if we are to restore trust and integrity to the financial sector and the FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interests of their customers.

The FCA's overall objective is to ensure financial markets function well. For the FCA this means:

- Consumers get financial services and products that meet their needs from firms they can trust.
- Markets and financial systems are sound, stable and resilient with transparent pricing information.
- Firms compete effectively, with the interests of their customers and the integrity of markets at the heart of how they run their business.

A successful financial services industry is one that can meet the needs of consumers: the need for a bank account in which they can save, credit to help them make important purchases and insurance to protect these purchases against loss or damage, to help pay for their home, or to invest for their family's future. But it is also one that can meet these needs in a safe and sustainable way. And that is, in effect, the goal of the FCA and the outcome which the objectives set for us by Parliament aim to achieve.

People need a financial industry they can trust – success for the FCA will be when both consumers and firms rebuild that bond of trust.

There are some issues that as a conduct regulator we may be unable to tackle alone, and maintaining effective relationships with our stakeholders will be vital in order to achieve the FCA vision. This will include the Prudential Regulatory Authority and the Bank of England; the regulatory family including the Financial Ombudsman Service; other European and international bodies; financial services firms; consumer organisations; and audit and law firms.

Achieving the FCA vision is in all of our interests, not only socially but also financially. There are numerous recent examples evidencing this point, from the redress bill firms now face following the mis-selling of payment protection insurance to the contagion effect of wholesale misconduct such as the attempted manipulation of LIBOR. Firms' behaviour, attitudes and motivations must be about good conduct; consumers, firms and individuals must take responsibility for their part in creating financial markets which work well and offer a better outcome for consumers.

Thus the risks set out in this document should not be of concern only to us, the regulator, but also to the industry as a whole. And we and the industry have a collective responsibility to co-operate in acting to address these challenges.

The majority of the consequences of our actions will be positive, in line with the objectives laid out for us. However in some situations there may be unintended consequences, not necessarily within our remit to address, which result from the actions we choose to take. When we and industry act to address the risks laid out in this document, we all need to have an awareness of the wider impact these actions might have – a wider social conscience if you will.

I therefore encourage you to read on and consider the risks we have identified and how you will play your part working with us to address these over the coming year.

We need to be mindful of the effect our interventions may have on society as a whole, particularly on groups that may find it harder to access the market than others.

Executive summary





Our Approach

This document sets out the FCA approach to assessing conduct risks to our objectives. It looks at the drivers of conduct risk – inherent factors, structures and behaviours that have been designed into and become embedded in the financial sector, and environmental factors – and how these factors impact the financial services market and its participants.

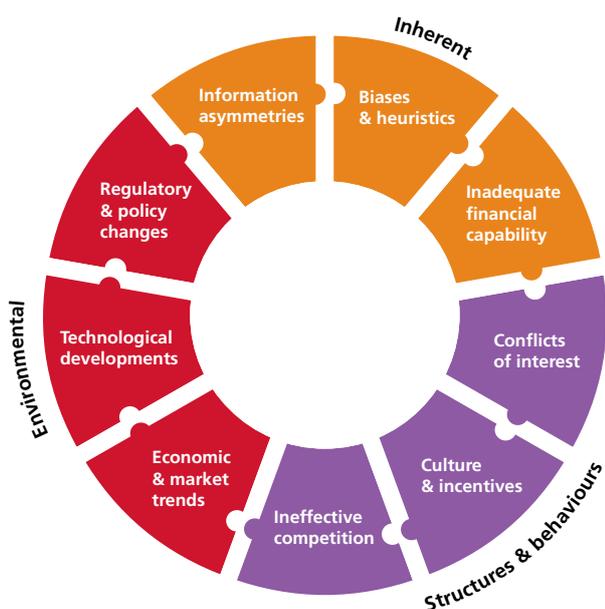
This approach enables us to monitor changing conditions and the responses and behaviours of firms and consumers. This helps us assess how these interactions may lead to faultlines in financial markets that drive poor consumer outcomes, weaken competition and threaten market integrity. This analysis will be used to inform our operational priorities (as set out in our Business Plan for 2013/14), and will also function as a baseline analysis of longer-running risks that regulators, firms and consumers need to address over the long term to improve conduct outcomes.

The document is structured in two parts. Part A examines the drivers of conduct risk and Part B presents our view of the implications of these drivers.

Part A. Drivers of conduct risk

In this section we analyse some of the most important root causes of poor consumer outcomes, risks to market integrity and ineffective competition in financial markets.

Key drivers of conduct risk



These include:

- *Chapter 1: Inherent factors*
A range of inherent drivers of conduct risk that interact to produce poor choices and outcomes in financial markets. These drivers are a combination of supply-side market failures (e.g. information problems) and demand-side weaknesses (e.g. biases), which are often exacerbated by low financial capability among consumers.

- *Chapter 2: Structures and behaviours*
Structures, processes and management (including culture and incentives) that have been designed into and become embedded in the financial sector, allowing firms to profit from systematic consumer shortcomings and from market failures.
- *Chapter 3: Environmental factors*
Long-running and current economic, regulatory and technological trends and changes that affect the factors explored in Chapters 1 and 2 and are important drivers of firm and consumer decisions.
- *Drivers of wholesale conduct risk*
The nuances to the drivers discussed in Chapters 1 and 3 that are relevant to wholesale markets and which we will recognise in our approach to wholesale conduct risk assessment and supervision.

Part B. Evolving risk landscape

In Part B we identify the implications and risks arising from the drivers discussed in Part A.

In Chapter 4 we cover a number of forward-looking cross-market conduct risks that fall out of the analysis in Part A, and which we consider will be key risks to our objectives in the future. These broad risks are:

- *Rising pressure on strategic business model adjustment*
This captures the long-running and post-crisis pressures firms are under to adjust their business models and looks at the implications this may have for our objectives. In this, we discuss the way in which products are designed, the market segments and consumer groups that firms rely on for growth, and how technology is developed and used.

- *Failure to balance prudential soundness and profitability with good consumer outcomes*

This captures the potential consumer detriment that may arise from measures firms take to improve prudential soundness and increase profitability, including cost cutting strategies, strategic adjustments and funding strategies.

- *Misalignment of market performance expectations and underlying fundamentals*

This captures the challenges firms and consumers face in making decisions due to expectations that are not aligned to underlying fundamentals and which may be based on ill-informed risk assessments.

In Chapter 5, we distil these cross-market risks into priority conduct risks for the FCA and show how these link to our operational priorities as set out in the 2013/14 Business Plan. These are:

1. Firms do not design products and services that respond to real consumer needs or are in consumers' long-term interests.
2. Distribution channels do not promote transparency for consumers on financial products and services.
3. Over-reliance on, and inadequate oversight of, payment and product technologies.
4. Shift towards more innovative, complex or risky funding strategies or structures that lack oversight, posing risks to market integrity and consumer protection.
5. Poor understanding of risk and return, combined with the search for yield or income, leads consumers to take on more risk than is appropriate.

Conclusion

Our proposed action to deal with these risks is set out fully in the Business Plan. A summary of these links can be found in the conclusion. We have also set out some key messages for firms and consumer bodies which include how we expect market participants (including the FCA) to use the conduct risk outlook strategically to achieve our objective of ensuring markets work well for consumers.

Part A: Drivers of conduct risk





In this section we set out the key drivers that have been at the root of conduct risk over the years and also underlie the risks we see in the evolving risk landscape.

The drivers of conduct risk we explore are:

- **Chapter 1: Inherent factors**

What lies beneath – features of financial market structures or the behaviours of market participants that are perennial drivers of conduct risk; a combination of supply-side market failures (e.g. information problems) and demand-side weaknesses (e.g. inbuilt biases), which are often exacerbated by low financial capability among consumers.

- **Chapter 2: Structures and behaviours**

Financial sector wiring – features of financial sector design (structure and processes) and management (culture and incentives) that have been designed into and become embedded in the financial sector, creating conflicts of interest and providing incentives for poor conduct.

- **Chapter 3: Environmental challenges, change and uncertainty**

Past and current environmental factors that have played a key role in firms' and consumers' decisions and will continue to drive choices and behaviours.

- **Drivers of wholesale conduct risk**

How these inherent factors, structures and behaviours, and environmental factors play out in wholesale markets.

These factors are particularly important in financial markets because when consumers buy financial products they are often tied to these for a period of time and they can have long-term implications for personal finances. In addition, the suitability of their decisions may not become clear for some time, e.g. upon maturity or making a claim. This makes consumers reliant on the products designed by firms and the advice they receive at the point of sale.

Many of the factors at the root of the risks we examine later in this document may sit outside the FCA's direct remit. However, it is important to explore these to gain a better understanding of the dynamic and complex environment in which conduct risks evolve.

1. Inherent factors – what lies beneath

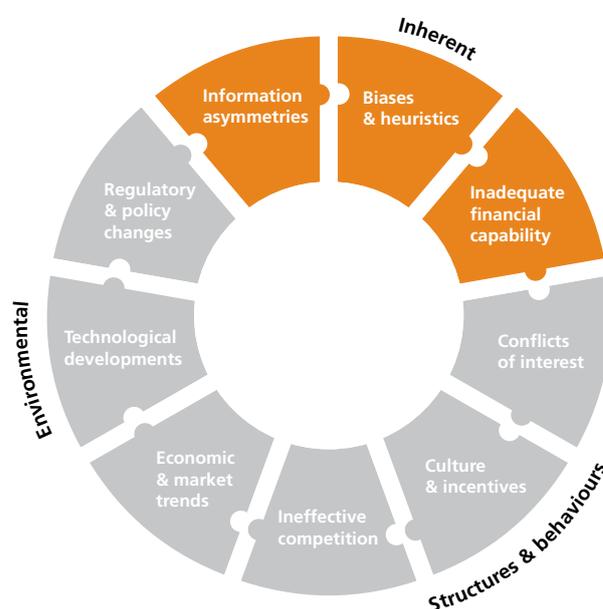
A range of inherent factors interact to produce poor choices and outcomes in financial markets¹. These factors are a combination of supply-side market failures (e.g. information problems) and demand-side weaknesses (e.g. inbuilt biases) which are often exacerbated by low financial capability among consumers. Inherent factors can interact with the structures, processes and management systems that have been designed into and become embedded in financial markets over time. These interactions create conflicts of interest and provide incentives for poor conduct (discussed in Chapter 2). By considering these issues together, and recognising that poor outcomes are driven by a complex range of factors, we aim to analyse and monitor the root causes of conduct risk across financial markets. This analysis will also help us understand how and where to intervene to tackle conduct risks before they threaten our objectives.

Here we focus on three inherent drivers of conduct risk, which are present across many financial markets:

- Information asymmetries
- Biases and heuristics²
- Inadequate financial capability

Consumer detriment has repeatedly arisen where consumers have bought unsuitable, deceptive or over-priced products or services. There are some inherent factors that are often at play in the mistaken choices that consumers make. Many of these centre on the role of information (its availability, quality and interpretation). But even where firms disclose information and consumers understand relevant financial concepts,

Inherent factors that drive conduct risk



unconscious biases and heuristics (mental shortcuts and thought processes) often cause consumers to focus on the wrong information or ignore important factors needed to make an appropriate decision.

The impact of biases and heuristics is particularly significant in financial decisions because, unlike many other consumer choices, a single financial decision can have long-lasting and costly implications: signing an unsuitable financial contract could lock a consumer in to a costly decision for a long time. The importance of understanding these fundamental causes of consumer mistakes is therefore especially crucial in financial services, and lies at the root of an increasing number of initiatives across the public and private sector that draw on behavioural insights to 'nudge' consumers towards more appropriate financial decisions.

¹ We discuss the nuances of these drivers of conduct risk for wholesale markets on pp. 40-42.

² Biases are defined as systematic errors that influence judgements and decisions. Heuristics are defined as mental shortcuts or rules of thumb that simplify judgements or decisions.

1.1 Information asymmetries

Many poor consumer outcomes in financial markets stem from incomplete availability, disclosure or understanding of information on the features or likely performance of financial products and services.

Information asymmetries – where one party in a transaction has additional or superior information to the other party – are at the root of many conduct issues in financial markets. Firms have used their superior access to and understanding of information over time to develop structures and processes that benefit the firm over the consumer, or put the interests of one group of consumers over another (see discussion of conflicts of interest in Chapter 2). This has led to poor outcomes for consumers, and a system in which consumer interests have not been at the centre of firms' business models. These asymmetries can be seen in some of the most prominent recent examples of poor conduct in the financial sector, including PPI mis-selling. In extreme cases, these asymmetries can be exploited by firms knowingly, with very negative implications for consumers (e.g. boiler room scams) or for market integrity (e.g. insider trading).

Consumers can also exploit information gaps by misrepresenting their circumstances, which could mean that they are sold inappropriate products or given advice that is not suited to their circumstances. Failure to disclose full information on financial circumstances or more serious fraudulent consumer activity imposes costs on the financial system that can lead to poor outcomes for other consumers if firms change their product and service offerings in response.

1.2 Biases and heuristics

Even where firms strive to provide good quality and accurate information, consumers can still make poor

financial choices as they struggle to match their needs with the products and services on offer. This is partly due to the difficulty (or impossibility, in some cases) of knowing what your future financial needs will be given that circumstances and the external environment may change significantly and in complex ways that cannot be predicted. It is also partly due to the systematic errors that consumers make in decisions, which are driven by inbuilt and often unconscious factors – biases and heuristics.

People are mostly unaware of these biases. They also tend to trust their intuitions (driven by heuristics) and institutions (in financial services this includes figures of authority e.g. IFAs or a well-known brand) even when this trust is misplaced and may increase the likelihood of making the wrong decision. Even people familiar with biases may not see how these affect a particular decision and therefore may not be able to prevent these biases from affecting their decision-making. A variety of biases and heuristics are relevant to financial decisions because they limit the individual's ability to fully assess both their own needs and long-term interests and to adequately understand the products and services on offer to them. They also translate into the behaviours that increase the likelihood of poor outcomes, e.g. consumer apathy or undue trust in financial institutions.

Of these unconscious factors in poor financial decisions, some of the most important include:

- *present bias*, which is at the root of many of the factors that cause consumers to make poor decisions – for example apathy, inertia;
- *availability bias*, under which people tend to make judgements based on new, recent or the most vivid/striking news or developments. This is particularly important in financial decisions, especially if these are being made for the long-term and should therefore be based on long-running needs and trends;

- *overconfidence*, which can exacerbate the present bias, and is often at the root of mistakes that consumers make with their finances (for example, around the future affordability or performance of a product); and
- *framing*, where consumers may make poor choices due to the way in which their decision is presented to them. Framing usually works by triggering a particular bias (such as loss aversion) to make certain information more salient and draw attention away from other information. This affects how consumers evaluate the benefits of individual products and as a result consumers may not find the cheapest and most appropriate product for their needs.

Because of biases, consumers tend to stick with their existing products and do not search enough, search based on the product characteristics most appropriate to their needs, or switch to better offers. In addition, firms can take advantage of or manipulate consumer biases in product design and sales processes to lower the quality of products and/or charge higher prices, without the threat of losing customers to their rivals. Consumers are particularly vulnerable to having these biases exploited where situational monopolies arise, e.g. where intermediaries sell add-on products at monopoly prices because consumers are not given the opportunity to shop around for better offers at the point of sale (this played a role, for example, in PPI mis-selling).

Various bodies across the public and private sectors are increasingly devising solutions that use biases and heuristics to 'nudge' consumers towards better savings and investment choices. The FCA is playing an active role in this, including examining how behavioural economics can affect both consumer choices and the effectiveness of regulation.

1.3 Inadequate financial capability

The extent to which biases influence consumer outcomes and contribute to conduct risk is also affected by the consumer's level of financial capability. Inadequate financial capability is most acute in those parts of the population that possess poor literacy and numeracy skills. However, there is growing responsibility on individuals to manage their finances for long-term spending needs while the number of financial products available is increasing in quantity and complexity. This means that consumers are required to make decisions that may be beyond their capability on an increasing array of financial products and services.

The features of financial capability that can lead to poor outcomes include:

- *Confidence*: Consumers can lack confidence in their ability to take an active role in managing their financial needs. Purchasing financial products and making financial decisions are not necessarily frequent occurrences for consumers (unlike buying other products) and it can take time for individuals to build their confidence. Furthermore, many important financial purchases, such as annuities or mortgages, are rare or one-off occurrences, meaning that consumers do not have the opportunity to build up their knowledge or learn from their mistakes.
- *Skills and knowledge*: Even where consumers may be confident in shopping around for financial products, they may often underestimate how product choices may affect long-term financial capability should their circumstances change, e.g. investing all savings in a 5-year fixed term bond could have a serious impact on financial capability should the consumer be subject to an income shock (e.g. redundancy, unexpected expense) before the bond matures.

- *Opportunity*: The opportunity to be financially capable may be limited by available financial resource, e.g. a person's income may not provide them with the opportunity to meet their necessary everyday spending needs as well as providing for their future through a pension, savings or protecting their assets through insurance.
- *Attitudes*: External factors may influence a person's attitude towards the importance of financial capability in ways that make it less of a priority, e.g. growing up in an environment where money is rarely or never discussed or where no perceived financial pressure exists could potentially skew a person's attitude towards the importance of financially capable behaviour.
- *Motivation*: Consumers may have the skills and knowledge required to engender financial capability but may not have the motivation to utilise these to their full potential, e.g. someone who understands the benefits of a pension may delay making contributions to their scheme because they feel too young to be concerned about their retirement income.

There are several fundamental factors that lead consumers and firms to make poor decisions. These include unconscious influences such as biases, information problems and differences in levels of understanding of financial concepts.

In some cases, firms have used these factors to sell inappropriate or lower-quality products or to charge higher prices. And even where consumers and firms are aware of these factors and their potential impact, they may not be able to avoid or counter them. The impact of these factors can be particularly significant in financial decisions because in many financial purchases, quality or suitability can only be judged a long time after the purchase, by which time the consumer may already have suffered harm, financial or otherwise.

Our ability to deal with these inherited problems is limited, and to make improvements we will need to continue working closely with other regulators and government bodies. Industry and consumer bodies will also need to continue encouraging consumers towards better financial decisions.

2. Structures and behaviours – financial sector wiring

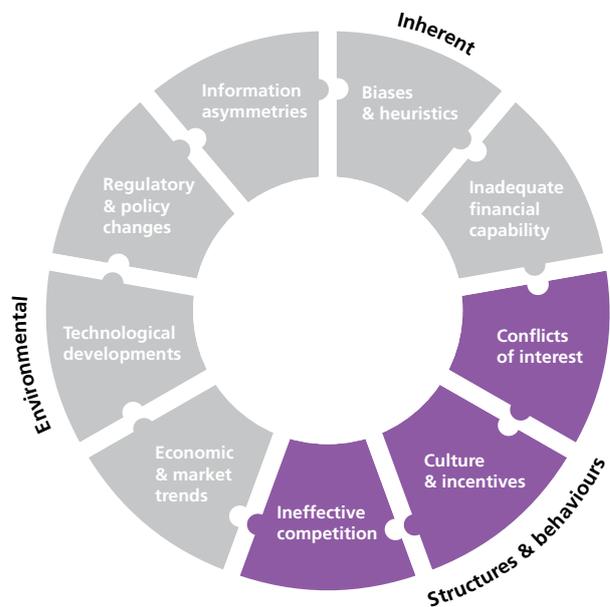
Financial sector design (structures and processes) and management (including culture and incentives) have been developed over time in ways that allow firms to profit from the systematic consumer shortcomings and market failures discussed in Chapter 1. These characteristics have been at the root of poor conduct outcomes in the past.

They are often areas where regulatory intervention in firms’ systems, processes and governance is used to change consumer outcomes or improve competition in financial markets or market integrity.

We focus on three key factors arising from the way in which the financial sector is designed and managed that are often at the root of poor conduct outcomes in financial markets:

- Conflicts of interest;
- Culture and incentives; and
- Ineffective competition.

Financial market structures and behaviours that drive conduct risk



2.1 Conflicts of interest

At the root of many conduct risks is the exploitation of conflicts of interest which, over time, have been built into financial sector structures, processes and management. Exploitation of these conflicts can undermine market integrity and competition and can lead to consumer detriment, and so has been the focus of much regulatory intervention over time.

The information problems discussed earlier underlie the different types of conflicts of interest that arise within financial market structures. Financial firms can undertake various activities, with different and potentially conflicting incentives and objectives and on behalf of different client bases (or on their own account). This creates conflicts of interest that can lead to poor conduct outcomes.

Conflicts can develop as firms balance the needs of different client groups against the importance of specific groups in the firm's business model and strategy. For example, one client segment may be more profitable than another, heightening the risk that the firm over-exploits this group and, in doing so, potentially excludes others.

The failure to properly manage the often inherent conflicts of interest in wholesale markets is a key root cause of risk to both market integrity and consumer protection. This is discussed in more detail in the wholesale section.

2.2 Culture and incentives

Firm culture and incentive structures often enable conflicts of interest to become profitable and entrenched in firms' businesses and processes.

Since the financial crisis, concerns have grown about poor conduct and inadequate levels of integrity among financial firms. Calls have grown for a change in culture that refocuses firms on their responsibilities to the long-term interests

of consumers, shareholders and the broader economy. Many recent examples of poor conduct in the UK financial sector (e.g. PPI mis-selling, the attempted manipulation of LIBOR) have emerged from products or systems that were developed in ways that took advantage of some of the inherent market failures and demand-side weaknesses set out in Chapter 1, and of the conflicts of interest discussed above. The FCA will continue to focus on how firms are managed and structured to ensure consumers are at the centre of their business. This change is needed to restore trust and integrity to the financial sector.

Incentives exacerbate these conflicts, e.g. by rewarding high-risk, short-term business development strategies or putting implicit or explicit pressure on the salesforce to promote particular products, regardless of differences in consumer needs and demands. Incentives can increase misalignments between firms and consumers – a dynamic that has given rise to various examples of consumer detriment in the past in the form of mis-selling.

Better design and alignment of remuneration and higher quality scrutiny by investors, auditors and regulators can mitigate the behaviours and processes that allow these conflicts of interest to become profitable for firms and costly for consumers. There have been several regulatory initiatives that seek to align remuneration and incentives with consumers' longer-term interests rather than short-term gain. However, it will be difficult to measure the true impact of regulatory interventions on behaviours. While executive incentive structures have shifted from short-term cash bonuses to share-based awards, longer vesting periods, and performance-related claw back schemes, ratios of executive compensation remain out of sync with performance. In addition, incentivisation of sales staff in financial services has yet to be significantly reformed, although FSA guidance based on analysis linking frontline sales staff incentives with mis-selling and poor conduct outcomes may speed up changes.

Box 1: Organisational and product design

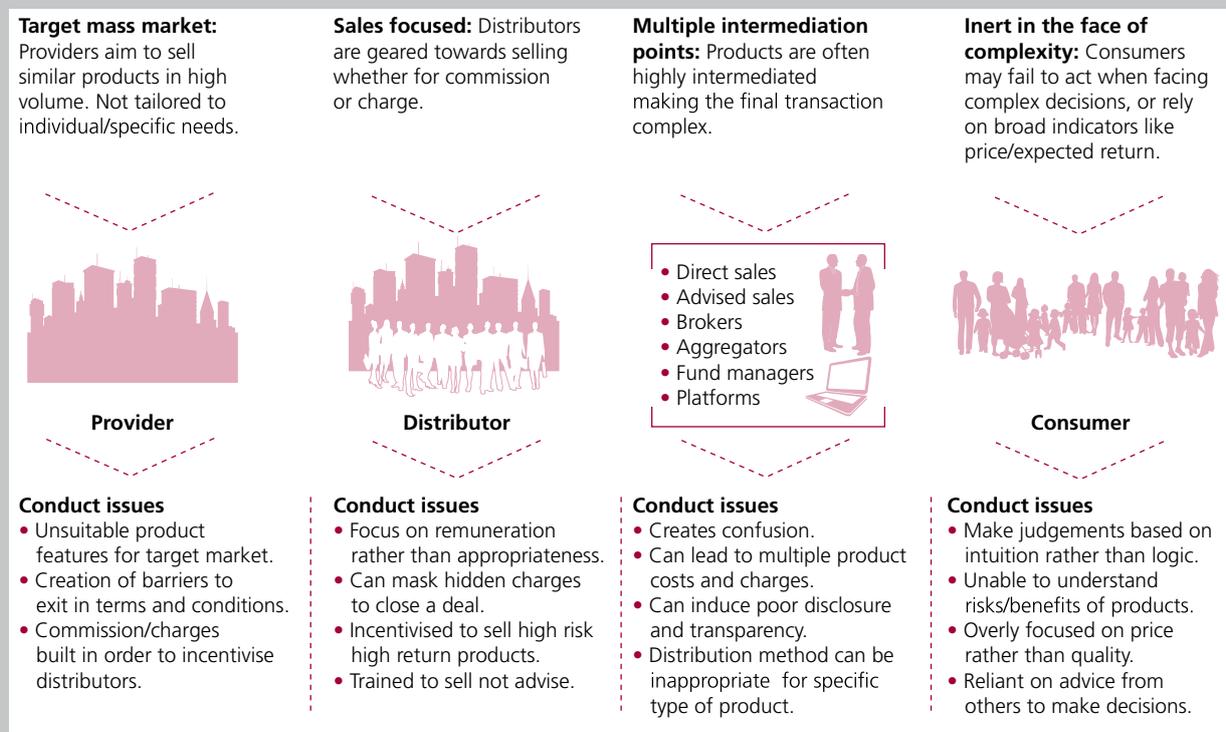
The inherent factors and financial market structures and behaviours discussed above create a complicated set of interactions that can reinforce or exacerbate each other, making it a challenging task to identify the causes of poor conduct and, therefore, to decide how and where to intervene as a regulator.

One area in which many of these long-running drivers of risk come to play is in the design and distribution of financial products and services, in ways that often mean that consumers end up with products that do not serve their real needs and may expose them to unwanted risks or exposures.

Organisational and product design: fragmentation of value

Since distributors of financial products act as agents to both consumers and product originators in financial markets, distribution channels can also act as an enabler of these conflicts (an illustration of principal-agent problems). Conflicts may arise from the direct benefits distributors receive from product providers (such as commission payments or rebates, which can influence placement of business). While regulations such as Retail Distribution Review (RDR) seek to mitigate this risk, the way in which these structures indirectly (and often unintentionally) enable conflicts to develop is also an important driver of risk and one that is difficult to tackle from a regulatory perspective.

Figure 1. Conflicts of interest in retail financial transactions



Complex and often highly intermediated distribution chains mean that different market participants are able to extract fees and charges from consumers at multiple points – a fact that is often unclear to the end user at the point of sale (see Figure 1). Increasingly complex charging structures (driven in part by pressure on firms from declining markets and changing consumer behaviours) have generated important new revenue streams for many firms. In some cases, these have also been accompanied by lower levels of transparency on products and pricing. In addition, disclosures on fees and charges for long-term investment products such as pension and long-term savings products, can mislead consumers on the life-time costs of the product. This could in turn lead to inappropriate product choices, with serious implications – for example, if consumers make poor decisions around their savings and provisioning for retirement this could lead to a squeeze on future income and reduced future spending power. Consumers need to place a significant amount of trust in firms at the point of sale and, for many products, will not be able to see whether or not they have been well advised for many years (by which time it may be too late to undo or reverse any detriment that has arisen).

Across complex distribution chains, firms may also fail to take on conduct responsibilities (e.g. ensuring treating customers fairly (TCF) principles are adhered to or that savers/investors are aware of their rights under the Financial Services Compensation Scheme (FSCS)) on the assumption that these have been taken

care of at previous stages in the transaction. For example, an adviser may assume that the product originator and/or distributor have ensured that the product offers value to the consumer, that performance credentials are realistic and that downside risks are clearly articulated.

Even where efforts are made to manage these inherent conflicts of interest and prevent poor consumer decisions through transparency and disclosure on products and services (e.g. through their responsibility to understand the customer's risk appetite and provide advertising literature that is fair and not misleading), more fundamental factors can create a division between the interests of firms and consumers. For example, the risk perceptions between consumers and firms are likely to differ, as professionals are less likely to see financial services products as complicated and may be less averse to losses as their knowledge of markets may enable some of them to see ways of recouping these in the future. These differences underline the inherent problems in communications between two parties who have fundamentally different understandings of the issues being discussed and who lack a shared perception of risk.

Product differentiation: consumer choice and needs

There are a vast number of financial products on offer to consumers. These have been developed to perform 'jobs' that address consumer needs. However, the real needs of consumers are not always matched to the products they are offered. This can leave consumers holding products they do not need or which do not perform as expected.

Furthermore information asymmetries and biases make it difficult for consumers to:

- a. Identify what their actual financial needs are and what product features would meet these needs and;
- b. Whether the product they are being offered delivers these desired features.

Firms can take advantage of these factors through situational monopolies (where consumers may be coerced into taking a product they have not asked for and do not have the opportunity to find out whether they need it), or through making products overly complicated, which distracts from the product's core functions and features and makes it hard for consumers to understand the product.

When innovating products, firms tend to define consumers according to group characteristics, e.g. by life stage or occupation. While many of these products serve particular needs and are useful to target consumers, attempts by firms to segment consumers have led to excessive product differentiation and unnecessary complexity in some markets (and for some consumers reduced access). This complexity, compounded by marketing which highlights unique product features (which may not be comparable across products), can make it more difficult to compare products making financial decisions confusing.

Product differentiation can give consumers the impression they are getting a product which has been tailored to their specific needs. However, most people within these defined groups do not have 'group' characteristics. This can lead to consumers purchasing inappropriate products and firms over-segmenting consumers to try and address this challenge.

However, under this strategy of differentiation, the genuinely different and changing needs of consumers continue to be neglected. For example, consumers with simple needs may be offered products which provide additional features that are never used, or homeowners looking to withdraw equity may be offered a traditional homeownership mortgage.

Technological advances have increased the number of direct interfaces available to consumers – and therefore the range of products and product providers available to them. However, this direct access may not necessarily lead to better consumer outcomes: consumers are exposed to products that historically they would not have considered and may not need, which may complicate and confuse their choices.

For products where firms are reliant on automated underwriting systems that use across-the-board criteria, decisions are transaction - rather than relationship-based, and provide little scope for firms to offer bespoke solutions for individuals. For niche products, where bespoke solutions are a part of the product's suitability, automated systems may be unable to accurately match these products to consumer needs. This can lead to poor outcomes through the life time of the product e.g. interest-only mortgages if the repayment strategy is not tailored to the individual.

These factors have created risks for those consumers whose needs simply are not met by the products that they have access to and who end up making inappropriate product choices.

2.3 Ineffective competition

Effective competition in the financial sector enhances market efficiency and helps ensure consumers get good quality products at the right price. The outcomes of effective competition are:

- prices are close to efficient costs, providing accurate signals for decisions and meaning that firms are not able to sustain excess profits; and
- entry and exit – and change over time in firms' competitive positions – are driven by consumers switching to providers that offer better price-quality combinations.

Ineffective competition, on the other hand, arises when the structure of the market or the behaviour of market participants distort these outcomes, allowing firms to charge excessive prices and earn abnormal profits, without the risk of losing customers.

Ineffective competition can arise both from aspects of the structure of markets (barriers to entry, barriers to switching) that give firms market power or from other market failures including demand-side weaknesses that can also affect market efficiency, innovation and the prices that firms are able to charge. Products may be created in such a way that makes it difficult for competition to function effectively; for example, if firms use complex pricing structures that make it hard for consumers to compare products.

Where barriers to switching financial providers are high, competition may be weak and consumers can end up with inappropriate or over-priced products. Markets with significant barriers to entry are likely to have low levels of competition as incumbent firms do not face the prospect of losing customers to new entrants, enabling them to charge higher prices and earn excess profits. In markets where existing firms create high barriers to new entrants, prices are excessively high for consumers.

In some financial markets there are structural sources of market power (e.g. reputation or presence of large sunk costs such as significant physical investment) that lead to barriers to entry. This can lead players to have opportunities to exploit their market power (e.g. payment systems). Network effects in financial markets may also lead to entrenched sources of market power. Demand-side weaknesses may create barriers to entry if consumers are unwilling or fail to switch to new entrants. Market power can lead to persistent poor outcomes for consumers, putting at risk both our effective competition and consumer protection objectives through consumers being offered less choice and charged higher prices.

However, even where there are low barriers to entry and switching, other market failures such as information asymmetries or demand side weaknesses such as biases (discussed in Chapter 1) can lead to ineffective competition, especially where they are exploited by firms (leading to a reduced ability to compare products or high perceived costs of switching). For example, consumers of financial products often face an information disadvantage due to the intrinsic complexity of financial products and the relative infrequency with which consumers buy these products. This can lead to reduced competition in the market as consumers face difficulties in comparing and evaluating products due to information asymmetries.

We have a responsibility to use regulation to good effect to achieve our objectives; we will be mindful of the impact our actions may have on firms, consumers and competition in markets. In particular, we must ensure our actions do not lead to stagnation and a lack of innovation by firms and we will take care to ensure our actions do not discourage innovation or new entry.

Some firms' cultures, processes and products have been designed to enable them to profit from consumer errors and to exploit their superior access to, or understanding of, information on financial products and services.

This can mean that consumers may not be getting what they need and that firms do not act in consumers' best interests, e.g. where incentives are designed to promote the short-term interests of the firms, rather than the long-term interests of the consumer.

We will seek to address these imbalances that have become part of the way the financial services industry operates. For example, we will seek to ensure that incentives are not working against consumer interests. We will also promote effective competition in the market to increase the choice of products that meet consumer needs and make it easier for consumers to compare products or switch providers or products where it would benefit them.

3. Environmental conditions – challenges, change and uncertainty

The inherent factors, along with the structures and behaviours that become embedded in financial markets, (discussed in Chapters 1 and 2) affect the way firms and consumers respond to environmental conditions – economic, regulatory and technological developments. Environmental challenges, change and uncertainty affect firms in both good times and bad. And it is particularly challenging for firms and consumers to make important financial decisions in the current uncertain and stressed environment.

Economic and financial market trends, along with regulatory changes and technological developments, play a central role in driving firm and consumer behaviours and decisions. Over time, firms and consumers have adapted their strategies to account for, and take advantage of, environmental changes and inherent and embedded factors. These dynamics have at times led to poor consumer outcomes, risks to market integrity and ineffective competition. This has especially been the case where firms and/or consumers have not fully adjusted to new economic or financial realities.

In addition to affecting previous strategies and decisions, these factors will continue to play a role in shaping the strategies that firms are willing and able to pursue and the financial decisions that consumers make.

In this section, we discuss the key aspects of environmental conditions that commonly play a role in the evolution of conduct risk:

- economic and market trends;
- technological developments; and
- regulatory and policy change.

Environmental drivers of conduct risk

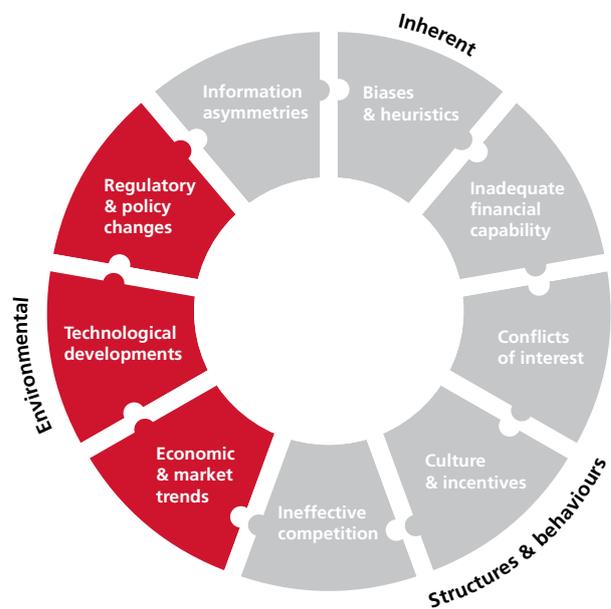
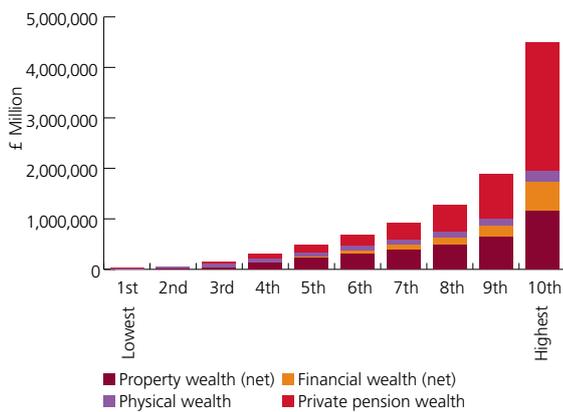
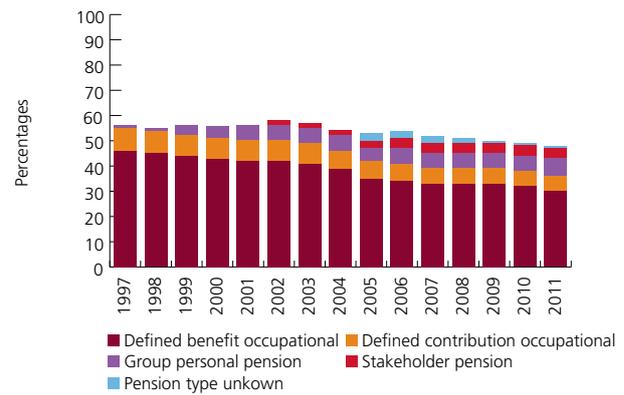


Figure 2: Breakdown of UK household aggregate wealth by decile and components 2008-2010



Source: Wealth and Assets Survey, ONS
 Note: Latest available data 2010

Figure 3: Employee membership of an employer-sponsored pension scheme: by pension type, 1997-2011



Source: ONS
 Note: Latest available data 2011

3.1 Economic and market trends

Economic and financial market trends influence the financial decisions consumers and firms make in good times and bad. Over the years, firm and consumer responses to long-running (socio-economic) trends and operating conditions have been among the drivers of conduct risk. Current conditions are putting additional pressure on firms and consumers, meaning that many decisions taken in today's stressed environment are likely to be focused on responding to short-term pressures rather than adapting to long-running challenges. The economic and financial market environment will therefore continue to be an important driver of conduct risk.

In this section we discuss the impact of long-running trends and current conditions on consumer balance sheets and needs. We then discuss the direct and indirect impact of these trends on firms.

Consumer needs and responses: wealth, low real returns and the search for yield

Consumer wealth relies heavily on the ability to accumulate assets and on the performance of these assets over time. The accumulation of wealth over a consumer's lifetime is an important component of their future well-being and will affect their financial needs and demands.

Financial wealth, which includes products designed for consumers to save or invest (e.g. savings, equities or bonds), is the most liquid form of wealth but is also the most unevenly distributed across the UK population. Financial wealth in the lower deciles has tended to act as a precautionary balance (i.e. easily accessible funds for unexpected expenses) rather than savings for the future, and accounts for a small proportion of total

wealth³. Current accounts are the most common form of financial wealth, with 96% of households holding a bank account (ONS Wealth and Assets Survey, 2008-10).

As a result of consistent growth in nominal house prices and the liberalisation of the housing market (through the right-to-buy-scheme that gave social tenants the right to buy their homes at a discount), the largest – and most evenly distributed - proportion of household wealth has come to be held in property (Figure 2). Property wealth is illiquid but, with a growing gap between savings and future spending needs, many consumers may choose to seek ways to release this wealth for future income.

Pension wealth is concentrated in the highest deciles. Lower down the wealth deciles the proportion of pension wealth declines rapidly. And there is a significant proportion of lower income households with no private pension provision at all (Department for Work and Pensions). Overall employer-sponsored pension scheme membership is low and falling (see Figure 3), leaving many with insufficient provisions for retirement.

In addition, pension deficits have been rising, driven by growing liabilities as redemption from the baby-boom generation increases (Figure 4). This is creating future challenges for pension funds in meeting their liabilities which could leave individuals in the future facing lower income. Other policy changes, such as the increase in defined contribution (DC) over defined benefit (DB) pension schemes and reduced state funding for long-term care, have put more responsibility onto the individual to save for the future.

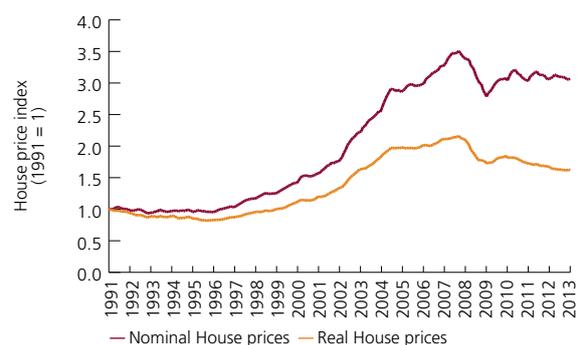
³ Here household wealth is divided into ten categories, referred to as deciles, with the lowest wealth group being the 1st decile, and the highest being the 10th.

Figure 4: Pension deficits 2003-2013 (Feb)



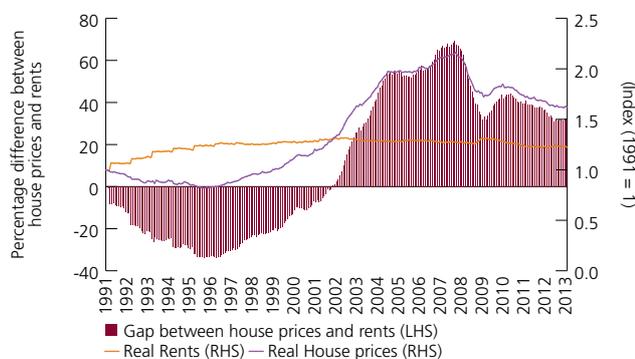
Source: Pension Protection Fund
 Note: Breaks in data are to allow for changes in actuarial definitions in March 2008, Oct 2009, April 2011

Figure 5: Real and nominal UK house prices 1991-2013 (Feb)



Source: ONS, Nationwide

Figure 6: Difference between real house prices and real gross rents 1991-2013 (Feb)



Source: ONS, Nationwide

At the same time, the savings environment and issues such as poor financial planning for the future, have combined to make saving for retirement highly challenging for a large proportion of the population. The increase in part-time work and self-employment is also likely to reduce households' ability to invest in their future through pension contributions or other financial benefits offered through the workplace (e.g. life insurance, health insurance). This could leave them more exposed to high future costs.

Expectations of future performance

Expectations of growth and performance play a big part in people's financial decisions. However, when looking at growth and performance, consumers and firms tend to focus on nominal returns (before inflation, tax and charges). Many ignore long-term performance trends, underlying levels of risk and the impact of inflation on their asset holdings, focusing instead on recent price movements. Financial decisions that do not account for these factors can create over-optimism around expected future returns and spending power. This over-optimism can lead to detriment if consumers are tied to inappropriate decisions arising from these mis-perceptions.

While nominal returns have been rising over the long term, real returns (which have been eroded by inflation, taxes and charges) have been relatively flat (or negative in some cases). Real returns on major assets have been weakening over time, affecting households' wealth and, in turn, their current and future spending power. In addition to a focus on nominal returns, consumers may be making decisions based on assets that remain out of line with their underlying fundamentals (and so are overpriced compared to long-run trends).

Real returns on **property** have been low over the long term despite significant gains in nominal terms (Figure 5). For those reliant on housing wealth for future income, low real returns could leave households with less future income than needed.⁴ In the lead-up to the crisis, there was a growing perception that the capital value of homes would continue to grow, even though prices were out of line with underlying fundamentals.

4 Most financial product information provided to consumers focuses on nominal returns and prices and reflects returns on assets in current rather than real prices (which take into account the rising costs of inflation). Inflation erodes current and future spending power and reduces the real returns consumers receive on their asset holdings. Over the long term, real returns will impact consumers' overall wealth and future income and could leave many with a gap between wealth and future spending needs.

Box 2. Negative equity

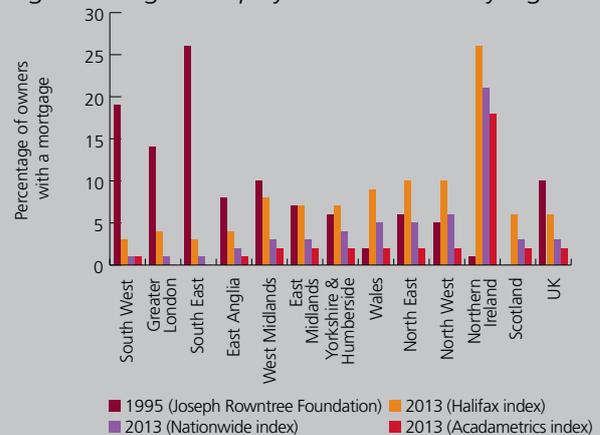
We have assessed the number of mortgages in negative equity, as at January 2013, using three popular house price indices. According to these estimates, between 160,000 and 630,000 borrowers could have been in negative equity at this point (Table 1).

Table 1: Negative equity estimates

	% loans	Number of residential loans to owners-occupiers
Jan. 2013, Halifax index	6.4%	630,000
Jan. 2013, Nationwide index	3.3%	320,000
Jan. 2013, Acadametrics index	1.6%	160,000

Source: FSA Calculations (Product Sales Database, Mortgage Market Review Product Sales Database Performance Data), Halifax, Nationwide, Acadametrics⁵

Figure 7: Negative equity: 1995 and 2013 by region



Source: Joseph Rowntree Foundation (1995), FSA Calculations (Product Sales Database, Mortgage Market Review Product Sales Database Performance Data), Halifax, Nationwide, Acadametrics

According to the Bank of England, negative equity affected around 1.1 million borrowers in the early 1990s, around 10.5% of mortgaged households. At a national level, this is significantly more than today's estimates imply. However at a regional level, the picture is different. In the 1990s, negative equity was concentrated primarily in the southern regions of the UK. This time around, the recession has hit the northern regions hardest and, as a result, negative equity is more concentrated in the North (Figure 7).

This fuelled accumulation of property assets and mortgage debt (Figure 6).

Changes in current and future house prices will have a significant impact on household wealth and decisions on asset holdings, and in turn on future spending power. Property prices have seen varied performance since the crisis, with recoveries concentrated in particular regions. Given that house prices remain out of line with their fundamentals, there could be further price falls, particularly if economic or financial conditions deteriorate. For those holding a mortgage, price falls can leave homeowners with little or negative equity in their homes, which can leave borrowers with unsustainable

burdens of debt, unable to move and restricted in their options to remortgage onto better rates (Box 2).

Falling rates of real return on **cash savings** since 1990, turned negative in 2002 (a trend that has been accentuated since 2010 by higher inflation and falls in nominal rates). This has made it difficult for consumers to make gains on what was formerly the most widely held form of financial wealth (traditional savings accounts) (Figure 8).

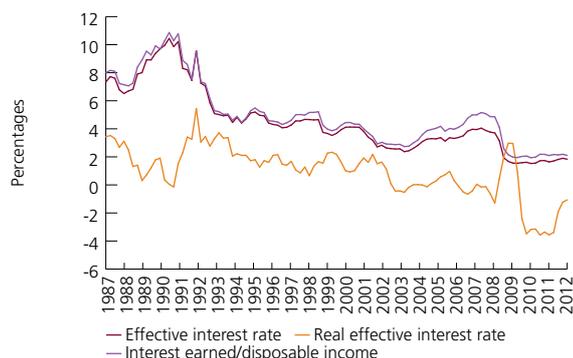
Since the early 2000s, the real return on **equities** has weakened. This has meant that investors (and other consumers who are exposed to equities, e.g. via pension funds) have received a lower earnings on their equity holdings since this period. This has led to greater uptake of alternative investment products for those who traditionally held equities as a high-yielding instrument.

Since the crisis, equity prices have returned close to their previous peak. Given the weak underlying economic conditions, this recovery may not be in line with underlying fundamentals and has, in part, been supported by central bank actions.

5 Notes:

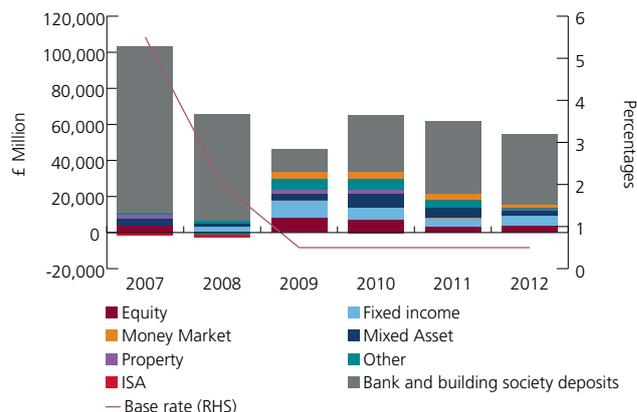
- (1) The estimates are based on the sample of 6.4m live mortgages and were grossed up assuming that there were 9.8m owner-occupier mortgages overall (source: CML), of which around 30% started before 2005. We assumed that none of the pre-2005 mortgages were in negative equity due to house price appreciation.
- (2) Although we took into account further advances, switches to different repayment types, overpayments and underpayments, as well as changes in interest rates and provision of forbearance where the data was available to us, this was not possible in all cases. We were also unable to take into account any potential property overvaluation at origination and any changes in value from home improvements. This means that our estimates are indicative and the numbers of borrowers in negative equity could be higher or lower than illustrated.

Figure 8: Real and nominal effective interest rates on interest bearing assets



Source: ONS
Note: Latest available data 2012

Figure 9: Post-crisis acquisition of retail financial products



Source: Investment Management Association 2013, ONS, Bank of England
Note: 2012 Bank and building society deposits are annualised from Q1-3 data as Q4 data not available at date of publication

Search for yield

The low interest rate environment has made it even more difficult for consumers to achieve the returns they seek. Where consumers are aware of the effects of inflation and current pressure from low interest rates on their wealth, the search for yield has strengthened. In their search for yield to date, some consumers have misunderstood the investment risks they have taken on: for example, products such as structured retail products, absolute return funds, or buy-to-let (BTL) investments were often marketed as lower risk than was in fact the case and were made more attractive to those seeking higher returns by highlighting attractive gross incomes or tax efficiency. This has left many with performance expectations and needs that do not align with the real performance of the products they hold.

Many of the retail investment products that consumers may take on to replace more traditional savings vehicles offer higher returns but may also leave consumers more heavily exposed to investment risks. As interest rates remain low, growing numbers of consumers may become increasingly exposed to investment risk in this way (Figure 9).

Consumer needs and responses: inequalities and debt

Household wealth and income have become more unevenly distributed over time, creating a gap between households with a higher capacity to consume and large asset holdings, and those with few assets but a desire to consume. This gap was smoothed from the 1980s onwards by looser credit conditions and increased availability of products that allowed consumers to release equity from their properties to fund current and future spending needs (equity withdrawal). Credit therefore acted to drive down consumption inequality even though income and wealth inequalities were rising (Figure 10).

In the lead-up to the crisis, growing numbers of homeowners took advantage of housing equity withdrawal to supplement income. This led to a large accumulation of debt and (given that indebtedness remains high despite the extent of household deleveraging that has taken place since the crisis) has left many borrowers vulnerable to income stress, tightening credit availability and further asset price falls (Figure 11).

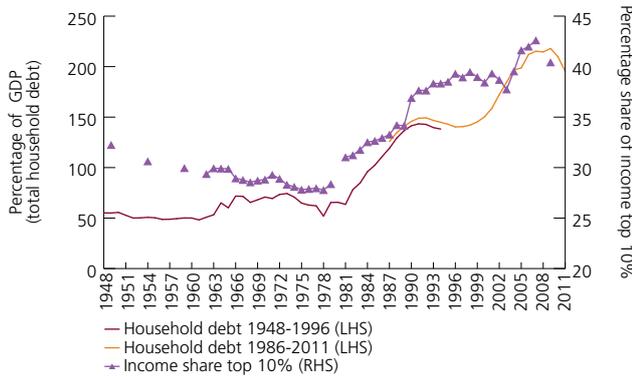
Despite poor economic growth, UK employment figures have been robust relative to previous recessions. This, combined with the low interest rate environment, has supported consumers' ability to service these high levels of debt. However, with job vacancies low and competition for jobs high, the labour market outlook is uncertain and there could be further falls in employment should the recovery stall. In addition, the true impact of the recession has been masked to date by wage cuts, temporary unpaid leave or reduced hours, and the rise in part-time and self-employment (Figure 12). While these measures have prevented a complete loss of income, they have reduced incomes for those affected.

Consumers have also been challenged by the impact of inflation on their spending power and continue to feel squeezed by rising living costs (Figure 13). These pressures could lead to further affordability problems in the future and a reduction in the ability to save.

In addition, there has been a marked downward trend in saving in the lowest income decile over the last 30 years. This trend is in large part due to increased credit expansion to this group, which has left them highly leveraged and has been one of the factors that has left them with fewer funds to save (Figure 14).

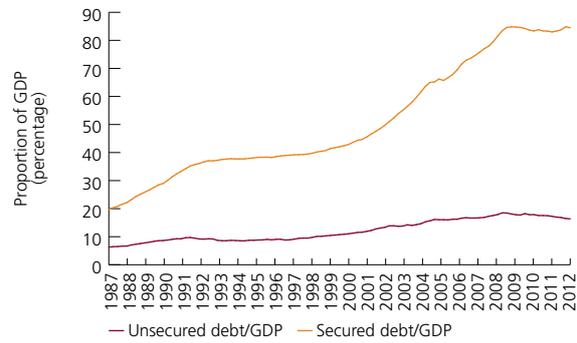
People in the lowest income group are also most likely to have no private pension. Despite auto enrolment,

Figure 10: As income inequality has increased so too has credit expansion



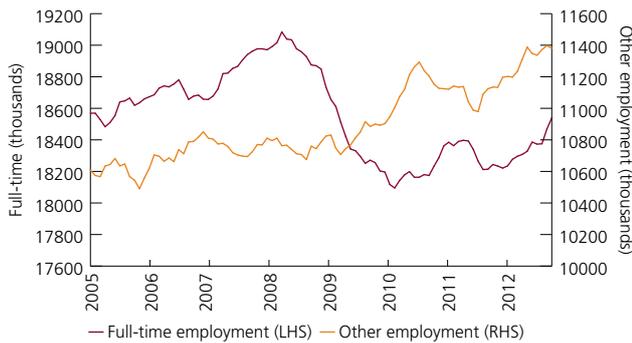
Source: ONS, Bank of England, Alvaredo, Facundo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez, The World Top Incomes Database, Feb 2013
 Note: Data on income share available up to 2009, data on household debt available until 2011

Figure 11: Unsecured and secured debt as a proportion of GDP



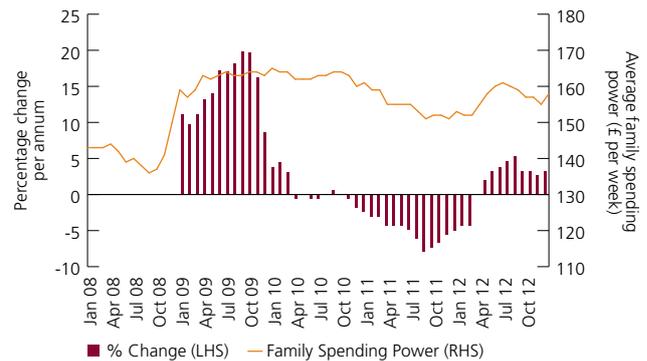
Source: ONS
 Note: Latest available data 2012

Figure 12: Employment full-time and other (part-time or self-employed)



Source: ONS
 Note: Latest available data 2012

Figure 13: Average household spending power



Source: Centre for Economics and Business Research

which aims to boost private pension membership, the gap between future income and future spending needs is likely to be too big to fill for a lot of households and will leave many with insufficient future income.

Firms' responses to changing consumer needs and behaviours

Changing consumer demands in core markets has led to maturity of some business lines and reduced business volumes. This has made it increasingly difficult for firms to maintain profits and competitiveness in core markets. Changing supply and demand dynamics have led firms to seek new ways to expand their profit margins in declining and increasingly complex markets. These include product innovation, focusing on alternative market segments, and seeking new delivery and market infrastructure to increase efficiency and lower costs. These shifts in the past were supported by relatively benign economic and market conditions that led many market participants to overlook their ability to monitor the risks they were taking or fully understand

their implications. This subsequently created new challenges for firms.

Product innovation and differentiation

Firms responded to lower business volumes and revenues from core markets partly through innovation and increased product differentiation. Many firms increased leverage to expand the number of products they could bring to market. But this increased the overall risk profile of the business and balance sheet on which these risks were sitting.

For example, with declining demand for traditional mortgages since the 1980s (when homeownership with a mortgage became a declining form of tenure), mortgage market lenders increased financial innovation and developed new products that enabled new homeowners to access the housing market (e.g. interest-only and self-certification) and increased the supply of products that enabled equity withdrawal.

Box 3. Biases and long-running illusions

Certain biases affecting firms and consumers have also been important ‘sustainers’ of overconfidence in returns on assets and investment. For instance, the tendency to focus on past performance – which is reflected, for example, in investor focus on recent stock market movements when making investment decisions (a rise in share price tends to make people more tolerant of risk) – rather than underlying fundamentals contributed to overconfidence in asset and equity markets. Other biases also play a role in investors’ tendencies to accept headline rates of return (without, for example, looking into the impact of fees and charges on the final rate of return or looking into the risks associated with higher-yielding products). The impact of these biases may also be magnified by over-reliance on particular (and usually exclusively financial) metrics such as price indices or analyst reports, which may not provide a complete view performance and risk and may therefore fail to reflect the true value of asset holdings.

Such systematic errors can also contribute to an escalation of commitment, in which, for example, overestimations of future returns may encourage consumers to continue to fund unaffordable liabilities or hold onto loss-making products. Similarly, firms can find themselves committed to inappropriate strategies that are difficult to exit (e.g. if they would incur high short-term losses that may be unfavourable to shareholders).

Changing dynamics in key core markets (and changes in consumer preferences) have forced firms to find alternatives to key income streams. This has led to an increase in the use of promotional strategies and cross-selling of products and services to drive sales (e.g. packaged bank accounts; bundling and add-on products; payment protection and other housing related insurance). These strategies increased the likelihood that consumers purchased products that were of little or no value to them. Where products have been bundled consumers find it difficult to determine whether they are suitable and have a poor understanding of what products the packages contain. In some cases poor transparency and lack of competition at the point of sale meant consumers suffered detriment (e.g. PPI mis-selling).

Many of these strategies failed to respond to the more fundamental changes taking place in financial markets and consumer needs and instead continued to be reliant on core markets even if these markets were maturing or had become saturated. For example, despite declining mortgage sales, the number of firms in the market remains the same, leaving firms with lower volumes of business, hence the spread of cross-selling strategies (Figure 15). However, under less benign post-crisis economic and financial conditions, there have been further falls in the volume of mortgages. This has reduced the viability of cross-selling strategies and, in some cases, made them unsustainable (Figure 16).

Focus on alternative market segments

In the pre-crisis environment credit was readily available and lenders made use of innovative funding structures. As a result, loan terms eased (e.g. growth in interest-only without repayment vehicles and self-certification without affordability/income assessments) and lenders focused on extending credit to consumers who had previously been excluded from the market, including less credit-worthy and lower income consumers

(Figure 17). This trend continued and became particularly pronounced, with a steady rise in lending to the lower income groups. Through this, lending firms exposed themselves to credit risks that many mis-assessed and are still dealing with.

Lowering costs and expanding market presence

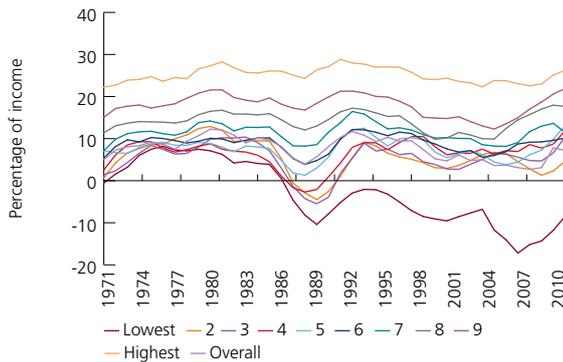
Firms also responded to lower volumes and pressure on earnings by seeking new ways to benefit from consumers’ increased focus on the near term and immediate needs. Key to these strategies was the consumer focus on price, which led to an increase in promotional strategies that highlighted near-term benefits and greater use of charging structures that underplayed subsequent or contingent charges (Figure 18). Firms were successful in selling a wide range of add-on products (even if they offered little real value to the consumer) by making the product appear attractive from a price perspective and capitalising on brand recognition and existing relationships at the point of sale.

Consumers often underestimated overall costs or were short-sighted in their financial decisions, meaning that many took on commitments and liabilities that became less affordable over time (e.g. teaser rate mortgages and interest-free balance transfers on credit cards). Alongside this, firms looked to expand their market presence through greater use of intermediary platforms (from price comparison sites to face-to-face intermediaries).

Firms’ strategic responses to current pressures

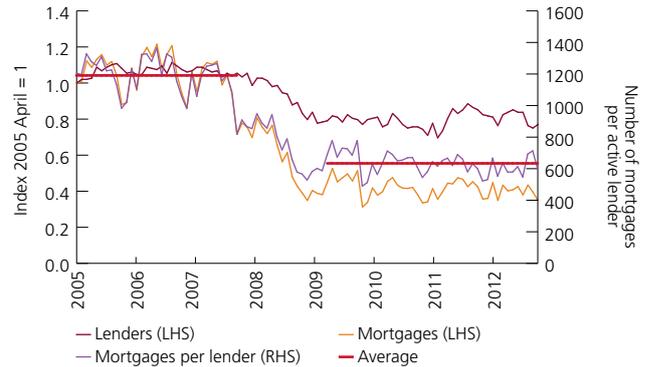
These changes in market practices and business strategies supported profitability for some time (despite the overall decline in volumes). However, the weak and uncertain external environment may mean that the sustainability of these strategies and the opportunities for material growth outside core markets become increasingly challenging. Recent market and economic developments have had a significant impact on firm and

Figure 14: Median savings rate by income decile



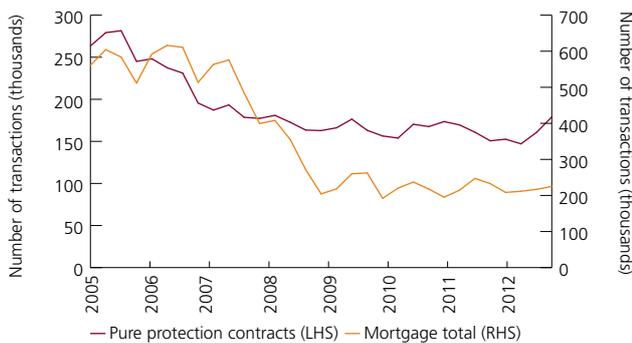
Source: NIESR analysis for the Resolution Foundation (See "Gaining from Growth" for full details)
 Note: Latest available data 2010

Figure 15: Number of residential mortgages per active lender



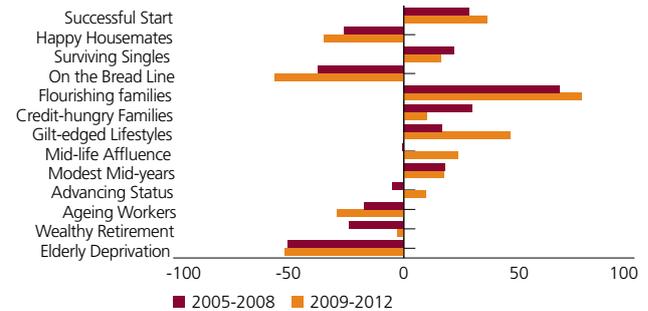
Source: FSA Calculations (Product Sales Database)
 Note: Data from April 2005 – December 2012

Figure 16: Mortgage sales and protection policy sales



Source: FSA Calculations (Product Sales Database)
 Note: Data available from Q2 2005 – Q4 2012

Figure 17: Residential mortgage lending by geo-demographic group 2005-08 vs 2009-12



Source: FSA Calculations (Product Sales Database), Experian Financial Strategy Segmentation

consumer behaviours and will continue to accentuate some of these challenges.

Squeezed margins

The low interest rate environment is placing significant pressure on net interest margins, which are a key source of profits for banks and building societies. This is creating challenges for firms as they need to maintain the differential between deposit rates and loan rates to remain profitable in the retail lending market (Figure 19).

For many firms, pre-crisis strategies to bolster margins, such as earnings from their trading books or relying on investment activities to supplement revenues, have become unviable in the post-crisis period due to either changing market conditions or new regulatory requirements. For example, retail and wholesale general insurers have historically relied on investment income to support bottom-line profitability and, in some years, offset loss-making underwriting. In order to be able to pay claims as they fall due, insurer investment strategies are by necessity conservative and based on liquid

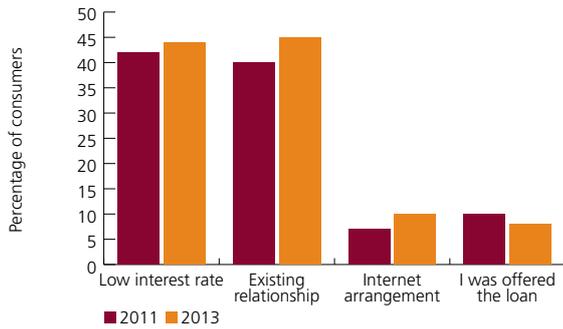
assets such as cash, bonds and gilts, which are lower-risk, but – due to the low interest rate environment – increasingly low-return.

Funding conditions

Funding conditions in the post-crisis period have also compounded pressures on firms' business models. Today, firms face continued funding risks while the search for eligible and good quality funding and collateral remains strong:

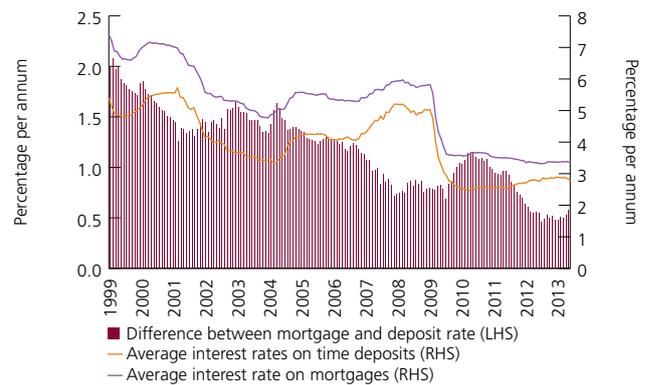
- while wholesale funding markets have improved, they remain tight;
- competition for long-term stable retail deposits remains strong; and
- higher capital, liquidity and risk management requirements have increased (increasing the cost of capital and reducing the viability of certain strategies that were previously used to improve firms' funding positions).

Figure 18: Reason for consumer choice of loan provider



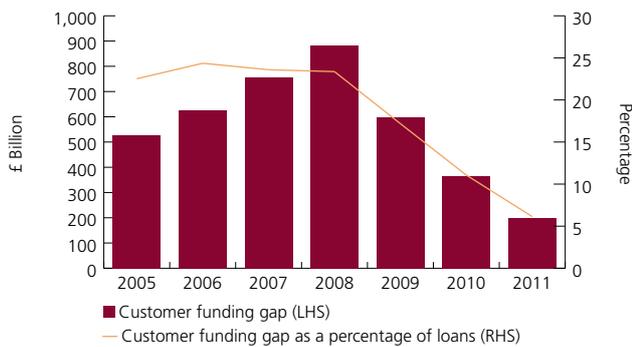
Source: GfK Financial Research Survey (FRS)
 Note: Base: All loans (GfK loan definition) opened in the last 12 months
 Time period: 6 months ending January 2013

Figure 19: Squeeze on retail lending net interest margins



Source: Bank of England
 Note: Calculations based on data available up to January 2013

Figure 20: UK banks' customer funding gap



Source: Published accounts, Bank of England calculations
 Note: Shows the gap between customer lending and customer funding, where customer refers to all non-bank borrowers and depositors. Repurchase agreement are excluded from loans and deposits where disclosed. Data available up to 2011

These funding stresses are leading to higher costs of capital and reduced margins for firms, and are being exacerbated by the impact of the unresolved financial crisis on safe assets and, thereby, on the availability of quality collateral.

In the post-crisis period, as many of the funding instruments that were widely used before the crisis have become unviable, firms have taken several steps to improve their funding positions. These have included strategies to attract deposits, increased covered bond issuance, cutting back cash and securities holdings, and selling or securitising parts of their loan portfolios.

Today, in the banking sector, following aggressive competition to attract retail deposits and the post-crisis reduction in credit expansion, the retail funding gap is closing (Figure 20) and firms are now reducing savings rates and the number of savings accounts they offer (so

as to avoid short-term depositors) and seeking instead to attract stable, long-term deposits. However, long-term deposits are in short supply and, as other players have entered the deposit space, competitive pressures are increasing.

Funding conditions raise several conduct risks related to whether financial firms will be able to continue to meet consumers' credit and savings needs and whether their search for funding and quality collateral could undermine fair treatment of consumers or market integrity. For example if the retail funding gap does not widen again and as government policies such as the Funding for Lending Scheme (FLS) reduce firms' need to attract deposits, firms may continue to offer fewer savings accounts and lower rates to consumers. Any significant improvement in margins, and therefore underlying profitability, may also encourage firms to tackle the rising number of long-term arrears cases some

lenders have, leading to a reduction in forbearance and a rise in repossessions (Box 4).

The future needs of firms and consumers are shaped by past financial decisions. Many of the financial commitments that firms and consumers have made in the past will continue to affect them for years to come. For example, consumers may have borrowed more than they can afford or relied on unsustainable returns (such as presuming their property will increase in value, when it may not) to fund their retirement; and firms may have over-extended themselves in risky markets or failed to adjust to changes in consumer needs or the economic environment.

As economic and market conditions remain stressed, the struggle to make the best of past decisions and prepare for an uncertain future will continue.

While we cannot influence these factors, we need to be aware of their implications for firm and consumers and the decisions they make, so that we can intervene when these go against our objectives.

3.2 Technological developments

Technology has been one of the most significant drivers of change in financial markets, increasing the speed and directness with which consumers engage with financial products and services. It has offered market incumbents the opportunity to capitalise on these new modes of engagement and delivery to increase their appeal and enhance their competitiveness. It has also reduced barriers to entry for new technology-based competitors. While greater use of technology has provided consumers with greater access to information and broadened firms' consumer interfaces, it also exposes both to new risks and plays a role in driving conduct risk.

Innovation and product distribution

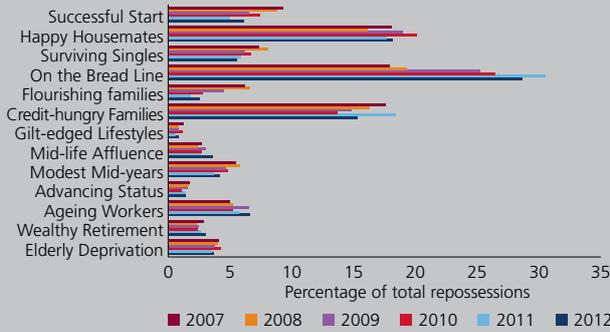
Technological innovations have played to changing consumer preferences for more direct and (seemingly) comparable interfaces and self-service propositions, as well as to their increased focus on price. In addition to responding to changing consumer preferences, such advances have, in themselves, contributed to these changes. For example, while price comparison sites and self-service online models increase the information and product choice available to consumers in core general insurance markets, they have also been a fundamental driver of consumers' increased focus on headline price and brand. This potentially distracts them from other crucial product features, such as policy coverage and terms.

Increased use of technology and internet access is providing firms with better information on their consumer base and how to price risk. The increased use of Big Data may promote further innovation and customisation of products and services available to consumers. It will also enable firms to use risk profiling to price products more accurately (and in many cases, more fairly). However, risk-based pricing may be prevented in some cases by policies such as the 2011

Box 4: Forbearance

Arrears and repossessions seen to date have not generally been driven by macroeconomic conditions. They are more likely to be the result of borrowers who were unable to manage their debts and afford their mortgage repayments even in stable economic conditions (Figure 21). Distress therefore reflects the underlying risks that were taken on by firms through the extension of credit to lower income consumers. Today, tighter lending criteria and a contraction in overall lending to households mean that indebted homeowners are unable to finance their consumption through additional home loans. This has led some highly indebted households to default. Many firms have been offering forbearance for those in distress, which has led to a fall in the repossession rate (Figure 22).

Figure 21: Geo-demographic profile of mortgage repossessions



Source: FSA Calculations (Product Sales Database), Experian Financial Strategy Segmentation

Figure 22: Number of mortgage loans in serious arrears and repossession rate



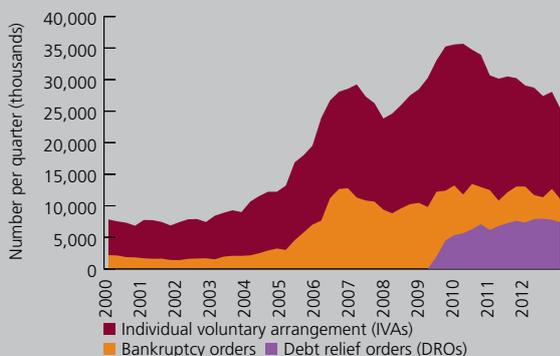
Source: Council of Mortgage Lenders
Note: Latest available data 2012

The low interest rate environment has helped reduce secured borrowing costs for consumers and supported firms' use of forbearance. Forbearance where the borrower is likely to cure their arrears and begin making regular repayments again will benefit both consumers and lenders. However, given the profile of repossessions to date, which suggests distress is being driven more by over-indebtedness and longstanding affordability issues than by short-term stresses, forbearance may just be delaying and prolonging the pain.

Some forbearance may be leaving consumers in a very difficult position in the future. For example, switching to an interest-only mortgage on a permanent basis (without a clear repayment vehicle); extending terms into retirement when income levels are expected to drop dramatically; or building up large levels of arrears and charges to cure through prolonged payment holidays in the hope that circumstances may change. For those heavily reliant on credit or who have low incomes, forbearance is unlikely to offer the release from mortgage distress intended – understanding of individual consumer circumstances is essential in the employment of and exit from forbearance strategies.

Pressure on firms' balance sheets from the current environment has been supported by firms offering alternative terms to those in distress, not only on secured lending in the form of forbearance but also on unsecured lending. For example, a decline in bankruptcy data has been supported by a rapid increase in the use of debt relief orders (Figure 23).

Figure 23: Individual voluntary agreement, bankruptcy orders and debt relief orders



Source: Insolvency Service
Note: Latest available data 2012

For lenders the sustainability of forbearance strategies could be challenged in a prolonged period of economic stress or funding pressure. This could lead to poor treatment of consumers if there is a sudden or unexpected change in the terms of the strategies being offered to them.

European Union Court of Justice ruling against gender discrimination in insurance premiums.

Data and network conduct implications

However, more accurate consumer profiling and risk-based pricing of products may have adverse conduct implications. Growing levels of intelligence using Big Data are likely to create higher costs for 'less-desirable' consumers; although this may be prudent from a firm perspective it could reduce access to some consumer groups to core products. In addition, the reliance on complex, large datasets to make decisions could lead to misjudgements if data is corrupted or not validated by the user. Firms using Big Data to make risk based decisions around access and the price of products need to ensure the technologies used to do this are suitable and able to process this information into meaningful intelligence (e.g. through contextualisation) and that controls are in place to identify any distortions that may arise (e.g. through data corruption).

Many technological interfaces and infrastructures in financial markets are reliant on global networks over which firms do not have oversight. Risks to these global networks can impact financial sector infrastructure and drive conduct risk. For example, critical infrastructure can be subject to cyber-attacks through network intrusions, which could lead to systems failures (e.g. payment systems) or breach or theft of personal information. Reliance on technology-based infrastructures can also leave firms exposed to risk management weaknesses from systems used outside financial markets (e.g. mobile phone providers for mobile payments).

Competition in markets

While increased competition in the market arising from technological advances is often beneficial to consumers (e.g. making switching between products and providers easier), the impact of information asymmetries and/or biases could affect competition dynamics in a way that leads to worse consumer outcomes. For example, growing competition in the general insurance sector

has, in the past, led to the poor design of complex and high-margin products which, while possibly being suitable for a niche group, may not be appropriate for the mass market. In recent years – with profound earnings pressure compounded by increased price competition from price comparison firms, national intermediaries and on- and offline direct writers – many insurers have supplemented self-service models with multi-channel distribution via intermediaries and affinity arrangements such as retail outlets and supermarkets.

More direct and accessible technology has been developed in the financial services industry to keep up with consumer needs, changes in the way we communicate and to improve margins.

The use of technology has brought about many benefits to access and efficiency in financial markets and has been an important source of change. But it has also meant that firms have become increasingly reliant on technological systems and more vulnerable to the risks that may arise from using them.

Firms therefore need to ensure that their systems are resilient and that the way they access and use consumer information is not vulnerable to distortion and does not lead to certain consumers being unfairly excluded. In turn, we will seek to ensure that firms consider the risks associated with technological advances and do all they can to ensure business continuity and consumer protection.

3.3 Regulatory and policy change

The international and domestic reform agendas aim to address longstanding problems in the financial system. Many of the initiatives aim to help firms and market infrastructure providers build more sustainable and resilient business models that balance risk with the needs of consumers and the wider market (e.g. RDR and Mortgage Market Review (MMR)). This regulatory agenda also seeks to ensure that changing structures across the financial sector and market fragmentation do not give rise to risk management weaknesses or lead to gaps in (firm and supervisory) oversight.

We have a responsibility to use regulation to good effect to achieve our objectives and will seek to ensure that the reforms we introduce and implement do not make it more difficult for firms to conduct their business in ways that promote consumer protection, effective competition and market integrity. This will be a significant challenge for us (and other UK regulatory authorities) given the volume of reform still needed to address financial market weaknesses and imbalances. In addition, since regulation is not solely domestically driven, the complexity of the regulatory landscape is likely to increase (even though a more uniform regulatory landscape across Europe looks likely to offset this to some extent). Where firms that are regulated across several jurisdictions engage in location arbitrage, this regulatory complexity may lead to increased opacity.

Pace and volume of change

The current regulatory reform agenda is causing significant change across markets and different business activities (Figure 24). This will result in increased pressure for firms as they adapt to new risk management standards and more stringent prudential requirements. The volume of change will continue to create operational challenges for firms (which are already under pressure from longstanding macro trends and from aspects of the current environment) as they prepare for, implement and ensure ongoing compliance with new regulatory

requirements. Compliance functions will remain under significant pressure, with questions over those sectors that were more lightly regulated in the past, will be able to find sufficient compliance staff. For firms that need to manage compliance with a range of regulations from multiple jurisdictions, the challenge will be particularly acute.

Prudential priorities and conduct implications

Current dynamic and uncertain economic and market conditions are making it difficult for firms and market infrastructure providers to make decisions for the future. For example, regulatory requirements are set years in advance (e.g. Basel III) but regulators may also need to respond tactically to changes in environmental conditions that affect the existing scope of planned regulation. This can create regulatory uncertainty, which firms may not be able to respond to easily (e.g. firms set capital strategies for the medium term and therefore find it difficult to respond tactically to changing conditions or requirements), with potential implications for the services and products that they are able or willing to offer to consumers. Regulatory uncertainty can lead to unintended outcomes if firms retract from markets or products where the future regulatory view is unclear.

This combination of uncertainty and increased requirements to change, may make it difficult for firms to step back and strategically assess the adjustments they need to make to their business models and strategies to ensure future viability and sustainability. This could lead to precipitous withdrawal of firms from business areas and products without fully assessing how they could continue to operate within the boundaries of new regulation. For example, major firms restricting interest-only mortgages because of concerns about retrospective regulatory judgements on lending decisions. While withdrawal from a product or market creates an opportunity for niche firms, the gap between withdrawal and the establishment of the niche market can leave consumer choices limited. Our responsibility

to ensure the proportionality of regulation and avoid regulatory failures will be particularly challenging where protracted economic and financial market stress may lead to changes in the timing of planned regulatory reforms.

The severity and duration of the financial crisis and its aftermath explain the focus of international regulation on ensuring prudential soundness and reducing systemic impacts of financial sector risk. However, recent reputational issues (such as the attempted manipulation of LIBOR; mis-selling of interest rate hedging products to SMEs, and money laundering exposures) are increasing political attention on conduct issues in the UK and internationally.

Even so, while external conditions remain difficult and the potential impact of financial market firms on the economy remains significant, prudential concerns may again distract from some of the conduct challenges firms face. From a conduct perspective, we will need to ensure that firms do not respond to higher compliance costs and increased prudential requirements by making cuts in important areas of risk management or charging excessive prices to consumers (especially in sectors or activities where the structure supports such a transfer of costs).

Changing structures and new pressures

The number of regulatory initiatives under way will change the characteristics of financial markets either by design (e.g. ring-fencing of retail from trading activities) or as the viability of current business models or strategies comes under pressure (e.g. as capital intensive and higher risk activities become less viable under more stringent capital and risk management requirements). This raises the risk of unintended consequences that may require firms to make further strategic shifts.

Pressures on capital- and collateral-raising may combine with pressure on returns and lower business volumes

to make current funding strategies and structures less viable. For example:

- Regulatory changes such as the Independent Commission on Banking's (ICB) recommendations on ring-fencing and the referral fee ban for general insurance firms will increase constraints on income and force firms to find alternative (and potentially more uncertain) funding sources. Given that future funding conditions remain uncertain, firms may seek to pursue more innovative funding strategies, including more complex funding structures, which could make it more difficult to monitor and assess risk. Alternatively, they may take short-term and more expedient measures to make up for earnings shortfalls by increasing sales targets (raising the risk of mis-selling) or raising prices without a change in the underlying risk.
- European Market Infrastructure Regulation (EMIR) will fundamentally change the over the counter (OTC) derivatives market and may cause increased demand for highly accepted collateral and decreased funding for less commonly accepted securities.

Regulation may affect the competitive landscape in different markets. For example:

- Solvency II is likely to force business divestment and drive mergers and acquisitions (M&A) activity, with potential implications for the competitive landscape and the products insurers offer (due to diversification of benefits).
- US and EU regulations will increase the demand for post-trade and clearing services, and are likely to result in increased competition in this space. In response to increased competition, firms are likely to seek out synergies across their business offerings, resulting in the consolidation of firms.

Shift outside the regulated perimeter

These possible outcomes of the current regulatory reform agenda may cause firms to shift into gaps in the market that look to offer higher profits or growth opportunities (e.g. trading platforms seeking to enter into the post-trade and ancillary services space) or that exploit regulatory loopholes (e.g. bridging finance). More intensive regulatory oversight may also provide a tipping point for regulated firms operating in crowded and mature markets to move into unregulated activities, where operating costs are lower (e.g. capital requirements) and less regulatory scrutiny allows them to pursue higher risk, more profitable strategies or product mixes.

Policy-driven changes may also cause consumers to opt for products and services that offer higher perceived benefits or lower costs. For example, the RDR may be expected to lead to a rise in the number of self-directed (unadvised) investors because of need to pay upfront fees to independent financial advisers (IFAs). By taking unadvised investment decisions, consumers may need higher financial capability to understand the level of risk they are taking on or the level of protection they can expect.

We are aware that the regulatory reform agenda will put pressure on firms as they implement significant changes and evolve to comply with new UK, EU and global regulatory requirements. The reforms will change the market in several ways, affecting structures and competition across the UK financial system.

Increased conduct and prudential requirements, together with the uncertain economic environment, may also lead firms to withdraw from certain markets rather than look into how they could do business under new regulation. This could lead to consumer detriment if fewer products become available and it could lead to more firms and consumers looking outside the regulated financial sector to provide and purchase financial products and services.

We will use regulation to improve consumer protection, competition and integrity in the market, without making it difficult for firms to conduct their business.

Figure 24: Snapshot of Regulatory Reform (2013-2021)*

Note:

- * All dates are expectations only and therefore subject to change.
- Life insurance is covered in "Retail investment, fund management & related services".
- ** Solvency II dates are subject to current Omnibus II negotiations and potential quick fix directive

			Retail deposits	Secured retail lending	Unsecured retail lending	General insurance	Retail investment, fund management & related services	Wholesale investment, fund management	Wholesale insurance & related services	Markets (primary & secondary)	
2013	Q2	UK: Implementation of new FSCS funding model (Apr)									
		UK: Implementation of new LIBOR regime (Apr)									
		UK: Implementation of referral fee ban in personal injury cases (Apr)									
		UK: Implementation of changes stemming from Consumer Insurance Act (Apr)									
	EU: Solvency II transposition deadline (Jun)**										
	EU: Legislative proposals on basic bank accounts, current account switching and transparency of fees and charges										
	EU: Legislative proposals for IORP Directive										
	EU: Legislative proposals for a European framework for MMFs										
	EU: Legislative proposal to review PSD										
	EU: Implementation of AIFMD across member states (Jul)										
	Q3	UK: FCA to publish two reviews into money laundering									
		Global: FSB proposed publication of final recommendations on shadow banking sector (Sep)									
		EU: Possible legislative proposals on long-term investments									
		UK: PRA implementation of new capital and liquidity requirements for credit unions (Sep)									
	Q4	EU: Possible agreement of Directive on mortgage credit									
		UK: Implementation of National Crime Agency (including economic crime unit) (Dec)									
EU: Possible agreement on PRIPs regulation											
EU: Legislative proposals on UCITS VI											
2014	Q1	EU: Possible agreement on UCITS V									
		EU: Proposed implementation date for Solvency II regime (Jan)**									
		EU: Possible implementation of minimum capital requirements under CRD IV									
		EU: Possible agreement on IMD2									
	Q2	Global: FATCA withholding begins for certain payments (Jan)									
		EU: Proposed implementation date for FTT (Jan)									
		UK: Possible implementation of new Platforms rules									
Q3	UK: MMR implementation (Apr)										
	UK: Transfer of consumer credit and peer-to-peer-lending regulation from the OFT to the FCA (Apr)										
2015	Q1	Global: Proposed implementation of US Volcker Rule (Jul)									
		Global: Revised implementation date for IFRS 9 (Jan)									
	Q3	UK: Banking Reform Bill to receive Royal Assent (before end of current Parliament)									
		EU: Possible implementation of Directive on mortgage credit									
	Q4	EU: Possible entry into force of PRIPs regulation									
		EU: Possible implementation of revised market abuse regulation									
2016	EU: Possible implementation of UCITS V										
	UK: Implementation of ILAS regime (end 2015)										
2018	EU: Possible implementation of revised MiFID/MiFIR										
	EU: Possible implementation of IMD2										
2019	EU: Possible implementation of NSFR (part of CRD IV) (Jan)										
	UK: Full implementation of pensions auto-enrolment										
2021	Global: Full implementation of CRD IV liquidity coverage ratio (Jan)										

Drivers of wholesale conduct risk

Poor conduct in wholesale markets poses a risk to our objectives through the way in which it threatens the soundness, stability and resilience of financial markets and transparency of the price formation process. It often involves exploitation of differences in expertise or market power, which undermines trust in the integrity of markets. While retail consumers are not generally direct participants in wholesale activities, risks caused by poor wholesale conduct can feed through to retail markets. This can impact retail consumers who rely on products and services that originate or are sold in wholesale markets to meet their needs, e.g. via their pension funds or through direct purchases of structured products. Moreover, poor product design, client mis-categorisation, and mis-selling of products designed for wholesale markets to retail consumers can cause consumer detriment and undermine market integrity.

Conduct risk in wholesale markets is fundamentally driven by many of the same factors relevant to retail markets, such as *information asymmetries*, *conflicts of interest* and the long-running *low returns environment* described in previous chapters. However, there are nuances to these drivers which we will recognise in our approach to wholesale conduct.

Information asymmetries

As in retail markets, information asymmetries are at the root of many wholesale conduct risks and in many respects are more firmly entrenched in wholesale activities (which are far more intermediated than retail transactions).

Poor wholesale conduct and some of the most entrenched challenges in wholesale markets, such as insider trading, are driven by the abuse of information asymmetries. Insider trading and other forms of market abuse threaten market integrity (and can be detrimental to consumers, the firm's risk profile or the level of systemic risk in the market) and can become more prevalent when firms' profitability is squeezed. For example if firms reduce investment in the surveillance of trading activity or individuals become more willing to execute trades that could be viewed as manipulative or fail to report profitable customers with suspicious trading patterns. While regulatory initiatives such as the Prospectus Directive seek to correct information asymmetries in wholesale markets through an enhanced disclosure regime, other market failures (from biases to competition problems) mean that consumers (whether sophisticated wholesale investors or less expert retail investors) may still fail/be unable to use the information they are provided within their best interests.

Conflicts of interest

The importance of information asymmetries as a driver of wholesale conduct risk is reflected in the extent to which structural conflicts of interest are often deeply embedded in wholesale business models. For example, consumers' interests can be compromised where firms exploit knowledge of a client's trading intentions to deal ahead (front running a client order and make a proprietary trading profit) or when firms or individuals are incentivised to carry out transactions that are not in the consumer's (client's) best interests, e.g. payment for order flow.

While many key regulatory initiatives in the wholesale space (such as Markets in Financial Instruments Directive's (MiFID) best execution requirements) seek to put in place measures to limit these conflicts, or mitigate their adverse implications for market integrity and consumer protection, conflicts of interest continue to be one of the more intractable barriers to good conduct outcomes in wholesale markets. This is partly due to the structure of wholesale activities, which means that firms are able to take advantage of the volume and speed of transactions and the fact that many transactions are highly intermediated and carried out removed from the end consumer or client in a way that exploits information asymmetries and conflicts of interest. For example, recent attempted manipulation of LIBOR and EURIBOR raised risks to market integrity (due to the impact of the attempted manipulation on the credibility of the benchmark) and to consumer protection (due to the number of financial and investment products that are determined according to the benchmarks).

Environmental developments

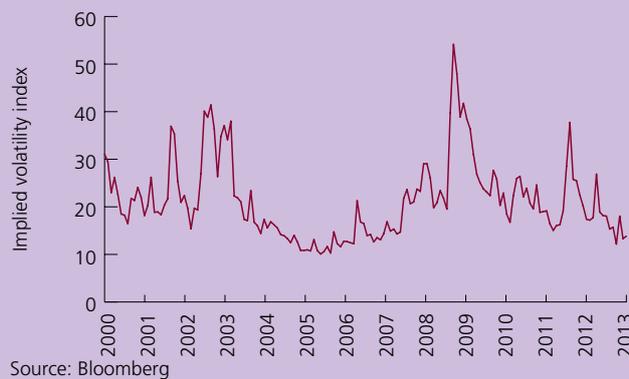
Economic and regulatory changes

Wholesale conduct risk is also driven by economic and regulatory pressures, which can increase complexity, opacity and fragmentation in wholesale activities and in the structure of wholesale markets.

Long-running low returns and falling volatility in markets have contributed to reduced margins in core wholesale activities and have been an important driver of firms' reassessment of their business models, trading strategies and cost bases. For example, a reduction in volatility in the pre-crisis period reduced trading margins (Figure 25) while falling volumes in activities that previously made a large contribution to firms' profitability (e.g. IPO issuance) caused firms to move into new activities or find ways of increasing the margins they extract from the remaining lower transaction levels.

Wholesale business models and strategies have also responded to broader shifts in financial markets, such as the move from equity to debt financing in the corporate sector. The related increase in alternative sources of funding and the increased complexity of funding structures and instruments (e.g. increased activity in or exposure to shadow banking activities), led to issues around transparency and interconnectedness (e.g. via increased off-exchange trading which enabled wholesale firms to execute large transactions with delayed broadcast to the general market in terms of price and size).

Figure 25: FTSE volatility



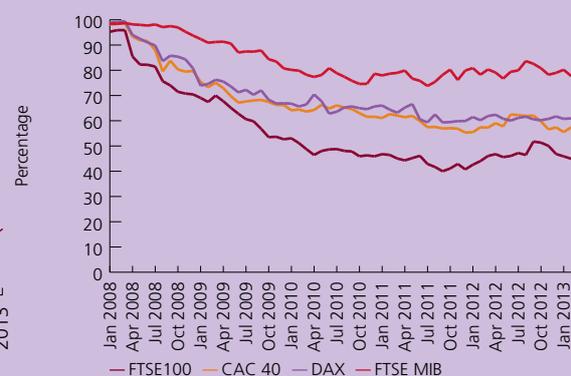
Source: Bloomberg

These adjustments to business models or strategies and cost controls can lead to conduct risks if systems, risk management and governance become unsuited to new levels of complexity that the adjustments bring about or to changes in the scale and risk profile of the business. Indeed, many of the most prominent wholesale conduct risks in recent years, including those which have had a direct impact on retail consumers (such as client assets risks) have emerged where oversight and controls have not been adapted to fundamental shifts in wholesale activities and changing wholesale market structures.

Regulatory changes have also brought about changes in the structure of markets, some of which have fundamentally affected the way in which wholesale activities are carried out and had implications for levels of competition and fragmentation. For example, changing dynamics between market infrastructure providers have created risks to market integrity and consumer protection. MiFID increased the level of competition by opening up exchanges to competition from new trading venues operated by investment firms (multilateral trading facilities (MTFs)) and allowing business to be internalised (Systemic Internalisers). Since MiFID implementation, a significant proportion of secondary trading of

shares has moved to MTFs, resulting in increased market fragmentation (Figure 26), which can make it more difficult to get an accurate and comprehensive picture of the level of trading activity in individual shares (raising issues of market quality) and increase opacity in the price formation process. Market fragmentation has been exacerbated by the current limitations in post-trade transparency requirements, including the scope and quality of trade-reporting and the absence of a European consolidated tape which would provide real-time data on trading volume and price for exchange traded securities.

Figure 26. Percentage of securities traded on incumbent national exchanges



Source: Thomson Reuters Equity Market Share Reporter
Note: Latest available data Feb 2013

The structural shift to multi-venue trading of individual shares has also created challenges for the supervision and detection of market abuse.

New technologies and the pace of change

Falling business volumes have also meant that firms and traditional exchanges have needed to review the fundamentals of their business models, from pricing to the technologies they use. Technological innovations have become key to the strategies they have implemented to increase the volume of transactions they handle, the margins they can extract, and the cost-effectiveness and directness of their operations (and therefore, the attractiveness of their client offering).

While generally decreasing the cost and increasing the speed of operations, technological advances have also increased firms' dependence on underlying systems meaning that the integrity of IT infrastructure has become increasingly important for firms' operational stability and, given the level of interconnectedness, for market integrity more broadly. The extent and pace of technological changes underway in wholesale markets also exacerbates risks around governance and oversight.

In recent years, there have been a wide range of crystallised operational losses, which were driven or exacerbated by technological issues and had poor conduct implications. These have included: customers being unable to process payments; the mishandling of an IPO due to a systems error; 'flash crashes', which can create severe market volatility due to a sudden withdrawal of liquidity; and the incorrect installation of trading software leading to a significant financial loss for a firm.

IT resilience failings are therefore important potential drivers of conduct risk in wholesale markets, as well as posing financial and reputational risks to firms and infrastructure providers themselves.

Part B: The evolving conduct risk landscape





This section presents a forward-looking view of the evolving conduct risk landscape across retail and wholesale markets. Forward-looking risks include some that we may already know about but will remain a challenge in the future, as well as new issues that are emerging from both longstanding and more recent stresses on firms and consumers.

In this section, we identify the implications and risks arising from the drivers of conduct risk discussed in Part A. Conduct risks can evolve in a number of different ways in different markets, posing direct risk to some or all of our objectives. Part B sets out:

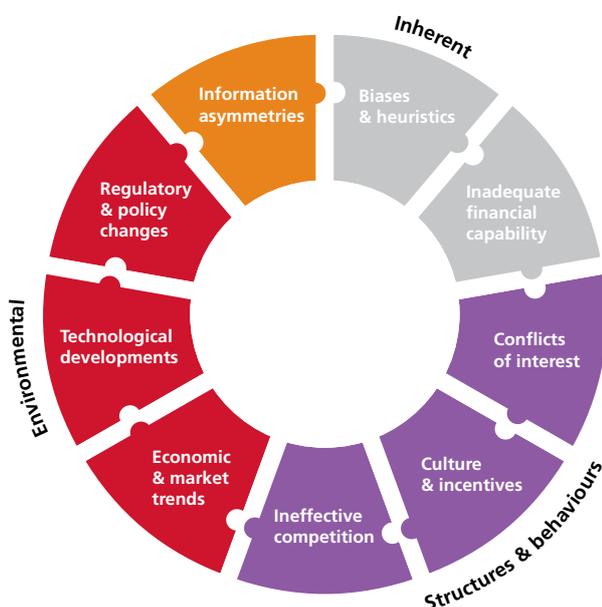
- Chapter 4: Forward-looking cross-market conduct risks:
 - Rising pressure on strategic business model adjustment
 - Failure to balance prudential soundness and profitability with good consumer outcomes
 - Misalignment of market performance expectations and underlying fundamentals
- Chapter 5: Priority conduct risks that emerge from the cross-market issues set out in Chapter 4 and how these link to our 2013/14 activities set out in the Business Plan.

4. Forward-looking cross-market risks

Conduct risks can manifest themselves in a number of different ways, but are often driven by the same underlying issues set out in Part A. This chapter presents a range of forward-looking conduct risks that cut across financial markets and have the potential to create risks to consumer protection, market integrity and effective competition. Our strategy for dealing with these forward-looking risks will be developed over time as their nature and specific market impacts will continue to develop. Work to mitigate these risks will require not only regulatory actions, but also measures from firms and consumers to improve outcomes.

4.1 Rising pressure on strategic business model adjustment

Drivers of pressure on strategic business models adjustment



Firms face considerable pressure on their business models and strategies. This is due to a combination of long-term trends, market dynamics and the current environment (which has lowered profitability and reduced business volumes at a time of significant operational pressure, economic uncertainty and high levels of regulatory change). These conditions are placing new demands on firms and infrastructure providers and altering consumer needs. Material growth in many core markets is unlikely and, without strategic changes to adjust to these building pressures, some of the practices that have led to consumer detriment in the past could re-emerge.

In the past, many firms have opted for short-term and expedient fixes to support profits and deliver (in many cases) on shareholder expectations. While these strategies have often supported profitability in core markets for a period, they can also exacerbate risky behaviours and poor practices, which pose risks to firms' long-term sustainability and to consumer outcomes.

Where there are significant market concentrations or tight margins, it will be particularly difficult for firms to adapt. Extracting value in declining or mature markets will place significant competitive pressure on existing providers and their strategies (many of which are still dealing with the fallout from the financial crisis and prolonged economic weakness). Where firms consolidate in reaction to business model stress, this could lead to fewer options for consumers, reduced competition and an increase in concentration risk. Where consumers' needs are no longer met by the mainstream financial sector, they may look outside the regulatory boundary for alternatives. This could reduce their wellbeing in the long term.

Firms are constantly under pressure to adapt. However, the acute and protracted nature of today's challenges increase the risk that the way in which they react and adjust to the pressure could cause poor conduct and consumer outcomes. The following are the main risks we see arising from this pressure:

Design and distribution of increasingly complex and more niche products or services that exploit conflicts of interest and do not respond to genuine consumer needs (Consumer protection; market integrity)

As firms look to adapt to lower demand and business volumes from core markets, they are more likely to design increasingly complex and overly segmented products to expand their product offering. This may increase information asymmetries and raise the risk that conflicts of interest are mis-managed or exploited. It may also mean that firms fail to adjust controls appropriately. Poor product design and distribution, in turn, raise the risk that consumers' genuine needs will not be met.

- **Insufficient management of conflicts** of interest that mean firms do not act in consumers' best interests.
- **Poor governance over new product design and development** could lead to weaknesses in proposed distribution and sales practices. This could lead to more complex products intended for a small group being sold more widely. With consumers and firms increasingly likely to engage with a broader range of financial products, the potential for inappropriate choices/purchases or mis-selling is increased.
- **Over-segmentation** where the differences between products may not be based on real consumer needs but give the impression of providing a product that has been designed for a specific consumer need. Unnecessary complexity (in the features of the product as well as the way in which it is distributed or reaches the end consumer) adds cost and makes it difficult for consumers to compare offerings.
- **Inadequate transparency** leading to poor consumer decisions – insufficient information on fees, charges, interest rates or performance (and any changes in these) can cause consumers to make ill-informed and inappropriate decisions.

- **Innovation and sale of more complex, niche or opaque products** to keep extracting value from mature markets. Firms may not ensure that consumers understand the trade-offs between risk, pricing, rates, fees and charges or product coverage. More complex products, intended for a small target group, may be mis-sold more widely as consumers and firms engage with a broader range of financial products. Greater complexity and opacity can also increase the risk that these products are used to hide financial crime.
- **Pressure selling** where firms encourage consumers to purchase more profitable products or services, which may not be in the consumer's best interests. For example, packaged bank accounts, add-on insurance or protection products.
- **Incentives narrow consumer choice.** Executive and salesforce incentives can lead to the development and promotion of products to large groups of consumers which may not meet their needs.

Over-exploitation of profitable market segments or consumer groups

(Consumer protection; effective competition)

A scramble to maintain margins and offset loss-making activities may mean that firms increasingly target well-performing but finite or unsustainable markets. This could lead to increased movement into lucrative niche markets and consumer groups where underlying risks may not be fully understood or expectations for growth are over-optimistic. In a saturated or declining market, where business volumes are falling, growing competition for business without a rationalisation of firm numbers could dilute returns and lead to more risky behaviours and poor practices such as aggressive sales targets and techniques. Crowded market risks will increase where many firms move into the most profitable business areas but where growth prospects are constrained. Where competition is weak, these trends could lead to a race to the bottom or practices that could breach TCF principles.

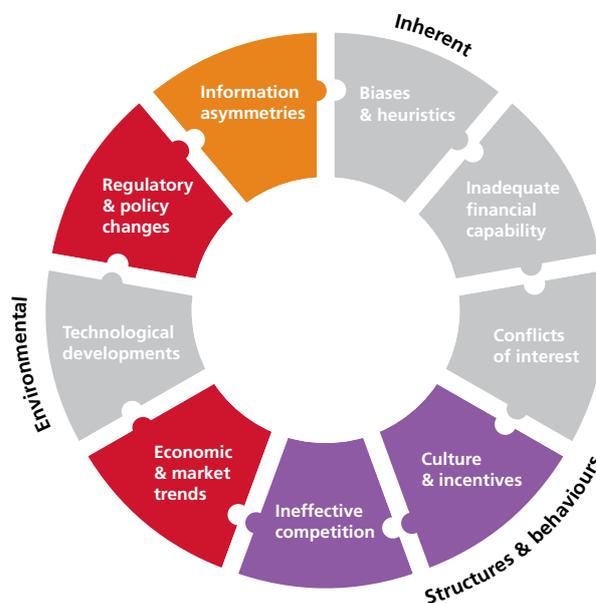
- **Over-exploitation of profitable but limited segments.** For example, by offering affluent consumers products that they do not need, or targeting income-constrained consumers with products that are unaffordable or offer insufficient protection or value. This may include increased cross-selling or on-selling of (high profit) secondary products or offering poor rates to captive consumers.
 - Exploitation of existing client base by **increasing use of auto-renewals and exit penalties** that can lead consumers to suffer significant costs or be forced to retain unwanted products.
 - Firms seeking to extract revenues at more points of the financial transaction, which could lead to **market over-intermediation**. This could lead to poor consumer outcomes, including higher costs, and reduced market integrity, particularly if value chains become increasingly complex and opaque making them confusing for consumers.
 - **Retrenchment from less-profitable markets despite continued consumer demand**, leading to reduced access, e.g. decline of basic bank accounts being offered at a time when there is growing reliance on basic banking facilities due to government changes to the way in which universal credit (welfare) is paid. This creates concentration risks or potential bottlenecks if the market relies on fewer providers of basic services.
- Increasing reliance on technology without a full understanding of the consequent risks and dependencies**
(Consumer protection; market integrity)
- Innovative ways of using technology can reduce cost and create easier and faster access to financial markets for firms and consumers. However, the volume and pace of technological change may reduce firms' ability to ensure adequate oversight of operations and technological interfaces, and may increase their dependency on underlying systems. Pressure from the level of change may threaten the resilience of technology, and could lead to systems outages. The pace of change may also lead to poor controls or conflicts around sales and trading processes and the security of IT systems, increasing the risk of financial crime, unauthorised payments and security breaches.
- **Business continuity risks**, may occur if technology is unable to operate effectively due to overloading. In many instances, firms rely on ageing and merged technologies and systems to process a growing volume of transactions and adapt to new demands from consumers. This may lead to increased, and not always well understood, operational risk (e.g. increased complexity of IT systems creates risks around firms being able to validate and test the structural integrity and operation of their end-to-end IT infrastructure). These issues are exacerbated and may lead to bottlenecks where firms have inherited legacy systems or are being required to make additional technology changes or scaling. The current environment is also affecting firms' ability to invest due to low profitability.
 - **Cyber-attacks**. There is an increasing threat of outside (cyber) attacks, which pose operational risks to firms and threaten market integrity through service disruption, breach or theft of personal information, or network intrusions causing loss of control of critical infrastructure (e.g. payment systems).
 - **High sunk costs and the cost of systems maintenance may create barriers to entry or reduce the number of participants in a given market.** This could reduce competition, particularly in markets that rely on highly sophisticated technology. It may also give rise to concentration risk when a critical element of infrastructure is provided by a limited number of firms (and thus any operational issue may have significant knock-on effects on market integrity and consumers).

- Increasing reliance on technology to engage in financial services, raising risks around consumer access.** Firms may increasingly fail to meet the needs of certain consumer groups (e.g. within certain age groups or regions) who do not have access to computers or who are not computer literate. Similarly, firms may not be adequately considering the needs of different consumer groups in developing and marketing mobile banking and payment services, which could lead to unfair treatment of certain consumer groups.
- Increased use of online and mobile platforms to access financial services could leave consumers more susceptible to financial crime** (such as breach or theft of personal information, fraud or scams) if they do not understand how to protect themselves.
- Technology could facilitate faster, less considered decisions by consumers** on important financial purchases, which could become costly (e.g. via hidden costs or purchasing products that do not match needs) or mean that they do not pay attention to other important details, (e.g. unauthorised transactions).
- As demand for price comparison sites continues to grow, these platforms could increasingly sell complex products that are marketed on price rather than coverage.** These products may not be appropriate for the mass market, and which may provide a misleading impression of products on offer (consumers may not realise that not all products are displayed on price comparison websites).
- Increased choice available via online platforms may overwhelm consumers.** The potentially overwhelming level of choice available via direct online financial services platforms may interact with economic uncertainty and stretched consumer finances to deter consumers from switching out of

inappropriate policies or products to more affordable or better performing options.

4.2 Failure to balance prudential soundness and profitability with good consumer outcomes

Drivers of failure to balance prudential soundness and profitability with good consumer outcomes



Firms face a continued squeeze on profits as a result of long-running pressures and the current environment (see Part A). The post-crisis pressure on firms to rebuild prudential soundness, attract new funding and maximise profits could lead to short-sighted strategies that have unintended conduct consequences.

Deep and prolonged cost-cutting strategies without a full understanding of the consequent risks and dependencies

(Consumer protection; market integrity)

Cost-cutting strategies may be the most expedient way to bolster profitability and can often benefit consumers. However, several of the most common cost cutting approaches – such as outsourcing or off-shoring – could have unintended consequences and entail costs for consumers. After several years of challenging operating conditions, a prolonged strategy of cost-cutting increases the risk that customer-facing services are not fit for purpose and that operational functionality is compromised.

- **Reduced quality in firms' product offerings or services for consumers, due to lower investment in pre- and post-sales care.** Service levels (both in terms of quality and flexibility) may suffer if firms cut spending or increasingly outsource/offshore key functions such as claims servicing, renewal administration and compliance checking.
- **Insufficient spending on oversight that could weaken operational resilience and market integrity.** Lower investment in controls could lead to inadequate risk management and oversight. This could give rise to poor administration, funds managed outside mandates, and inadequate business continuity planning (BCP). Firms may reduce investment in the surveillance of trading activity, raising the risk that market abuse goes undetected.

Poorly managed or controlled strategic adjustments

(Consumer protection; market integrity)

In response to post-financial crisis stresses and regulatory reforms, firms are adjusting their business models and strategies to adapt to current and future conditions. These adjustments may create risks if not carried out with appropriate governance and controls

and if the firm culture is not focused on ensuring good outcomes for consumers and on supporting integrity and competition in markets. For example, although de-risking to shore up prudential soundness is a large part of this process, some adjustments may increase the risk of unfair treatment of consumers and raise access issues if firms remove less profitable activities.

- **Unfair changes in existing policy or strategy** to support profitability leading to poor treatment of consumers, particularly where these do not reflect a change in consumers' underlying risk profile or circumstances, (e.g. withdrawal from forbearance without clear exit strategies or implementation of strategies to mitigate claims leakage, potentially causing legitimate claimants to be treated unfairly).
- **Reduced access to financial products and services** as firms rationalise offerings and move away from risky or lower-profit client segments or product and service areas.
- **Transfer of risk to consumers.** For example, changes to capital requirements for banks and insurers could encourage firms to promote capital-light products that push risk back to the consumer. These products may exploit information asymmetries, reduce market liquidity and result in inappropriate diversification.
- **Decoupling of governance and oversight from the business.** The level of change and uncertainty in financial markets may mean that firms fail to keep pace with changes in their activities or risk profile (or appetite). Under these conditions – and without concerted commitment from senior management and robust controls around culture and governance – perennial risks of poor conduct and unfair treatment of consumers may become increasingly prevalent.

Unsustainable strategies to attract funding promote risky behaviours

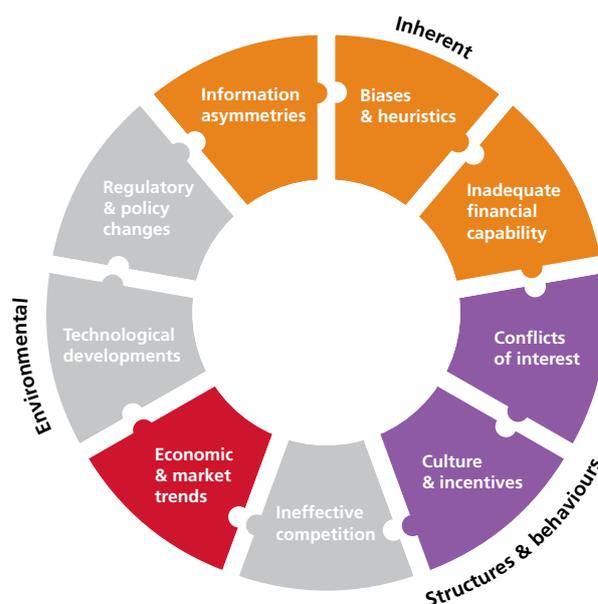
(Consumer protection; market integrity; effective competition)

Firms seeking to attract funding could look to retain or broaden existing sources beyond sustainable levels (e.g. retail deposits and covered bond issuance). Others may opt for higher risk funding sources or more complex structures, raising risks to market integrity and consumer protection (e.g. increased reliance on dominant shareholdings from international sources where there may be lower compliance with anti-money laundering and anti-corruption standards or less transparency).

- **More aggressive strategies to retain and attract long-term deposits.** For example, firms may look to strategies that require higher minimum deposit levels to be eligible for other services/products. This could exclude less affluent consumers from good deals and leave most depositors with poor rates.
- Less acute funding stresses (as a result of policy support such as FLS or improved sentiment in wholesale funding markets) may lead to **fewer and less profitable savings options** for most consumers. For example, firms may continue to offer fewer savings accounts, lower savings rates or attractive, yet unsustainable initial rates on deposits that tie consumers into contracts and reduce their ability to switch.
- **Increasing firm exposure to financial crime**, (e.g. firms being used as a conduit for money laundering by taking more risks around accepting the proceeds of corruption or other financial crime), or firms seeking to generate business by making or failing to prevent the payment of bribes to win business.

4.3 Misalignment of market performance expectations and underlying fundamentals

Drivers of misalignment of market performance expectations and underlying fundamentals



Low real returns continue to challenge firms' profitability and consumers' ability to grow their wealth and asset holdings. The current low interest rate environment is adding to this stress and fuelling a search for yield. Despite challenging current conditions and the uncertain outlook, firms and consumers may be underestimating potential downside risks or prospects of weaker future performance. Growth expectations for some better performing markets in the near term may be over-optimistic and lead to mispricing of risk. Despite prolonged adverse economic conditions, both firms and consumers are likely to continue to misjudge the risks associated with higher returns as they seek to maintain pre-crisis levels of return.

Misalignment of market performance expectations and underlying fundamentals can lead to:

Poor understanding of risk and return and the search for yield lead consumers to make inappropriate financial choices.

(Consumer protection)

Consumers seeking growth in higher-yielding investment products such as derivatives, contracts for difference (CFDs) or unregulated collective investment schemes (UCIS) may not understand the exposures and risks they are taking on, especially if the products appear to have a low risk of capital loss. Given that biases and heuristics that distract from performance realities tend to become more pronounced in complex and stressed conditions, poor borrowing and investment choices (for example, failing to switch to better options) and vulnerability to scams and fraud can be expected to increase. Similarly, tight post-crisis credit conditions are also leading certain consumer groups to seek alternative sources of credit to supplement their income and boost consumption.

- **The gap between perceptions and real performance creates opportunities for inaccurate risk assessments that can lead to poor decisions. This can expose consumers to more risk than is appropriate for their means,** e.g. interest-only mortgagors planning to use gains in equity value (which were strong in the lead-up to the crisis) as a means of capital repayment could be left short if house price growth remains weak or realigns to underlying fundamentals.
- **Exposures and protection may be misunderstood** and the riskiness of retail investment products that are marketed as cash-like or low risk may not be apparent. For example it may not be clear at the point of sale that structured retail deposits are exposed to market risk (i.e. that they are investment products not deposits) or that bonds sold by financial firms, such as with-profits or permanent interest bearing shares (PIBS), may be subject to seniority issues or penalties that could leave investors with losses on their initial investments.
- **Brand recognition and sales through single distribution channels increase the risk that consumers take inappropriate decisions.** Single distribution channels, branding recognition and poor labelling increase the risk that consumers fail to pay attention to the characteristics of individual products and may fail to differentiate between levels of risk exposure.
- **Consumers' search for yield may lead them to make inappropriate financial choices.** Low returns could lead more savers to seek higher returns by switching from savings to investment products and therefore taking on investment risk. Some consumers may place too much focus on past performance and nominal data, which may lead to overconfidence in future performance or mis-assessment of the risk of capital loss.
- **Loss of client money protections for retail consumers** where investment firms (e.g. those offering spread betting and Contracts for Difference) seek to (re)categorise them as professional clients in order to utilise their money to fund their own activities.
- **Increased appeal of products outside the regulatory perimeter that offer consumers access to higher yielding asset classes or geographies but often entail less protection and additional costs that may not be fully understood.**
 - With falling pension contributions and poor asset performance since the crisis, consumers (especially those nearing retirement) may seek to supplement savings with investment products,

e.g. further investment in property (such as becoming a buy-to-let landlord) or pension 'liberation' schemes.

- Investors may not appreciate that certain funds are not regulated (and therefore covered not covered by the Financial Services Compensation Scheme (FSCS)), e.g. offshore exchange traded products (ETPs), UCIS, retail bonds or investments in overseas assets (such as speculative property developments in potentially unstable geographies).
- Non-mainstream investments (which typically trade on unregulated markets), such as fine wines, carbon credits or viatical plans (life settlements), can also be highly illiquid and prone to significant losses in value or redemption risks.
- Consumers looking for higher yielding products may also be more susceptible to investment fraud e.g. share fraud, Ponzi schemes, land banking, or pension liberation fraud.
- **Alternative sources of credit** for consumers have grown in response to tight post-crisis credit conditions (e.g. payday lending). However, consumers may not recognise the difference between regulated and non-regulated providers or platforms (e.g. some crowd-funding providers may be regulated, while others may not be; peer-to-peer lenders are not regulated, while some consumers may think they are). In an environment where firms are targeting the lack of trust in mainstream banks, unregulated firms' marketing strategies may intentionally blur this distinction.

Firm mis-assessment of risks associated with sources of funding

(Consumer protection; Market integrity)

The prolonged and acute pressure on firms to make up for losses incurred in the financial crisis and ongoing

economic downturn, may increase the risk that they opt for risky funding sources or structures to maintain growth and performance potential in markets. This would have implications for market integrity and consumer outcomes.

- **Increased firm exposure to risky sources of funding** or vulnerability to complex and risky funding structures.
- **Gaming of accounting and underwriting standards** to circumvent inadequate funding or collateral positions.

5. Priority risks and links to the Business Plan

The following chapter takes a look across the broad risks set out in Chapter 4 and distils these into five priority forward-looking risks for the FCA in 2013/14. We will seek to make progress in addressing these risks over the next year and over the longer-term through our supervisory and policy work (see Links to the Business Plan on p. 58). Further work will be carried out to better understand potential impacts of these risks on individual markets through our market research and analysis. Our research and analysis activities will be key to our new forward-looking, earlier intervention approach, as they will help us monitor risks and refresh our thinking, and will show us how and where we can more effectively intervene to mitigate or prevent risks to our interconnecting (and at times conflicting) objectives.

In addition to these forward-looking risks to our objectives (where significant detriment may not yet have crystallised) we also face risks that are already crystallising, and that we will continue to mitigate. We will balance our resources across these immediate and longer-term priorities according to our risk appetite.

The priority risks for 2013/14 emerging from the analysis in Chapters 1-4 are:

Firms do not design products and services that respond to real consumer needs or are in consumers' long-term interests.

Products and services that are not designed in response to real consumer needs may be unnecessarily complex or lead to excessive prices for consumers or reduced access to financial services. Consumer detriment may also arise where there are obstacles to consumers being able to exit a product or service (e.g. through terms and conditions or excessive exit fees) if the product

becomes unsuitable, unaffordable or their needs or the environment changes.

In the short term we will seek to address this risk where:

- a) There are unfair obstacles to consumers' ability to exit or enter a product or service due to changing consumers' needs or environmental conditions. For example, firms offer poor value to consumers by unduly restricting access to individual products or reducing consumers' ability to switch (through bundling, disproportionate exit fees or unfair terms and conditions).
- b) In responding to environmental or changing business conditions, firms adopt strategies that support their own interests but may not be in the long-term interests of their consumers. For example, whilst long-term forbearance may be in the best interests of some consumers, the implicit cost of forbearance (e.g. fees, charges and accrued interest) may outweigh the benefits of staying in the home for others. The balance between the cost and benefits of forbearance for individual consumers are important considerations for to ensure they are in the long-term interest of consumers.
- c) Firms are over-exploiting their existing consumer base due to limited new business. For example firms targeting existing consumers with cash-generating products they do not need to improve margins.

In the long term we will seek to address this risk where:

- d) Firms are developing complex, opaque and over-priced products that are not in the long-term interests of consumers and are difficult to compare. For example alternative 'equity release' products (which allow consumers new ways to tap into their housing wealth in order to make up shortfalls in current or future retirement income) where complexities around pricing for longevity and

investment risk could lead to consumers buying an unsuitable product at a price that is not affordable into retirement.

- e) Consumers are not fully aware of their financial needs and what products or product features would adequately serve these needs. This could lead to a lack of trust and low confidence in financial services, which could reduce incentives for firms to innovate new products in the long term or; consumers taking out products that are inappropriate, with features they do not need or that they cannot afford.
- f) Consumers do not have access to products that meet real needs within regulated markets, due to a lack of competition and resulting shortfall in product availability and innovation. For example consumers may be pushed to take on products that are inappropriate for their needs or cannot afford but are the only option available to them or attracted to un-regulated sources of products e.g. payday-lenders for short-term credit needs.

Distribution channels do not promote transparency for consumers on financial products and services.

Firms may exploit information asymmetries or fail to manage conflicts of interest throughout distribution chains; or take advantage of demand-side weaknesses to reduce transparency, which could lead to consumers being led to buy inappropriate products or services. In addition where firms use existing distribution channels to target consumers with additional products that they may not need consumers may buy products they don't need. The culture of firms and incentives play a key role in the distribution of products and firms' interactions with consumers and the options made available to them. We will seek to address cultural issues and incentive structures that narrow consumer choice or create a

significant incentive for inappropriate or indiscriminate targeting of consumers.

In the short term we will seek to address this risk where:

- a) Consumers are prevented from being able to make well-informed financial decisions or compare product because features, costs and incentives are not transparent.
- Product features are not clearly disclosed or information provided to consumers prevents them from making well-informed financial choices/decisions (e.g. poor product labelling). For example, where features of structured products are not clearly described in the prospectus.
 - Pricing structures and charges are poorly disclosed or opaque and mean consumers are unable to work out, in aggregate, what is being charged over the lifetime of the product or service (e.g. additional features they have to pay for to stock-lending fees, contingent charges, or changes in rates after initial promotional period).
 - Firms exploit consumers' focus on headline price or other near-term features by marketing (framing) products and services in a misleading way; or take advantage of consumer inertia and other biases to prevent them from moving out of services or products that no longer offer value or expose them to risk beyond their risk appetite, e.g. consumers buying their annuity may stay with their existing life insurance provider rather than shopping around for better rates or products that better serve their particular needs.
- b) Information asymmetries and conflicts of interest are not managed and consumers may be using misleading information (in particular in relation to

key benchmarks for financial markets). This risk could lead to:

- Firms exploiting knowledge of a client's trading intentions to deal ahead (front-running a client order) and make a proprietary trading profit.
- Greater opportunities to profit at the expense of clients and in firms that lack robust systems and controls particularly where markets are fragmented.

In the long term we will seek to address this risk where:

- c) **Firms fail to re-assess the suitability of using existing distribution channels to push additional products onto consumers.** For example, risks could be created by firms changing distribution strategies in response to the RDR and competition from other sectors. In particular, where they do not review the suitability of their product offerings through these distribution channels or ensure products are delivered to appropriate customer segments through the right distribution channels.

Over-reliance on, and inadequate oversight of, payment and product technologies.

Firms may not fully mitigate the risks and dependencies associated with the technological systems and interfaces their businesses rely on. Poor oversight of technology may lead to weak operational resilience and risks to service continuity. It may also mean that firms fail to capture market abuse such as money laundering, where individuals may, for example, take advantage of complex product structures or opaque payment systems to hide illicit funds. In the development and marketing new technology-based services firms, may not be adequately considering the needs of different consumer groups. This could lead to unfair treatment

or reduced access for some consumers. Risks may also arise if consumers are not adequately informed about how to protect themselves from financial crime or how to use technologies correctly.

In the short term we will seek to address this risk where:

- a) **Systems may be unable to withstand growing transaction volumes and adapt to new consumer/user demands.** Complex systems (especially legacy systems that may be out of date, or have been merged with other potentially incompatible systems) may be difficult to validate and test for structural integrity. Business may be disrupted if plans are not in place to ensure continuity in the event of systems outages, whether driven by overloading (e.g. due to increased user demand from trading technologies such as algorithmic and High Frequency Trading (HFT)), human error or cyber-attacks.
- b) **Consumers may not be aware of risks associated with online or mobile platforms, including financial crime risks (such as breach or theft of personal information, fraud or scams).** In addition, they may not adequately monitor activity on online (or mobile) interfaces (for example consumers may be unaware of unauthorised transactions or changes in their holdings) in a way that allows them to make timely decisions. In wholesale markets, market abuse strategies may become more complicated and more difficult to detect, due in part to increased market fragmentation (as trading activity takes place across different venues) and to faster and more integrated systems, which result in both increased correlation (in price movements across asset classes).

In the long term we will seek to address this risk where:

- c) **Technology reduces consumer choice and access due to online interfaces having an adverse impact on the framing of products.** For example, the transition to online or mobile options may prevent

certain consumer groups from accessing products they need, e.g. firms may not be adequately considering the needs of different consumer groups in developing and marketing mobile banking and payment services which could lead to unfair treatment of consumers; or consumers may not realise that not all products available to them are presented on price comparison sites.

- d) Firms have not developed suitable controls around technologies that use Big Data to build intelligence and to inform decisions around pricing and access to products. This could lead to poor decision making if data is corrupted or not appropriately validated.

Shift towards more innovative, complex or risky funding strategies or structures that lack adequate oversight, posing risks to market integrity and consumer protection.

In response to economic and financial market conditions, as well as to new regulatory requirements, incumbent firms and new entrants may use increasingly innovative, complex and risky funding sources and structures. These could prove to be unsustainable and may not be compatible with firms' existing governance and oversight arrangements. Funding strategies and structures could expose firms to financial crime, raising risks to market integrity. They may also have implications for consumer protection if firms increasingly prioritise funding needs over consumer needs.

This risk is especially important at times of funding stress, but is one that is relevant in both the short and long term.

We will seek to address this risk where:

- a) Firms' funding structures or sources of funding may adversely affect market integrity (e.g. through

increasing exposures to money laundering) or pose future risks to consumer protection (e.g. where risk of capital loss may be pushed onto the consumer.

- b) Firms' funding structures (or proposed funding structures, which can be identified at the point of authorisation by the FCA) are predicated on products that have been developed and priced to meet investor demands rather than needs of the consumer of the product.
- c) Firms' governance and oversight arrangements may not have been developed, and therefore may not be compatible with new sources of funding, funding structures or collateral arrangements that firms implement in response to environmental conditions, e.g. in response to potential collateral shortage at some firms due to new increased collateral requirements under EMIR.

Poor understanding of risk and return, combined with the search for yield or income, leads consumers to take on more risk than is appropriate.

The gap between perceptions and real performance creates opportunities for inaccurate assessments of risk, which can lead to poor financial decisions. Consumers' search for yield may incentivise them to invest in higher yielding products that are inherently more risky. In addition, as credit conditions remain tight consumers may increasingly turn to alternative financial service providers or structures (such as payday lenders or peer-to-peer lending) to access credit – some of which may be unregulated. We will aim to improve consumers' understanding of the risk-return balance involved in their decisions. This will involve an ongoing body of work that addresses both the consumer mistakes and the firm strategies that can lead to these poor decisions. In particular we will aim to mitigate against:

- a) **Low consumer awareness of the risks associated with high-yielding products** (including those offered by unregulated firms) and the potential higher costs of alternative sources of credit.
 - b) **Consumer focus on brand** which can distract from product features and prevent consumers shopping around for alternative options that may better serve their particular needs.
 - c) **Firms that provide inaccurate or misleading assessments of risk and return to consumers**, which can mean that consumers do not have the information they need to make well-informed financial decisions
- on our newest objective (e.g. through market studies to strengthen our understanding of competition issues) and in preparation for new responsibilities that we will take on in the future (e.g. via consultation on conduct rules and guidance relating to consumer credit).

Links to the Business Plan 2013/14

Some of the drivers of conduct risk and the risks we identify and analyse in this document will take years to resolve. The more developed risks we discuss will be addressed through supervisory and policy work; the more forward-looking issues may require further investigation to fully understand their impact on markets and consumers and our ability to influence outcomes. Where we are planning work to address these in the next year, we have set this out in our Business Plan for 2013/14 (Table 3). However, some of these risks will take some years to resolve and we will continue to set out our planned work in future business plans.

We will also carry out a number of research and analysis initiatives in our Policy, Risk and Research Division over the coming year to monitor and refresh our thinking on the drivers and risks we describe in this document. These will help us further prioritise our actions at a market level or thematically and to balance our forward-looking workload with the crystallised risks and known problems we will continue to mitigate. We will also focus on in-depth research, analysis and policy work

Table 2. Summary of top risks and planned work in the Business Plan

Priority risk	Firms do not design products and services that respond to real consumer needs or are in consumers' long-term interests	Distribution channels do not promote transparency for consumers on financial products and services	Over-reliance on, and inadequate oversight of, payment and product technologies	Shift towards more innovative, complex or risky funding strategies or structures that lack adequate oversight, posing risks to market integrity and consumer protection	Poor understanding of risk and return, combined with the search for yield or income, leads consumers to take on more risk than is appropriate.
Activities outlined in the Business Plan 2013/14	<ul style="list-style-type: none"> • Product governance (including implementation of 2011 product intervention regime). • Thematic review of firms' strategies for mortgage arrears and forbearance management. • Asset management project on product design and oversight. • Development of competition expertise, including by carrying out market-level studies to analyse competition issues and input into product risk identification. 	<ul style="list-style-type: none"> • Follow-up on our 2012 guidance on financial incentives (including assessment of whether more intrusive supervisory work or rule changes are necessary). • Financial promotions review. • Negotiation of PRIPs regulation and contribution to development of technical standards. • Second phase of thematic review into conflicts of interest in the asset management sector to ensure compliance with conflicts of interest rules. • Asset management project on fund fee structures as part of product design and oversight project. • Project to assess transparency of secondary services provided by custody banks. • Project to review practices across the main transition management industry participants to assess whether unclear fee structures and complex legal and pre/post transition documentation are resulting in poor customer outcomes. • RDR implementation. • Wholesale conduct strategy: focusing on the culture, systems and controls that govern relationships in wholesale markets and may lead to risks to market integrity (e.g. payment for order flow) or consumer protection (e.g. if dealing commissions and stock-lending fees are poorly disclosed). • Follow-up work on the Wheatley Review to raise standards of governance, systems and controls around rate submissions and create new Controlled Functions relating to LIBOR. 	<ul style="list-style-type: none"> • Review of compliance among price comparison firms and potential consumer protection issues these platforms raise. • Supervisory work to ensure firms offering new/mobile payment methods are providing sufficient information to consumers on what the services provide and how they should be used. • Implementation of lessons learned exercise from 2012 RBS Group systems failure. • Supervisory and analytical work to assess resilience of market infrastructure and risks associated with trading strategies such as algorithmic or HFT. • Review of Payment Services Directive (PSD). 	<ul style="list-style-type: none"> • CRD IV consultation and preparation for implementation. 	<ul style="list-style-type: none"> • Publication of interest-only thematic review and follow-up work. • Research and consumer engagement work to devise regulatory interventions to improve understanding of risk and return and ensure these are clearly communicated to consumers.

Conclusion:
Conduct risk agenda and key messages

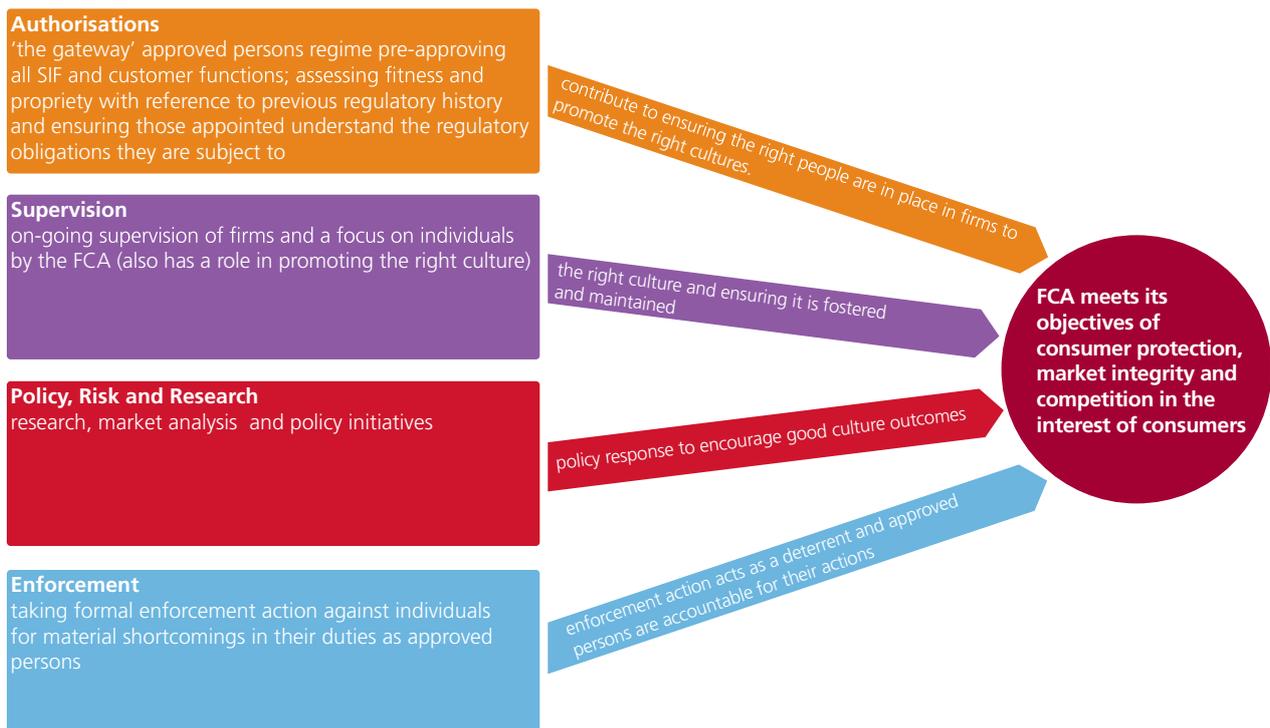


The drivers of conduct risk (Chapters 1-3) and the key areas of risk (Chapter 4-5) that we analyse in this document will help us set our regulatory and supervisory priorities.

We aim to be flexible and effective in our responses to the complex (and at times entrenched) challenges we discuss in this document. We will make use of a range of regulatory tools to intervene in different areas of the financial sector, at different stages of the problem and across the regulatory lifecycle (see Figure 27). Many of the risks discussed here will continue to develop and their market and consumer implications will change over time. We will therefore carry out further research to ensure our interventions are as timely and effective as possible.

Our intervention in these issues will need to be matched by a concerted effort from firms, consumer bodies and consumers themselves to help address the root causes of the poor conduct outcomes that arise again and again in financial markets. We will use our regulatory powers to improve outcomes for consumers, to protect and enhance the integrity of the UK financial system and to promote effective competition. We recognise that this will be a challenging task as external conditions remain stressed and the volume of near-term pressures continues to proliferate. We may need to adapt our responses over time to ensure our actions are proportionate and in line with our objectives.

Figure 27. FCA intervention example: dealing with risks relating to firm culture through the regulatory lifecycle



Key messages for firms and consumer bodies

Many firms are already taking steps to embed conduct considerations in their governance structures and strategies, driven by external pressures (i.e. regulation and government policy) and in an effort to put their businesses on a more sustainable footing. We are keen to ensure these adjustments continue and become more widespread across the sector. Consumer bodies are also working to help consumers understand both their needs and the financial products and services on offer, and to ensure they are well equipped to use financial services to meet their current and future needs.

Throughout this document we have set out a number of important issues for firms to consider when making decisions around their businesses and for consumers to consider when making financial decisions.

Key messages for firms

Firms need to ensure they are putting the consumer and the integrity of markets at the heart of their business models and strategies. This includes making strategic cultural changes which promote good conduct, establishing oversight around the design and innovation of products and services; and ensuring they are transparent in their dealings with consumers. Most importantly, that firms take an active role in maintaining the integrity of the financial markets to ensure consumers can have confidence in the firms and products they engage with. We expect firms to engage with the analysis and messages in this document in designing and distributing products (e.g. product literature).

Firms need to ensure they are putting the consumer and the integrity of markets at the heart of their business models and strategies. This includes making cultural changes that promote good conduct outcomes throughout the business; establishing appropriate oversight and governance around the design and innovation of products and services; and ensuring

they are transparent in their dealings with consumers. Most importantly, firms need to take an active role in maintaining the integrity of the financial markets to ensure consumers can have confidence in the firms and products they engage with.

We expect firms to engage with the analysis and messages in this document in a range of their business strategies and decisions – from product design and distribution to funding strategies and how they use and oversee technological developments. Firms should look at their business model, strategy and structure to critically assess whether any of the drivers and forward-looking risks apply to their own business and how they may play a role in dealing with these in a way that is fair to consumers, promotes effective competition and market integrity.

Key messages for consumer bodies

Consumer bodies engaging with consumers through their dealings with financial services should be mindful of the analysis covered in this document and the work being carried out by the FCA.

The content of this document should be used to inform consumers of the challenges they may face in financial markets and of how they can protect themselves against their own mistakes and make more sense of the products and services that are on offer. For example, consumers need to be mindful of the growing responsibility on individuals to manage their finances for current and long-term spending needs. They will also benefit (through consumer organisations) from a better understanding of how inherent factors (such as biases) may lead to mistakes, and of the cost these mistakes can have in the near term or long into the future. They also need to bear in mind that as firms look to innovate products to meet changing consumer needs, the number of financial products available is likely to increase in quantity and complexity, which could make decision-making more challenging.

Appendices



Acronyms

AIFMD: Alternative Investment Fund Managers Directive	IORP: Institutions for Occupational Retirement Provision
BIS: Bank for International Settlements	KYC: Know your customer
BTL: Buy-to-let	LIBOR: London Interbank Offered Rate
CFD: Contracts for difference	M&A: Mergers and acquisitions
DC/DB pension schemes: Defined Contribution/Defined Benefit pension schemes	MiFID/MiFIR: Markets in Financial Instruments Directive/Regulation
EIOPA: European Insurance and Occupational Pensions Authority	MMF: Money market fund
EMIR: European Market Infrastructure Regulation	MMR: Mortgage Market Review
ESMA: European Sales and Market Association	MTF: Multilateral Trading Facility
ETF: Exchange Traded Fund	NSFR: Net stable funding ratio
FATCA: Foreign Account Tax Compliance Act	OTC: Over-the-counter
FLS: Funding for Lending Scheme	PIBS: Permanent interest bearing shares
FSB: Financial Stability Board	PPI: Payment Protection Insurance
FSCS: Financial Services Compensation Scheme	PRIPs: Packaged Retail Investment Products
FTT: Financial Transaction Tax	PSD: Payment Services Directive
HFT: High frequency trading	RDR: Retail Distribution Review
ICB: Independent Commission on Banking	SME: Small and medium enterprises
IFA: Independent Financial Advisor	TCF: Treating Customers Fairly
IFRS: International Financial Reporting Standards	UCIS: Unregulated Collective Investments Scheme
ILAS: Individual Liquidity Adequacy Standards	UCITS: Undertakings for the Collective Investments in Transferable Securities
IMD: Insurance Mediation Directive	

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