

2018



### Financial Conduct Authority

Sector Views 2018

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### Introduction

### To regulate effectively we need a view of how the

system is working as a whole — as well as within its component sectors and markets. To develop this view, we divide the system into sectors and monitor them continuously using a wide range of data and intelligence. The picture evolves almost daily, but once a year we bring our collective intelligence together into documents called Sector Views. These give us a picture — an FCA view — of how a sector is performing. Sector Views describe the sector, the need it seeks to fulfil, the issues and developments we are seeing and the impact of change.

By their nature Sector Views are a snapshot of a sector at a given time, based on the information available at that time. They set out what we already know but, just as importantly, they tell us where we need to know more. We regularly update the Sector Views internally with any significant developments to reflect the changing dynamics in the sectors.

Sector Views play an important part in our work. Each Sector View helps determine our priorities for a sector, our resourcing decisions and our operational plans. We use an intervention framework to establish where harm is occuring and why. We analyse the scale and impact of the harm, and we assess how effective different remedies could be. Our Business Plan then sets out which areas we are prioritising and how we plan to tackle them. This all takes place in the context of our Mission, which provides a framework for our decisions and the approach we take to delivering our objectives. EU withdrawal features more prominently in some Sector Views than others but is a consistent theme across the financial landscape.

Last year, we made a commitment to publish our Sector Views annually after our Board has approved them. This year's Sector Views contain information based on the data situation and our views at mid-2017. We are publishing them alongside our Business Plan.

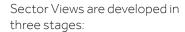
We would welcome your feedback on our observations. Please send your comments to SectorViews@fca.org.uk

Sector Views are a snapshot of a sector at a given time.
They set out what we already know but, just as importantly, they tell us where we need to know more



### Sector Views draw on the wide range of information,

research and insight held across the FCA. We supplement this with information from external sources, ranging from independent economic forecasts to MPs' correspondence, social media and the views of our Statutory Panels. We gather qualitative and quantitative information to show what is happening in markets. We consider this in the context of outside factors that might influence the sectors, such as macro-economic, technological, and social policy changes. We also consider the relationship between each sector under review and other sectors. This gives us as full a picture as possible of the key developments.



### Understanding the sector

We identify and map the markets that we are looking at in the sector, the size and scope of the sector and markets and inherent features of the sector. This includes consideration of consumers, their needs, the products and services offered and the firms that supply them.

## Assessing how the sector is performing and what is driving change in the sector

We analyse what the data and intelligence are telling us. We look at how the sector is performing for consumers and firms, the effectiveness of competition, whether markets operate fairly and cleanly, and the impact of market-wide forces. We then look at developments that may be driving change in the sector, including external factors, and consider how these will impact any harms and drivers we have identified and also whether they may give rise to new harms.

## Identifying the key themes for consumers, firms and the sector more widely

Finally, based on our assessment, we identify the key themes and associated harms in the sector, based on the actual or potential harm they cause. The areas of focus we identify then inform our planned activity in the sectors.

We also assess how sectors are interacting with each other as part of the wider financial landscape. We identify cross-sector themes that are relevant to a number of sectors, or that begin in one sector and affect another.

## The Sector Views cover all the markets we regulate, grouped into seven sectors:

- Retail banking
- Retail lending
- General insurance and protection
- Pensions savings and retirement income
- Retail investments
- Investment management
- Wholesale financial markets





### Introduction

### Methodology

Taking into account available intelligence, data, information,

current risks and issues, the following lenses are used to assess what is happening in the sector.

### Market integrity Stability and resilience Are markets, infrastructure and firms sustainable and resilient to disruption? **Effectiveness** Are prices formed, and users able to undertake transactions, efficiently and predictably? Fairness and cleanliness Are there clear, proportionate and consistently applied rules, Consumer journey and mechanisms that support Assessing product/ compliance? Do market service information participants act, and are they treated, fairly? Can consumers assess what the best options are for their needs? Accessing product/ service information Is key information about products and services available that consumers can access without difficulty? Assessing own needs Do consumers suffer harm as a result of their lack of understanding of their needs, now and in the future? Taking actions on decisions What prevents consumers from acting on their decisions or choices? Consumers are empowered and buy products/services offering the best value for money



### Firm specific behaviours

Do firms act in a way which results in good consumer outcomes?

### Firm specific incentives

Are firms' policies, processes, procedures and culture focused on ensuring good consumer outcomes?

Firms compete vigorously to offer consumers a fair deal

### Market wide drivers

### Barriers to entry or expansion

Are there factors which prevent new or existing firms from taking advantage of business opportunities?

### Side effects on other parties

Do firms or market participants act in a way that could have, or has had, side effects on other parties?

### Consequences of regulatory or government intervention

Has regulatory or government action led to adverse impacts on firms, competition between firms, or outcomes for consumers?

### **Conflicts of interest and competition**

### Suppliers coordinating

Do firms collude, damaging competition, causing harm to consumers?

### **Conflicts of interest**

When firms are obliged to act in the consumers interest, do they instead act in their own interest?

### Restrictive agreements within supply chain

Are there restrictive relationships within the supply chain that impede competitive rivalry within the market?

### Market power

Over time, can one or more firms maintain high prices or sustain poor product/service offerings without losing business to their competitors offering better deals?





### Retail banking

### Sector View

The retail banking sector is widely used by consumers in the UK. The average value of savings held has increased as has the total value of UK payments.

We've identified that the retail banking sector is going through significant change as a result of regulatory change, changing consumer behaviour, and rapid innovation. Initiatives such as the revised Payment Services Directive (PSD2) and Open Banking will potentially alter the relationship between firms and consumers. The major banks' share of the savings market has decreased. While this may indicate a potential increase in competition, the major banks still account for most of the market. Challenger firms are exploring opportunities where they can compete with the major banks, using technology and clearly focused business models to gain a competitive advantage.

### Introduction to the sector

The retail banking sector is the gateway into financial services for most consumers, including small and medium-sized enterprises (SMEs).1 It enables users to make fast and secure payments, hold funds securely, have a credit buffer to smooth cash flow, build savings for the short and long term, and earn interest.

For analysis, we have divided the sector into the current account market, the savings market and the payments market. Taken together, the cash savings and the current account markets form the market for retail deposits. The payments market includes current accounts, electronic money services, money remittance services, merchant acquiring, and credit card transactions. In practice, the

1. The Bank of England defines SMEs as those non-financial businesses with an annual turnover on the main business account of up to £25 million. The majority of lending to SMEs for business purposes is outside the FCA's regulatory perimeter, but most SMEs need access to credit and lending products.

Figure 1: Overview of the retail banking sector



# 73 million Personal current accounts<sup>2</sup>

## 4 million

## 26 million

British adults have a savings account<sup>4</sup>

People in unbanked households, 2013/14<sup>5</sup>

**730,000** 

Unbanked adults in the UK, 2013/14

1.71m

**14%** vs 2012/13

distinction between the sub-sectors is not clear-cut, although it helps to describe and understand the sector.

The retail banking sector is closely linked to the retail lending sector. Overdrafts are inseparable from current accounts and credit and charge cards are sometimes tied to a current account, although they are also offered as stand-alone products.

### Key developments in the sector

Our latest data show the retail banking sector is widely used by consumers in the UK. In the cash savings market there has been a small increase in the percentage of adults with cash savings. The average value of savings held has also increased by 3% to £17,403 from the previous year.6 In 2016, there were over 73,600 payments made by consumers and businesses every minute. During 2016, UK payment volumes increased to 39 billion with a total value of £7,669 billion (excluding CHAPS). Consumers accounted for 89% of all UK payment volumes and 21% of their value (excluding CHAPS).7

### Current account market

Competition in the current account market remains muted. This is likely to change over time as a result of the combined effect of new technology, changing consumer behaviour, and new

entrants. We anticipate that regulation will also help improve the current account market competitive landscape, notably PSD2, and the Competition and Markets Authority (CMA) remedies, including Open Banking.

Fee-based reward accounts, which offer higher interest rates on balances, have emerged as an alternative to savings accounts. Some electronic money accounts provide similar functionality to traditional current accounts.

The current account continues to be the most widely held financial product with 96% of UK adults holding a personal current account. However, the Financial Inclusion Annual Monitoring Report (2016) identified that 1.71 million adults were unbanked in 2013/14. Switching rates have remained static, with 1.01 million current accounts switched through the switching service in 2016. At 40% of consumers have more than one current account.

Consumers increasingly use mobile and digital channels with over 40 million adults using remote<sup>12</sup> banking channels in 2016.<sup>13</sup> Mobile banking has seen an increased uptake in the last three years with 19.6 million mobile banking users in 2016, compared to 8.9 million in 2013.<sup>14</sup>

The number of consumers who only use branches to manage their account continues to fall. Since 2012 it has fallen by 14%, to 12.4 million in 2016. 15

### 2. GfK FRS, data six months to December 2016.

Type of account	Number of accounts, 2016	
Personal current account	72.6m	96% UK adults <sup>16</sup>
Business current account	4m	5.5m SMEs <sup>17</sup>

### Recent trends in users of remote banking on main current account<sup>18</sup>

Channels used	Adults	vs 2013
Telephone only	12.6m	<b>▼</b> 10%
Mobile banking	19.6m	<b>1</b> 20%
Online banking	37.3m	<b>2</b> 1%
Total remote banking users	40.7m	<b>16%</b>

<sup>3.</sup> Bank Support for SMEs, Q4 2016, BBA.

 $<sup>4.\,</sup>FCA$  calculation based on GfK FRS December 2016 data and ONS data.

<sup>5.</sup> Unbanked households: Financial Inclusion Annual Monitoring Report 2016, University of Birmingham.

 $<sup>6.\,</sup>GfK\,FRS$  , data six months to December 2015 and December 2016.

<sup>7.</sup> UK Payment Markets 2017, Payments UK.

 $<sup>8.\</sup> GfK\ FRS,\ data\ six\ months\ to\ December\ 2016.$ 

<sup>9.</sup> Financial Inclusion Annual Monitoring Report 2016, University of Birmingham.

<sup>10.</sup> Current Account Switch Service Dashboard, issue 13, Q4 2016, Bacs.

 $<sup>11.\,</sup>UK\,Consumer\,Payments\,2016, Payments\,UK.$ 

<sup>12.</sup> Telephone, online or mobile banking.

 $<sup>13.\,</sup>UK\,Consumer\,Payments\,2016, Payments\,UK.$ 

<sup>14.</sup> UK Consumer Payments 2017, Payments UK.

 $<sup>15.\,</sup>GfK\,FRS, data\,six\,months\,to\,December\,2016.$ 

<sup>16.</sup> GfK FRS, data six months to December 2016. 17. Business current account 4m: Bank Support for SMEs, Q4 2016, BBA. SME 5.5m Business Population Estimates for the UK and Regions

<sup>2016,</sup> Department for Business, Energy and Industrial Strategy.

18. UK Payments Market 2017, Payments UK.

Firms are continuing to close branches, as well as transferring the provision of counter services to the Post Office to provide access to consumers who may not have a branch nearby.

### Savings market

Technology and low interest rates are having an impact on the savings market. The big six group's 19 overall market share of savings by value fell from 63% in March 2015 to 56% in September 2016.20 Additionally, their share of new business fell from 59% in March 2015 to 45.6% in September 2016.<sup>21</sup> Challenger firms are exploiting low technology costs to run business models specialising in a specific area (monoline models), where retail deposits fund a niche lending business. Average interest rates continued to decline with, for example, average interest rates for one year bonds reducing from 1.23% in May 2016 to 0.98% in May 2017. Household

saving ratio also dropped to 0.4% of disposable income, suggesting that consumers are saving less.

### Payments market

Technology is also changing the payments market; in December 2016, 32% of consumers made a mobile payment. <sup>22</sup> Businesses from other sectors are now working to offer payment functionality to their customers and financial technology (FinTech) firms are building partnerships in financial services.

Technology firms are looking for opportunities to share in the value chain and use insight from consumer data. Many of these firms operate outside the regulatory perimeter, that is, beyond the legal powers given to the FCA. As a result, this market may become increasingly fragmented, with more firms but less likelihood any of them will become dominant.

18. Barclays Group, HSBC Bank, Lloyds Banking Group, Nationwide Building Society, RBS Group, and Santander UK.

20. GfK FRS, data six months to March 2015 and September 2016.

21. GfK FRS, data six months to March 2015 and September 2016.

22. Mobile payments include all the payment methods which can be made via a mobile phone. This includes, but is not limited to, payments via mobile banking apps; purchases made online by shopping in a mobile browser; in-app purchases and purchases from app stores; using a phone to initiate in-store contactless payments; and payments initiated though online messaging service. Data from GfK FRS, December 2016 data.

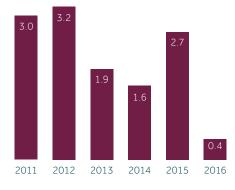
23. Q4 figures, OBR.

24. Moneyfacts Treasury Report, UK Savings Trends, May 2017.

25. Moneyfacts Treasury Reports, UK Savings Trends, May 2017.

26. UK Payments Market 2017, Payments UK.27. UK Payments Market 2017, Payments UK.

Figure 2: Household saving ratio as a percentage of disposable income (excluding pension equity adjustment)<sup>23</sup>



### Average interest rates<sup>24</sup>

Easy access account May 2016

0.58%

One year bond May 2016

1.23%

May 2017

0.37%

May 2017

0.98%

### £1,569bn

**Total value of retail deposits**<sup>25</sup> (including current account and cash savings)

▲ **5%** growth in retail deposits 2015 to 2016

### 39bn

Total volume of payments<sup>26</sup> (ex CHAPS)

▲ **3%** growth in payment volume 2015 to 2016

### Payment volumes, 2016<sup>27</sup>

Method of payment	Personal regular payments	Personal spontaneous payments
Cash (over £1)	<b>378m ▼ 12%</b> vs 2015	<b>14,824m ▼ 11%</b> vs 2015
Cheque	<b>40m ▼ 31%</b> ∨s 2015	<b>234m ▼ 9%</b> vs 2015
Faster payments	<b>157m</b> ▲ <b>3%</b> ∨s 2015	<b>517m 39%</b> vs 2015
Debit card	<b>192m ▼ 11%</b> vs 2015	<b>11,112m 15%</b> vs 2015
Credit/charge card	42m n/a	<b>2,423m</b> • <b>6%</b> vs 2015
Standing order/direct debit	<b>4,163m 4%</b> vs 2015	
Other personal payment	<b>41m</b> ▲ <b>8%</b> ∨s 2015	<b>442m</b> ▲ <b>375%</b> vs 2015
Total	<b>5,013m 2%</b> vs 2015	29,562m • 1% vs 2015

Retail banking

### Cross cutting developments

Cyber-crime, attacks and financial fraud continue to grow and pose a serious challenge to the resilience of the UK financial system. There were a number of high-profile incidents in 2016 and the 2016 Verizon Data Breach Report found that ten vulnerabilities accounted for 85% of successful breaches. <sup>28</sup>

Fraudsters are shifting their methods away from using malware attacks on online banking systems to those that make it less likely banks will intervene, such as scams which target consumers directly. In 2016 there were 172,919 incidents of identity fraud, an increase of 52% since 2014.<sup>29</sup> There are concerns that firms' procedures for handling cases of push payment scams can be unclear or not consistently applied, and there are insufficient data to understand the scale of these scams.<sup>30</sup> Consumers themselves are not always able to identify and avoid sophisticated scams and we continue to work with industry and the PSR to reduce the harms to consumers from push payment fraud.

In terms of competition, there are new players in the market which indicates that barriers to entry may be reducing. There are four new digital banks, niche lenders entering the savings market, and a new clearing bank. Following the implementation of PSD2, the number of new entrants may increase further.

### **Drivers of change**

Consumers themselves are embracing digital transactions for their ease of access, and firms are responding with new services and products. PSD2 and the CMA remedies should enable consumers to compare products more easily, potentially leading to increased shopping around and encouraging greater competition among firms. If new entrants provide niche products and services which existing firms currently find unviable then this could benefit segments of the population that are currently underserved.

#### **Firms**

As firms make greater use of technology, banks may have to compete with FinTech firms for each aspect of their service. This is likely to disrupt the traditional value chain, leading to increased fragmentation with more players in the market. Banks may serve as platforms for account information and other services, with third-party companies building their own applications using the banks' data.

Open Banking may increase the opportunities available from using big data and advanced analytics, creating potential for new types of businesses that did not previously exist. As a result, established business models could be disrupted and increased data sharing could create challenges for data security.

Smaller challengers are likely to target niche markets where they have a competitive advantage over established firms. This could be by offering specific banking services which focus on customer experience, potentially eroding incumbents' market share and margins. If challenger banks can continue to offer market-leading rates, they may increase their market share for cash savings. This may increase competition and persuade consumers to shop around in greater numbers.

Technology firms are exploring opportunities, particularly around payments, where they can compete

28. 2016 Data Breach Investigations Report, Verizon.

29. Identity fraud reaches record levels, CIFAS, 15 March 2017.

30. The Payment Systems Regulator (PSR), the FCA and the payments industry have been undertaking work to reduce the harm to consumers from authorised push payment scams. The PSR published a report and consultation in November 2017 (CP17/2).

Cyber-crime and financial fraud continue to grow. There were a number of high-profile incidents in 2016. The 2016 Verizon Data Breach Report found that ten vulnerabilities accounted for 85% of successful breaches



for a share of the payment value chain. A technology company with an established consumer brand might challenge the incumbents' market share. Digital banks have a lower cost base than existing firms and will become commonplace as people become more willing to use online and mobile banking.

#### Consumers

Household finances remain stretched and demand for traditional savings products may fall as a result of squeezed incomes and negative real interest rates. Consumers seeking a better return may be moving into higher-yield investments that may also involve more risk than traditional savings accounts.

An increasing shift towards digital transactions is likely as many consumers are willing to engage with new products and services offering greater access and convenience. This may open the market to new challengers, and lead incumbents to adopt new services and products.

### **Products**

Basic bank accounts and e-money accounts have emerged as products aimed at consumers with little or no credit history. Personalised budgeting solutions have potentially wide benefits and may be particularly useful for consumers with lower incomes or lower financial literacy.

Consumers' use of cash is expected to continue to decline as transactions become increasingly cashless. New types of payment services such as mobile wallets or payments via social media are likely to evolve further. Biometric solutions are becoming more commonplace as a means to authenticate consumers' identity or authorise payments.

### Distribution channels

The ongoing shift to digital channels is likely to continue giving consumers greater convenience and functionality, at lower costs for firms. There may also be a greater evolution towards automated bank branches.

Incumbents will increasingly be looking to develop multi-channel models which allow consumers to switch seamlessly between channels as they move through a transaction. For example, this could involve enabling a consumer to switch from an online transaction to being able to speak to an adviser using video messaging technology.

#### Areas of focus

During our analysis of the retail banking sector we have identified a number of areas of focus where consumers could either suffer harm in the future or where harm already appears to be occurring.

### Impact of technology and regulatory change

Regulatory interventions such as PSD2 and the CMA remedies offer consumers opportunities through increased competition, and incumbents' responses will be important to realising this. As the market responds to these interventions, potential harms might arise from increasing use of digital channels and data sharing. Cyber-attacks are increasing in number, scale and sophistication. Poor IT stability and security may cause disruption to consumers through banking service disruption or payment outages. This can cause financial loss for consumers and firms. It can also cause reputational damage to, and inhibit the effective working of, firms and markets.

Another characteristic of the evolving market is increased sharing of data between firms. The misuse or loss of personal data for consumers, or firms' reliance on inaccurate data could lead to consumer needs not being met, financial loss, and reduced market participation.

In the payments market the infrastructure is becoming increasingly complex and the regulatory framework will need to keep pace with technological developments. New and innovative payment firms are entering

the market, offering consumers novel and often competitively priced ways to make payments. This has positive implications for consumers and the market, although it is important that these new firms fully understand their regulatory obligations and have adequate governance and systems and controls.

### Financial crime and anti-money laundering controls

Preventing financial fraud and money laundering remains an important area of focus. Scams are becoming more sophisticated, while for consumers increased use of data sharing and social media as part of digital banking may also make them more susceptible to fraud. If prevention measures do not keep pace there is potential for increasing financial losses to consumers and firms. Similarly, both existing and new entrant firms need to maintain adequate controls that prevent money laundering.

### Incumbent business models

Levels of consumer engagement and switching are generally low in retail banking, and consumer inertia means that incumbents retain their position. They have limited incentive to innovate and improve quality and price, while new firms struggle to grow and gain market share.

Looking ahead, there are a number of developments that could improve the competitive environment for banking, but which will present both opportunities and challenges for incumbent firms. They will need to adjust to significant levels of change in regulation, technology and consumer demand against a background of lowerfor-longer interest rates.

Additionally, as incumbents' business models adapt to meet these demands there is potential that some of the harms discussed could develop if changes are not executed effectively. There is also a possibility that incumbent firms may wish to focus on more profitable consumer segments, potentially leading to problems of access for more vulnerable consumers.

### **Retail lending**

### Sector View

The retail lending sector is facing a period of potentially significant change as the economic environment develops and technology continues to change the way in which firms interact with consumers.

We've identified that consumer credit lending continued to grow, driven primarily by increases in the amounts borrowed on credit cards, motor finance, and unsecured personal loans.¹ There was notable growth in some of the smaller credit markets including peer-to-peer lending and some of the high-cost credit models.² Growth in the mortgage sector was primarily driven by first time buyers and re-mortgages. Consumers are likely to require flexible products to help manage variable incomes, while squeezed household income growth is likely to increase the demand for debt advice. The increase in consumer credit lending raises questions about the long-term sustainability of this growth,³ including any wider economic impact and how firms treat customers that fall into financial difficulty.



Consumer credit lending continued to increase...
This was driven primarily by increases in the amounts borrowed on credit cards, motor finance, and unsecured personal loans



<sup>1.</sup> Consumer credit lending continued to increase, with an annual growth rate of 10.3% in the twelve months to April 2017. The annual growth rate has since slowed and stood at 9.5% for the 12 months to December 2017. Bank of England, Money and Credit.

<sup>2.</sup> FCA High-Cost Credit Review Technical Annex, July 2017. Peer2Peer Finance Association.

<sup>3.</sup> FCA Insight, 'Who's driving consumer credit growth?', January 2018.

### Introduction to the sector

Retail lending is a single, interconnected sector which allows consumers to fund their spending or refinance debt by drawing on their expected future income. The sector serves consumers, including small and medium-sized enterprises, providing funds for everything from everyday expenses to buying a property. Retail lending is made up of:

 Mortgages, which are loans secured against a property. They are mainly used to fund or refinance a property purchase over a number of years. They may also be used for investment purposes or to finance a business.  Consumer credit, which allows consumers access to sources of flexible finance for a range of needs from, for example, everyday expenses to the purchase of vehicles. Credit is offered on a secured and unsecured basis.

There are many ways for consumers to access lenders, either directly or through intermediaries, such as mortgage or finance brokers, or via peer to peer platforms. Other sectors also provide distribution of these products, including retail banks and general insurance brokers. In addition, an incredibly diverse range

Figure 3: Overview of the retail lending sector

### Demand Supply Distribution Consumers Lending Services Mortgage Mortgage Mortgage distribution services lending markets administration Advice Residential Individual Introduction • Buy-to-let consumers Equity release

### £198bn

Total value consumer credit outstanding, April 2017

▲ 10.4% increase in 12 months to April 2017

£68,080m

Credit card value outstanding

▲ 9.7% increase in 12 months to April 2017

## 50 million

Credit card accounts

held by 31.8 million consumers

of businesses also provide access to credit as a secondary activity to their main line of business, from retailers to health services.

This sector also includes firms that provide ancillary services to both consumers and firms. These include debt collectors, debt advisors, administrative services and credit reference agencies, which provide information about the financial status of individuals.

### Key developments in the sector

Our latest data show considerable growth across many of the markets in the retail lending sector, including consumer credit, personal loans, motor finance and loan-based peer-to-peer. In the near to medium term we expect technology to have a significant impact across this sector, particularly as firms start to respond to PSD2 and Open Banking.

### Consumer credit

Consumer credit lending has continued to grow significantly, driven primarily by credit cards, motor finance and unsecured personal loans. There has also been notable growth in some of the smaller markets, such as peer-topeer lending and the higher cost credit markets, although this has been from a lower base.

### Personal loans and credit cards

The consumer credit market grew to £198 billion in the twelve months to

April 2017.<sup>4</sup> This was driven primarily by an increase of 9.7% borrowed on credit cards and a 10.7% increase in personal loan borrowings.<sup>5</sup>

A number of personal loan providers have been pursuing growth based on price, loan amount and loan duration. This has led to record low interest rates for unsecured personal loans of £10,000. However, there are some indications that interest rates for loans less than this are increasing to subsidise headline rates on larger loans. 6

In the credit card market, firms are competing strongly on price for prime consumers, with 0% balance transfer and purchase rates on credit cards at record lengths.<sup>7</sup>

#### Motor finance

The motor finance market grew 8.2% in the twelve months to April 2017, notably lower than the 15.7% growth over the same period to April 2016. New point of sale (POS) lending for car purchases totalled £32.6 billion in the twelve months to the end of Q1 2017. Growth in this market continued to be supported by Personal Contract Purchase (PCP), with PCP accounting for 82% of annual new lending in the POS consumer new car finance market and 47% of new lending in the POS consumer used car finance market.

### Sub-prime credit

Regulation to protect consumers has had an impact on the fees that sub-prime credit providers charge. While the high-cost short-term credit market remains viable as a whole, some

Figure 4: Annualised growth in consumer credit lending (%)10



Credit cardsOther unsecured lending

<sup>4.</sup> Bank of England Statistics - Money and Credit, April 2017.

<sup>5.</sup> Bank of England Statistics - Money and Credit, April 2017.

<sup>6.</sup> A Moneyfacts UK Treasury Report found that the average rate on loans of £3,000 over three years has now breached 15%, compared to a rate of 14.6% in October 2016. Loans of £1,000 and £2,000 have also increased in the same period by an average of 0.5% and 0.8% respectively. (Moneyfacts, UK Credit Trends Q1 2017.)

<sup>7.</sup> As of Q1 2017, the average purchase term was 316 days (an increase of 22 days over the quarter), while the average balance transfer term has risen to 657 days (up from 637 days in December 2016). Moneyfacts Treasury Report, UK Credit Card Trends, Q1 2017.

<sup>8.</sup> FLA Data. The FLA has subsequently stated that the annual rate of growth slowed to 6.0% in the twelve months to December 2017.

<sup>9.</sup> FLA Data. New POS lending to consumers for car purchases in the twelve months to December 2017 totalled £34.2 billion.

<sup>10.</sup> Bank of England Statistics - Money and Credit, April 2017.

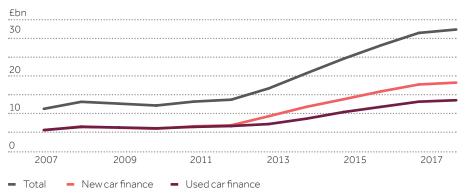
Retail lending

firms face challenges to their long-term viability. Several firms have either stopped offering loans or are looking for additional investment or new owners. With many firms unprofitable in their current form, there is a trend towards offering instalment loans instead of single repayment loans. The high-cost short-term credit market grew by 20% in 2016, but the total amount lent was only 41% of that lent at the peak of the market.

### Loan-based peer-to-peer

The popularity of the loan-based peer-to-peer (P2P) market continues to grow, although from a low base. The number of borrowers grew 37% in 2016 with the total amount of loans outstanding increasing by 29% in the twelve months to the end of Q1 2017 to £3.2 billion. There are signs that the rate of growth in this market is starting to slow. 12

Figure 5: Consumer car finance: total value of new lending, 12 month total (£bn)<sup>13</sup>



Car purchase made using PCP agreements, Q1 2017

All new car purchases

70/

Second hand car purchases

49%

Home collected credit number of consumer/sales, 2016:14

Consumers

700,000

Value of loans oustanding

£1.6bn

**21%** 2015

### High-cost short-term credit number of consumer/sales, 2016:

Consumers

764,000

3.7 million loans originated

Value of loans

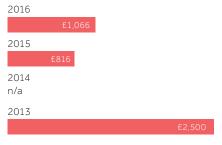
£1bn

**20%** 2016

### Figure 6: Home collected credit value of loans originated (£m)



### Figure 7: High-cost short-term credit value of loans originated (£m)



### 11. Peer to Peer Finance Association.

### Value of new peer-to-peer lending (12 months to end Q1 2017)<sup>15</sup>

	Total value of new lending	12 month growth rate
Total lending	£3,206m	<b>2</b> 9%
Business lending	£2,015m	<b>~</b> 31%
Consumer lending	£1,191m	<b>2</b> 5%

 $<sup>12.\,</sup>By$  way of comparison, new lending in the twelve months to Q1 2016 was 96%. Peer to Peer Finance Association.

<sup>13.</sup> FLA data, May 2017.

<sup>14.</sup> Home collected credit and high-cost short-term credit, Figure 6 and 7: FCA High-Cost Credit Review Technical Annex 1 July 2017.
15. Based on P2PFA Data (Q1 2017) published April 2017.

### Debt management

Since the transfer of consumer credit to the FCA we have worked closely with this market to improve compliance standards, which has led to fewer firms in this market. We continue to engage closely with the debt management industry to address concerns about the quality of debt advice.

Financial Lives Survey data suggest that 3% of UK adults used debt advice or debt management services in the last twelve months and, of these, 19% used a paid-for service. 16

### Mortgage lending<sup>17</sup>

Growth in the mortgage sector was primarily driven by first time buyers and re-mortgages and, in the near term, we expect any growth in this market to continue to be driven by these groups. In 2016 the number of house sales decreased, as did demand in the buy-to-let market, primarily due to tax changes.

There are early signs that some firms are starting to offer loans to consumers who have found it harder

to get mortgages in the recent past <sup>18</sup> We expect more firms to respond to changes in the socio-economic environment by developing products in the short to medium term for consumers on zero-hour contracts, older borrowers, and the very-recently self-employed within the framework of our existing affordability requirements.

### **Drivers of change**

The retail lending sector is particularly exposed to changes in the external environment, which is likely to influence consumer demand as well as firm behaviours and their interactions with consumers. Household finances are coming under increasing strain from macro-economic, demographic and labour market changes. We expect these trends to increase the demand for consumer credit borrowing and create further demand for debt advice. Increasingly diverse consumer needs are likely to challenge the ways firms' currently engage with their customers.

Figure 8: Change in the value of mortgage advances by borrower type (%)19

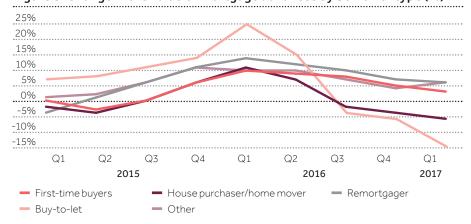


Figure 9: Products seen as higher risk % of total mortgage sales<sup>20</sup>



<sup>16.</sup> FCA Financial Lives Survey, 2017.

<sup>17.</sup> The FCA's Mortgages Market Study collected more data and qualitative information on how the market works (including data on internal product switches). This data was not available during the development of the 2017 sector views. The Mortgages Market Study interim report findings will be published in Spring 2018.

<sup>18.</sup> See Figure 9. For example one provider has stated that it will lend to those on zero-hours contracts, and two more have developed have developed products for older borrowers.

<sup>19.</sup> MLAR (data to Q4 2016) - publication April 2017.

<sup>20.</sup> Product Sales Data, extracted April 2017.

Retail lending

Total
Self-employed
Temporary employees
Total people working full-time

Total people working part-time

Figure 10: UK employment and types of employment growth<sup>21</sup>



In the near to medium term we expect increased use of technology to have wide-reaching market impact. This will grow as firms start to respond to the opportunities provided by Payments Services Directive 2 (PSD2) and Open Banking, which may accelerate the digital transformation of lending and the means by which firms interact with consumers.

#### Consumer

Squeezed real household income growth is likely to lead to a rise in borrowing for groups on lower incomes. Labour market changes, including the growth of self-employment, zero-hour contracts and more flexible work patterns (the 'gig economy') will challenge many households' financial resilience. This will lead to consumers requiring flexible products to help manage variable incomes. Squeezed household income growth is also likely to increase the demand for debt advice.

#### **Products**

As consumers' needs grow more diverse (both within and across generations), we expect to see a growth in the number of products available to meet them. We expect demand for flexible lending products from consumers with less secure employment or income to increase. For example, in consumer credit we are seeing an increase in 'income smoothing' products which aim to level out the income of those with

irregular (and typically low) incomes through the provision of credit. The range of mortgage products available is also growing to meet cross-generational needs, as some younger consumers seek to purchase their first property and those in later life look to release equity.

PSD2 and Open Banking are likely to accelerate the digital transformation of retail lending business models. As a result, new technology-driven firms entering the market are likely to compete for market share in a range of markets, but particularly mortgage intermediation and credit broking. We also expect technological developments to lead to mortgage firms reducing their reliance on traditional mortgage brokers.

#### **Firms**

Firms will need to respond to changing retirement patterns and to younger consumers who want to purchase their own homes. This is likely to result in an increased range of products for consumers with different needs, such as those looking to borrow into retirement, or guarantor mortgages for younger consumers.

The greater use of data analytics by firms and credit reference agencies is likely to change the way they make lending decisions. More personalised risk information is likely to change the ability of higher risk or lower income consumers to access credit.

<sup>21.</sup>ONS, Employment and labour market, data ending January-March 2017.

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#### Distribution channels

We expect technology to affect all markets to some degree, with emerging technology changing firms' strategies and leading to market disruption of established models. Firms are likely to develop new distribution channels as a result of PSD2 and Open Banking, while many consumers will opt for the greater convenience of online services as firms reduce costs. This may lead to a continued reduction in physical branches and a greater shift towards online banking. It will also lead to some disruption of both mortgage and credit brokers.

### Areas of focus

### Consumers being sold unaffordable or unsustainable products

One of the ways consumers can be harmed is through being sold products that are unaffordable and/ or unsustainable. Factors behind this include inappropriate incentives for firms' staff, consumers focusing on their immediate needs, or an imbalance of information between consumers and firms.

There are indications that a wider range of firms are starting to lend to consumers who are less able to withstand a financial shock. For firms, this can be a response to market saturation and competitive pressures. For consumers, it can be the result of focusing only on short-term needs and over-optimism about their ability to repay.

The risk of unaffordable and unsustainable products is a particular concern in both the high-cost credit and debt management markets. It is also prevalent in situations where credit-provision is a secondary product, such as when a firm provides credit to enable customers to purchase goods.

### Treatment of consumers with financial difficulties

Firms' poor treatment of consumers in financial difficulty can have a significant impact, resulting in consumers failing to manage their liabilities properly. This leads to consumers suffering unnecessary financial loss or personal detriment. Drivers of this issue include inappropriate firm incentives, a focus on short-term profit, and a lack of consumer knowledge. This can be caused when firms sell consumers unsuitable debt solutions, provide over-forbearance for those in mortgage arrears, or by poor treatment of customers who persistently use overdrafts. It also occurs through the high-cost credit sector and where the credit is provided to support the purchase of goods, particularly rent-to-own.

### Unsuitable products

Harm can be caused by consumers purchasing or staying with unsuitable products. This is caused by an imbalance of information, misleading point of sale material, a lack of consumer engagement, and/or consumers poorly assessing their own needs. This can arise from material given to consumers at the point of sale that exploits their focus on their primary purchase, where providing credit is an ancillary product. It can also arise where consumers focus primarily on fixed rates in mortgages without also considering other options. This can occur in the debt management, high cost credit and mortgage markets.

### Cyber-crime

The evolving threat of cyber-crime cuts across a number of sectors. It is driven by poor security and the increasing complexity of value chains. Established firms are facing difficulties adapting their systems to keep pace with advances in technology. The potential size of this harm is a concern as many retail lending firms hold a wide range of consumer data. This has led to the loss of consumer data, or firms being subject to fraudulent loans. Successful cyber-attacks also erode market confidence and could result in financial loss to consumers.

### General insurance and protection

### Sector View

### The general insurance and protection sector remains

relatively stable as it adapts and evolves in a low growth environment. This environment is characterised by pressure on household budgets, rapid technological change, and strong competition in parts of the sector.

We've identified that the majority of UK adults hold one or more general insurance products. While retail consumers remain sensitive to price due to pressures on household income, their behaviours are changing through use of social media and an increasing interest in more flexible products. Despite these levels of engagement, many consumers focus on the headline price of insurance products and may not realise that the policy they buy is unsuitable until they need to make a claim. Market access and choice can be restricted due to long and complex distribution chains, and potential lack of transparency around market practices in parts of the wholesale market.

### Introduction to the sector

The general insurance and protection sector protects individuals and businesses (SMEs and large corporates) against uncertainty. This sector is a key part of the UK economy, generating over £78 billion in premiums for UK insurers.¹ There is also a significant two-way flow of premiums to and from other EEA states, with many firms operating across the Single Market using the Freedom of Services directives ('passporting').

General insurance and protection form a single sector, made up of three inter-connected sub-sectors:

• Retail – serving the needs of individual consumers. The vast majority of UK adults hold one or more general insurance products, either individually or jointly with others. The level of penetration varies considerably across products. For example, 61% of UK adults currently hold motor insurance and 49% hold buildings and contents insurance.<sup>2</sup>

<sup>1.</sup> FCA estimates using PRA Returns and Lloyd's Annual Report (all EEA Branch estimated at 10%).

<sup>2.</sup> FCA Financial Lives 2017.

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£32.9bn

Total retail written premium,

£62.2bn

Total wholesale and commercial gross written premium, 2015

- Commercial and wholesale providing insurance for corporate customers. Commercial insurance serves the needs of smaller corporates including SMEs. The wholesale insurance market serves large corporates, including providing reinsurance to other insurers.
- Protection protection insurance is designed to protect consumers and their dependants against the impact of unexpected, and potentially costly, life events, such as illness, accident, unemployment and death.

### Key developments in the sector

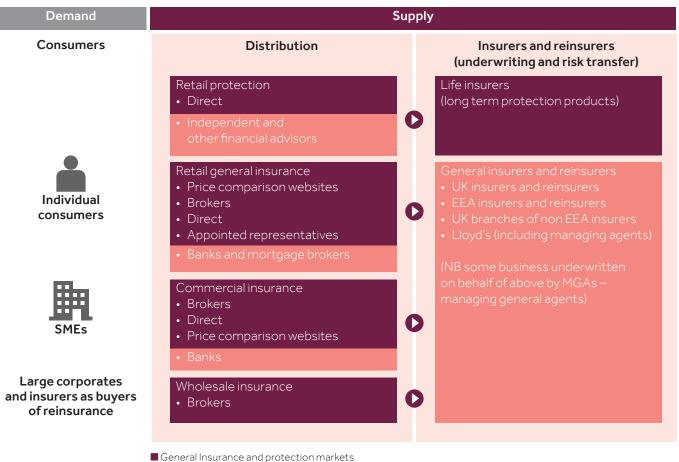
The general insurance and protection sector remains relatively stable. While there has been little overall premium growth, many parts of the market are competing strongly to acquire new business. The sector is experiencing gradual, rather than disruptive, change and the key drivers are technological, demographic, political and regulatory.

#### **Retail markets**

Switching rates for home and motor insurance remain largely static, although there is evidence of more consumer engagement at renewal for motor insurance. 4 Consumers are increasingly using price comparison websites to compare premiums, although not all customers complete the transaction online. 5 Our new rules requiring greater transparency

3. FCA estimates using PRA Returns and Lloyd's Annual Report (all EEA Branch estimated at 10%).

Figure 11: Overview of the general insurance and protection sector



- Market players in other sectors which distribute in the general insurance and protection sector

<sup>4.</sup> GlobalData - UK Insurance Aggregators, April 2017

<sup>5.</sup> GlobalData - UK Insurance Aggregators, April 2017.

from firms at renewal were introduced in April 2017, so there has been limited time to assess the impact. However, the available data still point to existing customers being offered higher rates than new customers. The retail household insurance market is seeing an ongoing gradual shift from sales made through traditional intermediaries and banks to price comparison websites and direct channels.

There is evidence of some increase in engagement among retail customers. While the available data for this sector are not as rich or current as for other sectors, new customers are increasingly price-sensitive, especially given the pressure on household income. The range of on-demand insurance products (eg 'pay as you drive' motor insurance) is growing. This could be a result of the sharing economy and technological advances.

Key developments for specific classes and products include:

#### Home insurance

Some new products aim to provide home insurance linked to 'connected home' devices such as those to detect burgulary and water leaks. Another development in home insurance is the launch of Flood Re, which as of October 2016, has given over 130,000 consumers in flood-prone areas access to flood cover.

#### Motor insurance

As the UK's demographic profile gets older, the average age of drivers is increasing. A growing proportion of drivers are over 70, and fewer under-25s have a driving licence. There is increasing evidence of consumers using price comparison websites (PCWs) to compare prices before buying or renewing, although not all complete the purchase through this

Figure 12: Gross written premium for the UK general insurance market, by business sector (£bn) $^{7}$ 

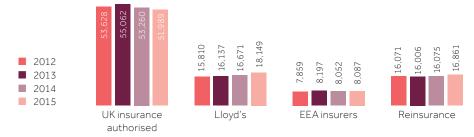


Figure 13: Gross written premium for the UK general insurance retail market, by line of business (£bn)

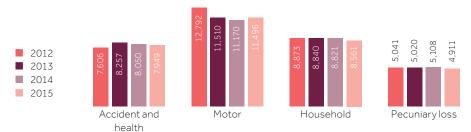


Figure 14: Gross written premium for the UK general insurance commercial and wholesale market, by line of business (£bn)



<sup>6.</sup> National Travel Survey (Government Statistics – DfT).

<sup>7.</sup> Figures 12-14: FCA estimates using PRA Returns and Lloyd's Annual Report (all EEA Branch estimated at 10%). Based on data available at July 2017.

<sup>8.</sup> ABI Key Facts.

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Number of consumers (households):8

20.1 million

20.4 million contents insurance

17.3 million buildings insurance

channel. Our Financial Lives Survey 2017 found that 60% of policies were purchased with or arranged through PCWs. This is for UK adults with motor insurance taken out, renewed or switched in the last three years (and not part of an employee benefits package). However, over the past five years, there has been little change in the percentage of customers who have switched insurers at renewal across all channels. Motor premiums continued to increase in 2016/17, reflecting claims costs and a 3% increase in Insurance Premium Tax.

#### Private medical insurance (PMI)

Nearly three quarters of those covered by private medical policies are members of corporate schemes, which account for over half of total premiums.  $^{10}$  While numbers covered by these schemes are estimated to have fallen by 600,000 since  $2008, ^{11}$  policy numbers rose slightly in  $2015. ^{12}$  Demand for PMI is partly driven by service levels in the NHS and we expect the continuing pressure on NHS budgets to lead to further growth in demand.

#### Commercial and wholesale markets

Given low investment returns and increased competition on pricing, in commercial and wholesale markets there is continuing consolidation in parts of the distribution chain. The merger and acquisition activity in the commercial market has been between regional brokers and managing general agents (MGAs). There have also been acquisitions of each by national and global brokers.

Figure 15: Market participants' share of London Market Premiums, 2015<sup>13</sup>



- Lloyd's (60%)
- Company market (36%)
- Protection and indemnity (P&I) clubs (4%)

Figure 16: Average premium for combined buildings and contents home insurance policies, quarter by quarter<sup>14</sup>

£297

**▼ 4%** vs Q1 2016



Figure 17: Average premium (£) for new and renewed private car comprehensive motor insurance policy (including sales via PCWs), Q1 2017<sup>15</sup>

£462

▲ **7%** vs Q1 2016

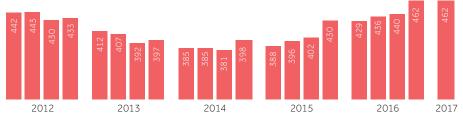


Figure 18: Share (%) of gross written premiums by distribution channel for household insurance<sup>16</sup>

Channel	2010	2015		
■ Independent brokers	43%	30%		
■ Banks, building societies	26%	24.5%		
■ Direct	16%	27.5%	2010	2015
Other	15%	18%		

<sup>8.</sup> ABI Key Facts.

<sup>9.</sup> GlobalData - UK Insurance Aggregators, April 2017

<sup>10.</sup> FCA estimates using LaingBuisson Heath Cover, 13th Edition, January 2017.

 $<sup>11.\,</sup>FCA\,estimates\,using\,LaingBuisson\,Heath\,Cover,\,13th\,Edition,\,January\,2017.$ 

<sup>12.</sup> FCA estimations using LaingBuisson Heath Cover, 13th Edition, January 2017.

<sup>13.</sup> London Market Group, May 2017.

<sup>14.</sup> ABI Property Premium Tracker, April 2017.

<sup>15.</sup> ABI Motor Premium Tracker, April 2017.

<sup>16.</sup> ABI Product Distribution 2015.



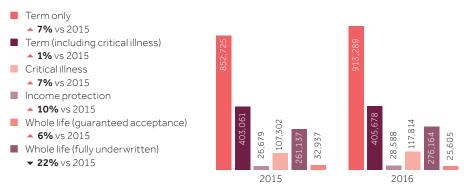
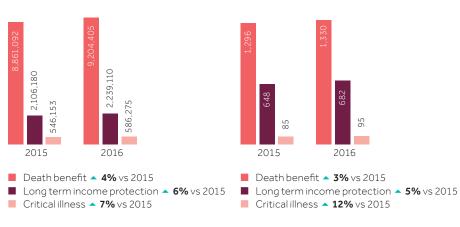


Figure 20: Group protection: number of people covered, 2016<sup>18</sup>



Over the past year there has been no overall material change in premiums and market shares across commercial and wholesale classes. However there has been growth in premium volumes in liability and cyber insurance, the latter being driven by the rise in cyber crime. The global market is estimated to generate \$2.5 billion in premiums, and the London Market reported a 50% growth in the number of cyber insurance policies taken out in 2016.<sup>20</sup>

### **Protection**

Sales of protection products grew slightly for the first time since the financial crisis. Some of this growth is from employee benefit schemes, for products that are sold alongside auto-enrolled pensions. Part of this increase is due to the increasing profile of protection products as firms invest to generate interest and engagement within the market.

### **Drivers of change**

#### Firms

General insurance firms operate in a challenging environment with low interest rates and investment yields. They have high levels of capacity, leading to strong competition in many parts of the sector. This may lead to firms seeking further consolidation through merger and acquisition activity, as they try to gain scale and diversify risk.

Figure 21: Group protection in-force

market premiums (£m)19

The increased use of technology is leading to changes in the way transactions are carried out. In both the retail sector and the London wholesale markets there is a gradual transition from face-to-face sales and telephone to digital transaction models. 'InsurTech' innovators are likely to continue to partner and collaborate with incumbent general insurance firms.

<sup>17.</sup> Swiss Re Term and Health Watch 2017.

<sup>18.</sup> Swiss Re Group Watch 2017.

<sup>19.</sup> Swiss Re Group Watch 2017.

<sup>20.</sup> Financial Times, 29 December 2016, quoting data compiled by CFC Underwriting.

#### **Financial Conduct Authority**

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Changing behaviours, such as the diverse uses of social media and younger consumers' preferences are likely to drive further interest in more flexible products, such as on-demand insurance

#### Consumers

Changing behaviours, such as the diverse uses of social media and younger consumers' preferences are likely to drive further interest in more flexible products, such as on-demand insurance. Some firms may respond with products that offer differentiated levels of service and cover, which will depend on consumers' willingness to pay for additional benefits and to adopt new technologies.

Consumers continue to be sensitive about price, including those switching at renewal. This reflects the sustained pressure on household income from limited wage growth and rising inflation. In addition, lower income groups are affected by changes to benefits and welfare payments.

#### **Products**

The ability of firms to assess risk more accurately may lead to their segmenting consumers and offering personalised products, driving growth in on-demand insurance products. We expect further development of insurance products around the needs of driverless cars, and drones, as the adoption of these technologies increases.

### **Technology**

Technological advances in the availability and analysis of data are likely to drive further disruption and innovation across the sector. This will include increased automation of the distribution chain, productivity improvements, reduced costs and the use of artificial intelligence (AI) in functions such as claims processing. As well as delivering benefits, this also increases firms' vulnerability to cyber attacks and financial crime.

### **EU** withdrawal

There is a high volume of cross-border general insurance business between the UK and the other EEA states. As a result, the impact of EU withdrawal on this sector may be significant. Firms may currently passport within the EEA under Solvency II Directives (for insurers) and Insurance Mediation Directive (for intermediaries). The potential for loss of passporting rights after EU withdrawal has led many UK

insurers to announce contingency plans to restructure their cross-border business. Many of these plans include transfers of business from the UK to EEA entities, under the process set out in Part VII of Financial Services and Markets Act (FSMA) 2000. Many EEA firms are also planning to set up presence in the UK to continue writing UK business.

A number of wider issues subject to the negotiations between the UK and the EU will also be of importance to the sector, for example arrangements for transfer and protection of personal data. In addition, there are sector-specific arrangements, such as cross-border recognition of motor insurance, that will also need to be addressed.

### Areas of focus

Our assessment of the general insurance and protection sector has identified a number of areas of focus where consumers are already suffering harm or there is the potential for them to do so. Much of this relates to specific customer groups or sub-sectors.

### Areas of focus that apply across the sector

### Operational resilience

IT outages or cyber-attacks on firms or market-wide systems could affect consumers through delays in claims settlement or placement of cover. They could also lead to a loss of confidence in the market, in the event of a market-wide outage. Cyber-attacks in the financial services sector are becoming more frequent and widespread. The issue is potentially made worse by the use of complex and legacy IT systems, outsourcing of operations and the growing transfer of data between firms.

### Data security

Unauthorised loss or disclosure of customer data, could include sensitive client data and payment card details, and affecting both individual and corporate customers.

### Governance and culture - distribution chains

Inadequate governance and oversight of appointed representatives by principal firms has resulted in misselling and poor service to retail and commercial consumers. Our 2016 thematic review (TR16/6) into principals and their appointed representatives in general insurance identified potential mis-selling and customer harm at a third of the firms we assessed. Over half the principal firms involved could not consistently demonstrate effective risk management and control frameworks to identify and manage the risks from their appointed representatives' activities.

### Regulatory arbitrage

Recent insolvencies of insurers outside the UK have caused harm to retail and commercial customers. They have also created additional costs from Financial Services Compensation Scheme (FSCS) levies that are ultimately borne by consumers.

#### Financial crime (insurance fraud)

Insurance fraud increases both the level of costs in the sector itself and in the higher premiums that consumers have to pay as a result. ABI members uncovered 130,000 fraudulent claims worth £1.32 billion in 2015. 21

### Areas of focus in the retail sub sector

### Renewal pricing

Switching rates remain low and consumers can be harmed by not engaging at renewal and so paying above-market rates. Both home and motor insurance premiums for existing customers are on average higher than for new customers. To encourage greater transparency and customer engagement at renewal, the Insurance (Information Disclosure for Renewals) Instrument 2016 came into force in April 2017. It made new rules that require disclosure of the previous year's premium on renewal notices.

### **Product suitability**

Many consumers focus on the headline price of insurance products, and may not realise a policy they bought is unsuitable until they need to make

a claim. This could result either in claims being declined or not paid in full, and could be the result of misselling. Features may have been poorly explained or consumers themselves may have wrongly compared the features of new products with more familiar alternatives.

#### **Product performance**

Either through mis-selling or a focus on price, consumers may purchase products with little value and little prospect of making a valid claim. This could be, for example, because of policy exclusions which consumers may not have properly considered.

### Areas of focus in retail and protection sectors

### Access for high-risk customers

Customers with medical or other conditions can experience difficulties buying insurance, whether or not these conditions actually increase the underwriting risk. While insurance might still be available from specialist providers, often higher premiums may again not reflect the actual risk to the insurer.

### Access to protection products

Consumers without workplace schemes face higher costs and fewer opportunities to actively engage in making decisions about protection products. Low take up of these products could expose consumers to long-term hardship.

### Areas of focus in the wholesale and commercial sectors

### Market conduct and competition

Market practices that restrict access or limit choice can cause harm to consumers and compromise market integrity. Complex and opaque relationships between firms in the market can also restrict access and choice.

### Employers' liability traceability

Firms that fail to comply with Employers' Liability (EL) Insurance tracing rules can also result in harm, particularly to vulnerable or elderly claimants, if they cannot trace former employers' EL cover.

<sup>21.</sup> ABI - General Insurance Detected Fraud 2015.

### Pensions savings and retirement income

### Sector view

### The growth in pension membership as a result of

auto-enrolment (AE) suggests defined contribution workplace pensions will continue to be the primary long-term savings vehicles for the majority of consumers. Meanwhile the non-workplace pension market will still play an important role in helping consumers outside the remit of AE to save for later life. Non-workplace pensions will also enable consumers with multiple pots to consolidate into a new single product at retirement.

We've identified that low costs have been achieved in workplace pensions through the introduction of the pensions charge cap. Our analysis also noted the growing use of master trusts in delivering AE, particularly now that some of the smallest employers in the market are enacted AE for their employees. Demand side issues remain, however, as consumers struggle with the complexity of the pension system and challenges selecting pension products that are well-matched to their long-term needs.

This Sector View aims to capture a wide range of the issues within the sector, even where the issues and the measures to address them do not fall solely within our remit.

### Introduction to the sector

We split the pensions sector into two main sub-sectors:

#### Accumulation

The accumulation sub-sector incorporates the two routes through which consumers build up funds for their retirement – workplace and individual pensions. Our view of the accumulation sub-sector includes both participants and markets that do not currently fall within our regulatory remit. A significant example of this is trust-based pensions in the workplace pension savings market. We have included these participants and markets so that we can consider the potential for harm in sector as widely as possible.

### Decumulation

The decumulation sub-sector provides vehicles by which consumers can access their pension savings. Members of defined contribution pensions will usually do this after they reach 55, while those in defined benefit schemes will do so at a preagreed retirement date. This sub-sector includes retirement income market products such as annuities

and drawdown, as well as retirement income generated by equity release. It also includes the market for bulk annuity products.

We also looked at two service sub-sectors that support the delivery of pension products to pension scheme members:

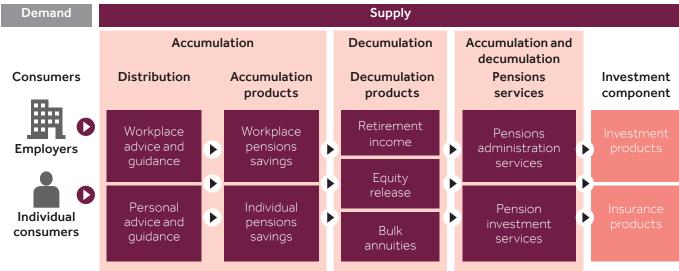
#### Pensions advice and guidance

Retail advice is broadly covered by our retail investments sector view. Our pensions sector view considers the potential harms to pension savers when they use pension advice and guidance services. To provide a more holistic view of this sub sector, we have also looked beyond the FCA's current remit. For example we consider the potential for harm from the advice and guidance services employers use when setting up pension savings for their employees.

#### Pensions services

We considered the role of pension administration services and pension investment services. These are used both by employers and product providers to support the delivery of pension schemes and products to consumers.

Figure 22: Overview of the pensions savings and retirement income sector



Pensions savings and retirement income

### **Financial Conduct Authority**

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### Accumulation - size of assets held or invested:

£168bn

contract-based defined contribution workplace pensions

£403bn

personal pensions savings market<sup>1</sup>

### Assets held or invested: workplace pensions savings market<sup>2</sup>

	Size	
Defined benefit schemes	£1,341bn	
Defined contribution single employer trust	£165bn	
Defined contribution master trust	£18bn	
Defined contribution contract-based	£168bn	

### Assets held or invested: equity release<sup>3</sup>

Size	Sales growth (by volume)
Lifetime mortgage balances <b>£9bn</b>	23% last 12 months

### Assets held or invested: bulk annuity/derisking4

	Size	Sales growth (by volume)
Buy-ins/buy-outs	£70bn	26% last 12 months
Longevity swaps	£60bn	▼ 83% last 12 months

## Figure 23: Annual GPP sales vs annual change in master trust membership<sup>5</sup>



- 1. FCA calculation using FCA retirement income data 2016 and Broadridge, UK DC Market Intelligence Report 2016.
- 2. Defined benefit schemes: TPR, The Purple Book 2016.Contract-based and master trusts: Broadridge, UK DC Market Intelligence Report 2016. Single employer trust: FCA calculation using Broadridge and TPR data
- 3. FCA, MLAR 2016 and PSD 2016.
- 4. Lane, Clark & Peacock, Pensions De-risking report 2016.
- 5. FCA, PSD 2016 and TPR.
- 6. ONS, Annual Survey of Hours and Earnings 2016. ONS, Workplace Pension Participation and Savings Trends of Eligible Savers Official Statistics: 2006 to 2016.
- 7. ONS data in Professional Pensions, "AE continues to impress as 68% now have pensions", March 2017.
- 8. Citizen's Advice, "People in multiple jobs missing out on a workplace pension", February 2017.

### Key developments in the sector

We have seen growth in enrolments and contributions to workplace pensions. With the introduction of pension freedoms there has been a move away from annuities towards drawdown products that offer greater flexibility.

### Accumulation

In accumulation we have seen the number of consumers contributing to workplace pensions continue to grow. This growth has been driven in large part by auto-enrolment (AE). ONS figures published in the first quarter of 2017 show that 68% of all employees enrolled in a pension. This equates to 78% of all eligible employee. <sup>6</sup>

New membership growth in workplace pensions has, however, shifted away from group personal pensions (GPP) and towards master trusts. GPP sales in 2016 were just under 1 million while master trusts attracted 3 million additional memberships (Figure 23). This trend shows that master trusts are becoming key defined contribution workplace providers alongside more established life company providers. This is especially true for those focused on the mass AE market of smaller employers.

Although the number of consumers enrolled in workplace pensions is growing, current contribution rates may not be high enough to provide retirees with their desired income in retirement. According to one ONS estimate, less than 6% of enrolled employees are making member contributions of more than 7% of their salary. The AE framework laid out in government legislation will require minimum contribution rates to rise over the next couple of years to a combined employee and employee total of 8% of an employee's salary.

Our research also highlighted similar concerns to those explored in the Department of Work and Pensions' (DWP) review of the AE system regarding the exclusion of potentially eligible workers from the AE process. For example, one report estimated that there may be over 100,000 workers earning annual total salaries over the £10,000 threshold who have not been auto-enrolled.8 This is because their income comes from more than one job. While developing strategies to address this falls outside the FCA's remit, we will continue to monitor developments in this area in order to assess the potential harm to consumers.

When it comes to costs, the data show that the charge cap and the work done by providers' independent

governance committees (IGCs) have been effective at controlling costs in the workplace pensions market. DWP figures indicate 98% of qualifying schemes have member charges below the cap. The data also show that, on average contract-based members pay fees of 54bps versus 48bps for master trust, and 38bps for bundled trust members.9

A breakdown of the asset allocation used in the defined contribution workplace pensions reveals one of the keys to achieving these low costs. This shows defined contribution lifestyle strategies, which account for the majority of workplace pensions assets, contain large allocations to low cost, passive funds such as passive equities (Figure 24).

Another development in the accumulation sub-sector was the growth of sales of non-workplace pensions policies through 'advised' channels by 8% in 2016. This growth was driven in particular by a 20% increase in the number of personal pension policies sold through advised channels.

#### Decumulation

As a result of pension freedoms, we have continued to see a shift away from consumers using annuities to purchase a quaranteed income towards drawdown products that offer greater flexibility (Figures 25 and 26). Drawdown products attracted inflows of approximately £16.2 billion in 2016 versus £4.6 billion for annuities.

### Decumulation - size of assets held or invested:10

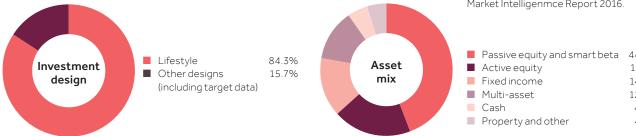
retirement income market annuity reserves

retirement income market in drawdown

<sup>14.</sup> ABI in Broadridge, UK Retirement Income Market Intelligenmce Report 2016.



Figure 24: Workplace defined contribution scheme investment design<sup>11</sup>



### Personal pension advice and guidance, 201612

Advised products	Status/growth rate	Number of new policies
SIPPs	▲ <b>1%</b> vs 2015	129,000
Personal pensions	<b>20%</b> vs 2015	164,000
Stakeholder pensions	<b>▼ 20%</b> vs 2015	15,000
Overall	▲ <b>8%</b> vs 2015	307,000

Figure 25: Retirement income sales (volume)13

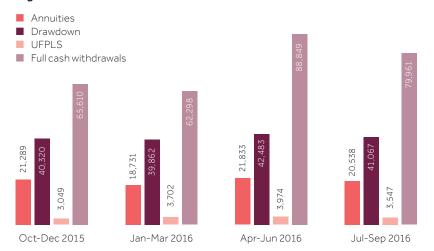
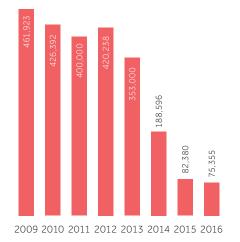


Figure 26: Annuities sales (volumes)14



<sup>9.</sup> DWP, Pension Charges Survey 2016.

<sup>10.</sup> Broadridge, UK Retirement Income Market Intelligence Report 2016. FCA retirement income data 2016.

<sup>11.</sup> Broadridge, UK DC Market Intelligence Report 2016.

<sup>12.</sup> FCA, PSD 2016.

<sup>13.</sup> FCA, retirement income data 2016.

#### **Financial Conduct Authority**

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Despite the high levels of demand for drawdown, our retirement income data suggest that many of the pots accessed through pension freedoms are not yet being used to provide retirement incomes. 60%-80% of new drawdown customers are in zero-income drawdown. 15 Our consumer research suggests this is because consumers are primarily accessing their pots to gain access to their tax-free cash. Our analysis also shows that the mass market for retirement income products has seen generally low levels of new entrants and product innovation.

We also looked at the issue of defined benefit transfers from both a consumer and scheme perspective. In the consumer space, our retirement income data, drawn from a sample of providers, show a 92% increase in reported transfers from defined benefit to defined contribution schemes in the six months to March 2017<sup>16</sup> (compared to the previous six months). Meanwhile defined benefit schemes continue to look for ways to reduce their liabilities, as evidenced by the growth of defined benefit pension de-risking. Data in 2017 showed an estimated one million consumers and £70 billion of liabilities are now covered by buy-out or buy-in arrangements in the bulk annuity market.17

One of the main concerns in this part of the market is the extent to which members are receiving suitable advice when they do choose to transfer out of their defined benfit scheme. Although outside of our remit, we have also noted concerns that the drive towards de-risking may be leading some schemes to encourage defined benefit scheme members to transfer out.

### **Drivers of change**

We expect several macro trends to have an important impact on the sector. Increasing longevity (Figure 27) means that consumers may spend longer in retirement or may have to work longer (Figure 28). Either way the financial pressures consumers face when funding their lifestyle, and potentially care, in later life look likely to increase in the years ahead.

Consumers may amass inadequate savings to fund their retirement. In part this is because generating pension savings will remain challenging if wage growth continues to be low and debt levels continue to rise (Figure 29). Consumers may also face difficulties in managing their exposure to key risks like life expectancy, investment risk and inflation. These difficulties may be made worse by the fact that some consumers may not even be aware of their exposure to these risks. In a low yield (Figure 30) environment consumers could also struggle to find investment opportunities that match their risk appetite, and still generate enough for their retirement.

15. FCA, Retirement Outcomes Review – Interim Report 2017.

Figure 27: Life expectancy at age 65<sup>18</sup>

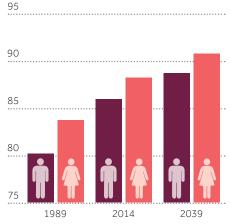
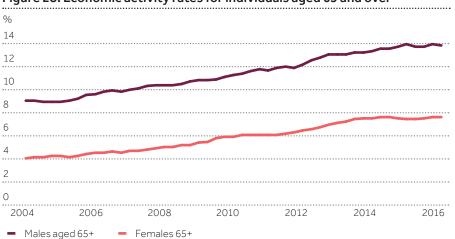


Figure 28: Economic activity rates for individuals aged 65 and over<sup>19</sup>



<sup>16.</sup> FCA, retirement income data 2017 preliminary analysis.

<sup>17.</sup> Lane, Clark & Peacock, Pensions De-risking report 2016.

<sup>18.</sup> ONS, Life expectancy at age 65 2015.

<sup>19.</sup> UK Data Service, Annual population survey 2016.





Figure 30: FTSE all share vs 10 year gilt year<sup>21</sup>



#### **Firms**

Providers in the market are shifting towards 'asset gatherer' business models with lighter capital requirements, and away from more traditional insurance-based approaches. Meanwhile, firms seeking to remain competitive are cutting costs and some are consolidating. This in turn could drive further merger and acquisition activity in the sector, as well as continued firm demand for outsourced solutions.

Consolidation is also likely amongst emerging master trust providers, as the Pensions Regulator's scrutiny of the sector increases. In this environment some master trusts, especially those that struggle to build scale, may face increased pressures to merge with larger competitors.

With the introduction of pension freedoms, and the prospect of rising demand from an ageing population, product development focus is moving from accumulation products to decumulation product options.

Providers, especially those in the master trust market, are designing propositions with the goal of retaining consumers into their retirement. If adopted, these could significantly increase the importance of master trusts in the defined contribution decumulation markets.

Finally the impact of new technology in the sector could increase the competitive pressures on existing providers. This may encourage the development of improved services and lower costs for the mass market, especially in areas such as guidance and advice.

#### Consumers

Defined benefit pension membership is in long term decline, while defined contribution memberships are increasing. Auto-enrolment (AE) is bringing millions of new customers into the sector. As minimum contribution rates rise we are unsure what the impact will be on financially constrained consumers, and opt out rates in particular. The focus on

<sup>20.</sup> ONS, OBR, Spring Budget Statement 2017. 21. Thompson Reuters Datastream, 2017.

Pensions savings and retirement income

Sector Views 2018

employers means the AE system may not be well suited to fit the needs of the certain sections of the labour market as it evolves. This may be particularly true for the self-employed and the increasing number of workers with multiple jobs working in the flexible 'gig' economy. As a result alternative solutions may need to be found to help these workers build up their long-term savings. This is something that DWP committed to explore in its recent review of AE.

Significant transfers from defined benfit to defined contribution schemes are likely to continue. As a result of this, many consumers may be faced with taking on a greater level of financial responsibility in their retirement than previous generations have experienced.

Consumer uncertainty regarding the future direction of pension policy and their concerns over the sector's future stability could see them withdrawing completely from the sector. As a result they may opt to hold more savings in cash or move their pension savings into less wellsuited alternative savings vehicles. In addition, restrictions on pension contributions for high earners may lead to them increasingly saving in alternative (non-pension) options. For those that remain invested there is also a risk that the low yield environment could push them towards higher risk investments than they are comfortable with in order to generate their desired levels of return. Historically these levels of return would have been provided by lower risk investment options.

Underlying many of the potential harms identified in this SectorView is the general issue of weak demand-side pressure. This is driven by a range of factors including consumer inertia and low levels of engagement with the sector. It also arises from the complexity of the decisions many consumers face in making pension choices.

Some consumers have a limited

understanding of how much to save, or how to invest to meet their needs. They may therefore find it hard to judge the suitability of the pension products they are offered. In addition few consumers engage post-sale and many face difficulties in assessing and monitoring their pensions. They also have difficulty identifying that fairer outcomes or better value might be available through a different fund, product or provider.

### **Products**

Providers may be less likely to offer annuities as a result of the growth in drawdown product sales and cash withdrawals, high capital costs and continued low interest rates. The low yield, low growth environment may prompt an increase in the investment risk contained within pension propositions in order to generate returns in line with pension savers' expectations. This is likely to become more acute as defined benefit scheme membership declines and retirees become more reliant on their defined contribution pots as their primary source of pensions income.

Pricing pressures in the workplace defined contribution market are likely to encourage the continued use of passive investments in pension products instead of more expensive, actively managed options. Passive product allocations in defined contribution strategies may start to see growth in the use of smart beta investment approaches that track factor or risk-based indices. These products offer defined contribution schemes exposure to the same investment factors that have historically driven outperformance in traditional 'active' fund management approaches, but at a much lower cost.

The bulk purchase annuities market is likely to continue to grow as defined benefit schemes try to limit future liabilities. In addition, as retiree debt levels rise, demand for equity release products could increase. The future may also see an increase in alternatives to traditional pension products.

This could include new long-term savings products, similar in nature to the Lifetime ISA, which target a broader range of consumers' long-term savings goals.

#### Distribution

Technology is likely to drive a continuing shift to investment via platforms and direct to consumer channels. It will also offer firms the opportunity to tailor the products they sell. Meanwhile the introduction and development of new technology, such as the Pensions Dashboard that helps people calculate what they need to save for retirement, could facilitate greater levels of consumer engagement and consumer control. This, in turn, may stimulate greater competition in the longer term. Ensuring the suitability of new technologically-enabled product offerings for consumers is therefore one of the key future challenges facing the industry.

Growth of automated advice in both accumulation and decumulation is probable. Another key question for the industry is how well fully-automated advice systems can support the complex decision making involved in long-term financial planning. The future of distribution seems likely to be multi-channel, with automated systems integrated into a broader customer service offering.

The growth of more technology-enabled distribution should broadly benefit consumers. It may, however, prove challenging for some consumers to benefit fully from these developments. For example, people with limited access to technology could suffer if the availability of local, face-to-face services in the pension advice market was reduced. This might particularly affect elderly or technologically less able consumers.

### Areas of focus

In conducting our analysis of the pensions sector we have identified a number of areas of focus where consumers could either suffer harm in the future or where harm already appears to be occurring.

#### Poor value products

Poor value retirement income and personal pension products can cause significant harm to consumers. Our analysis shows consumers are unlikely to shop around or switch provider when moving from accumulation to decumulation. This decreases providers' incentive to compete either on quality or on price. On personal pensions, we looked at concerns that legacy schemes may offer consumers poor value for money relative to more modern provision. Poorly designed or governed lifestyle strategies are also a potential driver of poor value pensions.

Complex charging structures are also a driver of potential harm in this area. They make it harder for consumers to compare different pension products and advice or guidance services. In addition, in the advice market, commercial incentives often favour the provision of advice that generates a recurring income. Business models can favour the provision of ongoing advice services over the lower cost transactional advice that may better meet the demands of some consumers in the pensions mass market.

## Unsuitable products

We are also concerned about unsuitable purchases and choices in retirement income and personal pensions, where there is significant potential harm associated with some options. Examples of this harm include:

- consumers who choose to enter drawdown instead of selecting more secure guaranteed income products, without fully appreciating the longer-term risks involved
- non-standard investments offered within self-invested personal pensions

 legacy products where product designs may no longer match consumers' long-term needs

Pension scams remain an inherent harm, particularly for consumers approaching retirement, and can also act as a driver of low consumer confidence.

#### Unsuitable advice

Following our work into pension transfer advice given by financial advisory firms, we remain concerned about continued unsuitable advice being received by consumers. This is of particular concern where consumers may be giving up valuable guarantees.

#### Broader market harms

Our Sector View identified a number of broader harms in the pensions market that we cannot tackle alone. Most notably these include:

- general levels of consumer confidence in pensions – for example, the issue that consumer sentiment is strongly affected by failures of high profile employer schemes.
- levels of retirement saving low levels of pension savings, especially for older consumers, has an impact on the quality of later life, and reduces resilience to financial shocks. While we have a role in helping consumers understand their pension needs, other factors that may affect consumer levels of retirement saving, such as AE eligibility, are not within our control.

## **Retail investments**

## Sector view

## The retail investments sector continues to grow

steadily, but the types of products consumers are investing in are changing.

We've identified that in relation to distribution, wealth managers and platforms have continued to see growth in the assets they administer. Financial advisers have also seen revenue growth with stocks and shares ISAs remaining the most popular form of investment. By contrast, the equity crowd funding market, which had previously grown rapidly, shrank for the first time in 2016 and there has been reduced take-up of both structured products and endowments. Other long-term trends are also affecting this sector. Consolidation is likely as firms seek to benefit from greater economies of scale and diversify the types of product they offer. Technological development in the advice market, through 'robo' or automated advice models, is offering consumers new ways to access investments.

#### Introduction to the sector

The Retail Investment Sector View focuses on the services used by consumers to access investment markets. We divide this sector into four broad segments:

#### Distribution and advice

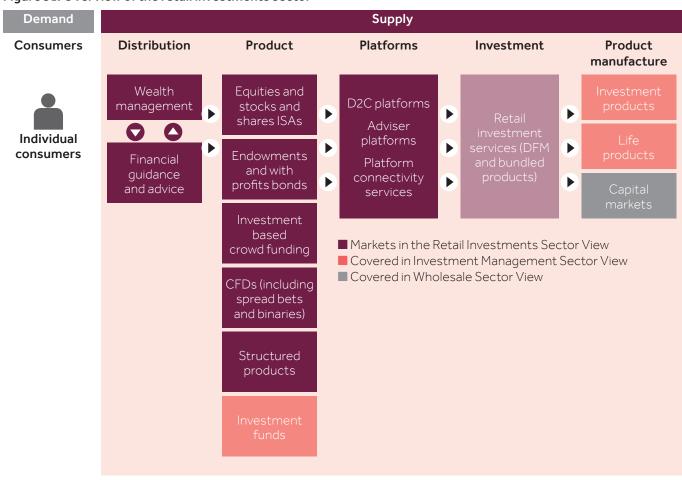
Consumers may need advice to decide which products and services best suit their investment needs. This segment is broadly split between the wealth management market and the more general financial advice and guidance market. Wealth management provides highly tailored services and advice to high net worth individuals. The more general financial advice and guidance market caters

for the mass market. In recent years, however, the lines between these two markets have blurred.

#### **Products**

This sector offers a broad range of products. These include structured products, tax-wrapped stocks and shares ISAs and long-term savings vehicles such as endowments and with-profits bonds. There is also a range of smaller retail investment markets that are growing fast. These include spread betting, contract for difference products (CFDs) and investment-based crowd funding. Investment funds are another type of investment product available to retail consumers through the platforms and wrappers covered in this sector.

Figure 31: Overview of the retail investments sector



Retail investments

#### **Financial Conduct Authority**

Sector Views 2018

Total size of assets held or invested (AuM):

£824bn wealth management

£548bn

£267bn

equities and stocks and shares ISAs

#### **Platforms**

Consumers and financial advisers are increasingly using platforms to buy and access retail investment products. Many consumers, however, still use different channels to buy investments.

#### Investment services

These markets supply product providers and individuals with investment services and create portfolio allocations on a third-party basis. This part of the market also provides many discretionary fund management (DFM) services.

# Key developments in the sector

Firms providing advice have continued to consolidate and develop robo-advice services. The platform market also continues to consolidate. Consumer preferences for certain products remain the same.

#### Advice

3.2 million consumers received financial advice from regulated firms in 2016/17.¹ The wealth management market continues to have the highest level of assets (£663 billion).² In the broader advice market, the trend for consolidation among firms continues, with the larger adviser networks buying up smaller firms. Tilney, St James

Place, Close Brothers and Intrinsic, for example, all reported acquisitions. There has been ongoing merger and acquisition activity in discretionary fund management services, as well as announcements of new partnerships.

A number of firms have either launched new robo-advisory services or started to develop them. Several retail and investment banks, including Goldman Sachs, HSBC, Santander and NatWest, announced plans to introduce robo-advice services, while Moneyfarm agreed a partnership with Allianz Global to offer low-cost wealth management services.

The suitability of advice that investors receive is clearly central to their long-term financial wellbeing. Our recent Assessing Suitability Review looked at the suitability of pensions and investment advice. It assessed 1,142 pieces of advice given by 656 firms and found that 93% of the advice given was suitable. Firms still needed, however, to improve their disclosure. The Review found acceptable levels of disclosure in only 53% of cases, and unacceptable levels in 42%. So while most advice is suitable, wider issues around disclosure remain.

#### **Products**

Stocks and shares ISAs remain the most widely used product within the sector, with an estimated 2.5 million consumers holding stocks and shares

#### Assets held or invested3

Wealth management	Size	Sales growth
Wealth managers	£663bn	<b>11%</b> 2015 to 2016
Execution only brokers	£161bn	<b>19%</b> 2015 to 2016

1. FCA/HM Treasury Financial Advice Market
Review (FMAR) Baseline

<sup>2.</sup> Compeer – UK Wealth Management Q4 2016 update.

<sup>3.</sup> Wealth management: Compeer – UK Wealth Management Q4 2016 update. Platforms: Platforum: UK D2C Guide: Market Size and Structure - February 2017, Platforum: UK Adviser Platform Guide - Issue 27 September 2016. Crowdfunding: Cambridge Centre for Alternative Finance – Pushing Boundaries: The 2015 UK Alternative Finance Industry Report.

Platforms	Size	Sales growth
D2C	£170bn	▲ <b>18%</b> 2015 to 2016
Adviser platforms	£378bn	▲ <b>15%</b> 2015 to 2016

Investment-based crowdfunding	Size	Sales growth
Equity crowdfunding	£245m	<b>295%</b> 2014 to 2015
Real estate crowdfunding	£87m	-
Debt based crowdfunding	£6m	-

Figure 32: Number of ISA subscriptions (m)

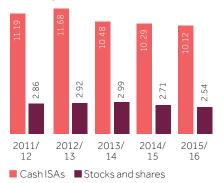


Figure 33: ISAs amount subscribed (£m)



Figure 34: D2C platform AuA growth

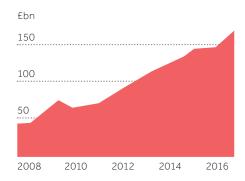
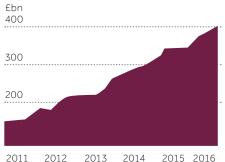


Figure 35: Adviser platform AuA growth



ISAs worth a total of £267 billion. Though the amount consumers subscribed to stocks and shares ISAs actually fell by 5% in 2015/16. In addition, despite record low interest rates, eight in ten ISA investors opted for cash ISAs in the 2015/16 tax year. Stocks and shares ISAs accounted for just £21 billion of the nearly £80 billion subscribed to ISA accounts in 2015/16 (Figure 33).4

Equity crowdfunding was the fastest growing product in this market, although this is from a low base, with the amount invested growing by 295% in 2015 alone. 5 A secondary market for for equity crowdfunding investments has also emerged; Seedrs, one of the UK's largest crowdfunding platforms, announced it intended to launch a secondary market on its platform. A viable secondary market may make it more attractive to consumers to invest in equity crowdfunding and help fuelindustry growth. In contrast to the crowdfunding market, structured products have seen a significant 85% fall in sales since 2009.6

#### **Platforms**

Direct-to-consumer (D2C) platforms and share dealing services currently administer £170 billion of assets, and the assets under administration in both the D2C and adviser platform market grew rapidly in 2016 (Figures 34 and 35).  $^7$  £378 billion in assets is currently administered on platforms targeted at supporting the financial advice market.  $^8$ 

As well as a continuing trend of consolidation in the platform market. we have found significant levels of 're-platforming' in the market. A large number of platforms are changing the third party technology provider building their platform, while others are moving their reliance on proprietary platform technology to outsourced solutions. When these re-platforming projects are completed, a large proportion of the advised platform market share will be held on thirdparty provider technology. This could potentially increase systemic risks in the market if one of these providers has significant service delivery problems.

<sup>4.</sup> Gov.uk – Individual Savings Account (ISA) statistics April 2017 release.

<sup>5.</sup> Cambridge Centre for Alternative Finance – Pushing Boundaries: The 2015 UK Alternative Finance Industry Report.

<sup>6.</sup> This number reprtesents the retail market only (not including private placements). structuredretailproducts.com - UK Database Analysis: Product Types by Provider Report 2007-2016.

<sup>7.</sup> Platforum: UK D2C Guide: Market Size and Structure - February 2017.

<sup>8.</sup> Platforum: UK Adviser Platform Guide - Issue 27 September 2016.

## **Drivers of change**

We expect external developments to affect the retail investments sector in a number of ways. Consumers have lower financial resilience, as reflected by low and falling non-pensions household savings ratios (Figure 36) and younger consumers' attitudes to saving are changing. This may lead consumers to feel they have less need to engage with the sector.

The combination of consumers' limited financial resources and technical developments may lead firms to introduce innovative products, such as micro-investments, which enable consumers to save small amounts in a flexible way. Technological development is also occurring in the advice market, with 'robo advice' models being developed to offer consumers new and cheaper ways to choose the best form of investment.

We also anticipate continuing consolidation among firms in this sector, as they seek to benefit from greater economies of scale and diversify their products.

This sector is also affected by regulatory developments affecting the wider investment management sector. These include the remedies proposed as a result of our Asset Management Market Study (AMMS), the Market in Financial Instruments Directive II (MiFID II), and packaged retail and insurance-based investment products (PRIIPs). The cumulative impact of multiple regulatory changes, including any resulting from the UK's withdrawal from the EU, may create prudential and conduct risks which could result in a range of potential harms. We cover these in greater detail in the Investment Management Sector View.

Figure 36: UK household savings ratio9



<sup>9.</sup> OBR for the forecasts, Economic and fiscal outlook, March 2017.





#### Consumer

The number of people aged over 65 is forecast to increase significantly by 2027 as life expectancy increases (Figure 37). This could lead to raised demand for new types of long-term savings products. For younger consumers, products such as the new LISA are emerging, aimed at increasing their long-term savings. Consumers may invest in these new long-term savings products at the expense of existing retail investment products. Meanwhile, younger consumers may have lower financial resilience than older generations, as well as changing attitudes towards savings, which could lead them to de-prioritise their engagement with this sector.

Regulation is increasingly aimed at making the sector more transparent. This will be achieved through MiFID II and through innovation, and may encourage consumers to engage more in the sector.

#### Firms

Rising costs from investment in areas like technological innovation are likely to drive further consolidation among firms. Established providers may face competition from technologically expert players offering innovative solutions.

It is likely that there will be an increase in vertical integration and the provision of restricted advice as firms look to diversify the products they offer. Driven by the crossselling opportunities in their existing customer base, retail banks have started to look at increasing their retail investment product range.

Firms' business models, which rely on fee paying activities such as discretionary fund management and financial advice, may come under pressure, resulting in lower business volumes and lower margins.

### **Products**

We expect to see continued growth of lower-cost, passive investment solutions at the expense of active asset management. This will particularly apply to mainstream retail investment products, as consumers seek greater value for money and become more aware of the impact of charges on their portfolio returns.

Firms are likely to focus on wealth products aimed at later life consumers who are accessing their pension savings, responding to demand created by pension freedoms and the ageing population.

Technological solutions, such as appbased investing, may help overcome consumers' lack of engagement and limited financial resources. The combination of automated advice with new Al-driven investment techniques could also enable firms to offer increasingly tailored and sophisticated investment options to retail investors.

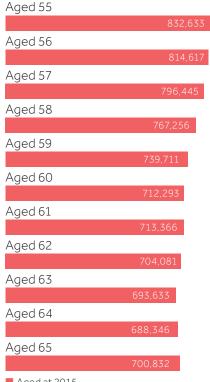
Despite the benefits offered by technology in areas such as investment design and advice, however, it remains unclear how well fully-automated advice systems will be able support the complex decision making involved in long-term financial planning

In addition to new products such as micro-investments, which enable consumers to save small amounts, we may also see a rising demand from consumers for socially responsible and ethical investment options. To date, a focus on environmental, social and governance (ESG) has come largely from institutional investors, particularly pension funds, but there is growing demand in the retail sector from certain client segments such as millennials. Assets in UK ethical funds have grown 80% from £7.6 billion in 2012 to £13.7 billion in June 2017, although they still only account for 1.2% of total UK assets.11

## Distribution

The wealthiest consumers are expected to benefit from more personalised advice and services, making increased customer segmentation likely. By contrast, the increased use of digital technology in the mainstream market is likely to lead to greater levels of commoditisation and standardisation of products in these markets.

Figure 37: UK population by age10



Aged at 2015

<sup>10.</sup> ONS, Population estimates

<sup>11.</sup> Investment Association: Fund Statistics.

Retail investments

#### **Financial Conduct Authority**

Sector Views 2018

In the mainstream market we expect to see advisers continuing to increase their use of Discretionary Fund Management services to drive down costs. We may see more digital retail investment solution products, especially in areas like portfolio selection. This may result in a decline in face to-face dealings.

#### Areas of focus

In our analysis of the retail investment sector we have identified a number of areas of focus where consumers could either suffer harm in the future or where consumer harms already appear to be occurring.

#### Unsuitable products

One of the key areas of potential harm is that consumers in the retail investment sector buy, or are mis-sold, unsuitable products, or given unsuitable advice. Our analysis identified possible issues relating to this harm across a number of markets. These include advice services, wealth management, investment-based crowd funding, structured products and platforms. These possible harms are generally being driven by weak demandside pressures, mainly as a result of consumers' limited financial capability.

For example, consumers who may benefit from some form of financial advice may struggle to access it. They may also fail to seek out this advice because they believe it will be of limited value. As a result some of these consumers may pick cheaper options such as 'robo' or automated 'advice' services. These provide a more limited service in circumstances where these consumers would benefit more from investment advice covering all their financial needs.

Additionally, even when consumers do seek advice they may find it difficult to assess the value or level of the service they receive.

Conflicts of interest and low levels of investment due diligence in firms can also lead consumers to unsuitable investments. Examples here include wealth managers and investment

crowdfunding platforms that explain investment risk poorly, or carrying out inadequate assessments of suitability for their clients.

## Poor value products

The FCA's Mission describes one harm to consumers as products where prices are too high or quality is too low. This is particularly relevant to this sector.

There are a number of drivers that result in consumers purchasing products that are of poor value. Consumers may lack the ability to pressure firms to fix issues, leading to an absence of pressure on firms to improve the quality of service they provide, for example when it comes to lengthy switching times. Firms may also fail to provide consumers with services such as best execution or high quality investment due diligence. Customers are frequently unaware of these failings and therefore cannot engage with them.

In addition, complex charging structures mean consumers may struggle to assess the value for money offered, and can also end up overpaying for services from advisers and platforms. This is especially true where opaque charging makes it difficult to assess what services are being provided within the product. There is also a risk that structural issues in the platform market can affect product quality for consumers.

#### Market confidence

Effective markets depend on the confidence of those who participate in them. Our analysis identified the threat to this confidence and participation as another possible area of harm. This includes confidence being damaged by firms not preventing money laundering or other forms of financial crime or by failing to meet their prudential requirements. Consumers may also be harmed by firms' poor Client Assets and Money (CASS) controls, and by finding it difficult to get redress in complex legal situations. In extreme circumstances, consumers can fall prey to criminals pretending to be advisers or wealth managers, further damaging confidence in the market.

## Investment management

## Sector view

## The investment management sector has grown steadily

in recent years and this growth is expected to continue. The investment management sector is an important contributor to the UK economy, with just over £8 trillion in total assets under management (AuM) at the end of 2016.

We summarise the mechanics of the sector. We then draw on the FCA's recent Asset Management Market Study that seeks to remedy weak price competition, a lack of transparency around fees, and fund objectives that make it difficult for investors in assess products in this sector. We also look at custody banks and investment administration services. Asset managers of both pooled and segregated accounts are the biggest consumers of these services. Given this, we highlight the dependence on technology and the service packaging practices of custody banks in a relatively concentrated sector. We finish by looking at intermediary and advice services.

#### Introduction to the sector

This Sector View includes the following three main areas, as well as other services that span the sector more widely:

- Asset management: this industry manages assets on behalf of individual investors, UK pension funds and other institutional investors. It currently has around £8 trillion of assets under management (AuM)
- Custody banking and investment administration: custody banks hold and safeguard the assets of a firm or individual for asset managers; they do not provide traditional banking services
- Intermediary and advice: these include a range of services provided to institutional investors by, for example, investment consultants, institutional platforms and fiduciary managers

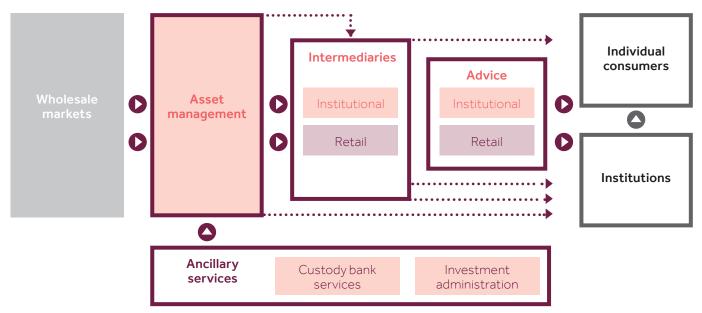
We illustrate how these three areas fit within the value chain in the market map overleaf.

This Sector View does not cover the distribution of asset management services to individual consumers through independent financial advisers, wealth managers, adviser platforms and direct-to-consumer platforms. These are included within the Retail Investments Sector View. Construction and distribution of pension and retirement income investment solutions is included within the Pension Savings and Retirement Income Sector View.

# Key developments in the sector

For some time there have been ongoing concerns around weak price competition and a lack of clarity on objectives and charges. Also of concern were the roles of investment

Figure 38: Overview of the investment management sector



■ Investment Management Sector View ■ Wholesale Financial Markets Sector View ■ Retail Investments Sector View

consultants and other intermediaries within the investment management sector. In response, we launched an Asset Management Market Study in 2015. The FCA delivered its final report in 2017, together with a proposed package of remedies that addresses these concerns.

## Asset management

Asset management covers the designing, manufacturing and ongoing management of investments on behalf of consumers and institutional investors to meet specific investment goals. Asset management is the main activity in the markets covered by this Sector View and was the focus of our Asset Management Market Study (AMMS), completed in June 2017.

Over £8 trillion of assets are managed in the UK, up from nearly £7 trillion the previous year. The UK's asset management industry is the largest in Europe and the second largest in the world.

Below we look at the products delivered by the providers and the clients of asset management services.

## **Products**

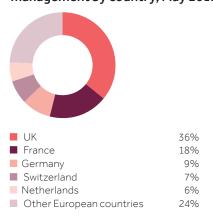
Asset management investment products are structured in either pooled vehicles or segregated accounts:

 Pooled vehicles: these include collective investment schemes (CIS) and other products, such as life funds, which pool clients' money and invest

Figure 39: Assets under management in the UK (£tn) <sup>1</sup>



Figure 40: European assets under management by country, May 2017<sup>2</sup>



<sup>1.</sup> The Investment Association Annual Survey, Asset Management in the UK 2015-2016.

<sup>2.</sup> EFAMA Asset Management Report, May 2017.

it in one portfolio. At the end of 2016, these vehicles accounted for 43% of UK industry assets. They include authorised funds, unauthorised funds and life and pension funds.<sup>3</sup>

 Segregated accounts - these include bespoke investment portfolios and investment solutions with pre-agreed investment guidelines. At the end of 2016, they accounted for 57% of UK industry assets and are used predominantly by institutional investors.<sup>4</sup>

Both pooled funds and segregated accounts can:

- cover a single asset class or be multiasset portfolios with allocations to multiple asset classes
- use a variety of management strategies, including active or passive management or a combination of aspects of both, such as Smart Beta products
- include investments into traditional assets, such as stocks and bonds,

- and/or alternative assets, such as private equity and hedge funds
- include all or part of an investment sector, eg technology stocks, or small cap equity or European investment grade credit
- invest into other pooled vehicles, eg funds of funds (FoFs)

#### **Providers**

Managers or operators of pooled funds and segregated accounts can be titled asset managers, fund managers, or portfolio managers.

Managers range from small 'boutiques', which only focus on asset management, to large international organisations. Some of these large organisations offer related services. These may include investment consulting or access to platforms, access to other asset managers, eg multi-manager funds, or access to a wider variety of products, eg insurance products or pension administration services.

Figure 41: UK assets under management pooled versus segregated accounts (%)<sup>5</sup>

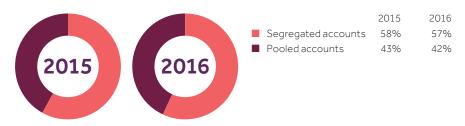
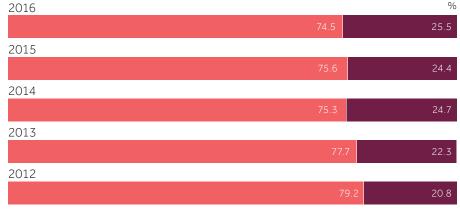


Figure 42: UK assets under management split by active versus passive management (%)<sup>6</sup>



<sup>3.</sup> The Investment Association Annual Survey, Asset Management in the UK 2015-2016.

<sup>4.</sup> The Investment Association Annual Surveys, Asset Management in the UK 2014 to 2016

<sup>5.</sup> The Investment Association Annual Surveys, Asset Management in the UK 2014 to 2016.

<sup>6.</sup> The Investment Association Annual Surveys, Asset Management in the UK 2011 to 2016.

<sup>■</sup> Active management ■ Passive management

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The FCA regulates asset managers as Authorised Fund Managers (AFM). AFMs can be an Authorised Corporate Director (ACD), an authorised contractual scheme manager or an authorised unit trust manager. Non-FCA regulated asset management firms can market and sell their products to UK investors by passporting under the Alternative Investment Fund Managers Directive (AIFMD), the Markets in Financial Instruments Directive (MiFID), and/or the UCITS directive while being regulated in their home state.

The UK investment management industry overall is not highly concentrated, with the top ten firms accounting for around half of assets under management (AuM). Certain parts of the sector, particularly passive management, are more concentrated.

#### Clients

Clients of asset management products fall generally into three categories:

 Individual consumers, who account for a relatively stable proportion (onefifth) of assets under management

- Institutional investors, such as pension funds and insurance companies
- Financial intermediaries, such as platforms, wealth managers, independent financial advisers and investment consultants.
   Consultants act on behalf of both individual consumers and institutional investors

While the majority of the UK's asset management sector's clients live in the UK, the industry manages £2.6 trillion for overseas clients. European clients account for the largest proportion of this, with US-domiciled clients coming next.

# Custody bank and investment administration services

Both AIFMD and UCITS directives have requirements for asset managers to use a depositary who is responsible for the assets. The depositary, often a custody bank, is obliged to arrange custody and safekeeping of those assets. In addition custody banks and others also provide investment administration services. We look

Figure 43: Concentration in the passive management sector - top five firms' market share by AuM<sup>7</sup>

- UK index tracker fund industry, June 2017
- Total UK asset management industry, 2016





Figure 44: UK assets managed for overseas clients (£tn)<sup>8</sup>

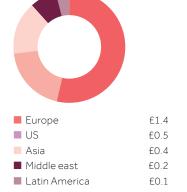
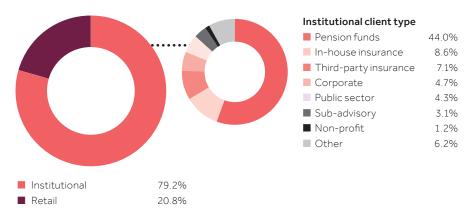


Figure 45: Assets managed in the UK by client type, 2016 9



<sup>7.</sup> The Investment Association Annual Survey. Asset Management in the UK 2015-2016. Morningstar Direct data extract on 27 June 2017.

<sup>8.</sup> The Investment Association Annual Survey. Asset Management in the UK 2016-2017.

<sup>9.</sup> The Investment Association Annual Survey. Asset Management in the UK 2016-2017.

below at what custody and other services are provided and by whom.

#### Services

Custody bank services, which are often offered as a package, include custody and transaction settlement, securities lending and collateral management and fund accounting. They also generally include services such as the management of treasury, FX and net interest income.

Investment administration services are offered to asset managers alongside core custody bank services and include transfer agency and record keeping, issuer services, post-trade record keeping, trustee and depositary services.

#### **Providers**

The providers of custody bank services broadly include:

- specialist custody banks, such as State Street Bank and Bank of New York Mellon (BNYM), for whom custody and related activities are the major banking business
- integrated wholesale banks, such as JP Morgan Chase Bank and Citibank, for whom custody is a service offered alongside a wide portfolio of services

In the UK, there are six major global custodians: Northern Trust, State Street, Bank of New York Mellon, JP Morgan Investor Services, Citi Securities Services and HSBC Securities Services. Five of these have parent companies based in the US. Together with Pershing (a wholly owned subsidiary of BNYM), these custodians hold approximately 80% of total assets under custody in the UK. There are also over 1,000 other smaller firms safeguarding assets for clients, ranging from prime brokers to wealth managers. <sup>10</sup>

The top six custody banks also provide investment administration services. In addition, International Financial Data Services (IFDS), now DST, has the largest market share of transfer agency services. Transfer agency services are also provided by actuarial consultants

#### Clients

Asset managers of both pooled and segregated accounts are the biggest consumers of custody bank services and investment administration services. Assets under custody are held on behalf of UK-based funds, such as UK authorised collective investment schemes and UK pension funds, but also on behalf of financial intermediaries and overseas institutions.

#### Intermediaries and advice

In this Sector View, we cover intermediary services and investment advice provided to institutional investors. We cover retail intermediaries and investment advice to individual consumers in the Retail Investments Sector View. Below we look at the products provided, who provides them and who their clients are.

#### **Products**

Portfolio optimisation, investment advice, and platform services may be offered alone or together to financial intermediaries or institutional investors.

Portfolio optimisation services are provided to institutional investors and financial intermediaries. These services construct an investor's portfolio with the aim of maximising returns against the client's risk appetite. This process includes setting the strategic and tactical asset allocation, portfolio diversification, research and periodic rebalancing as needed.

Investment advice services are provided to institutional investors. These cover the services that help an institutional investor to develop and implement their own asset allocation strategy and investment guidelines, including manager selection and monitoring.

Platform services are principally sold to financial intermediaries. They allow the intermediaries' institutional investor clients to buy a range of funds from different asset managers and hold them together in one account.

#### **Financial Conduct Authority**

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They also provide facilities for investments to be bought and sold. Additionally, the platforms are often used to aggregate funds and arrange custody for institutional investors' assets. We cover platform services for retail investors in the Retail Investments Sector View.

Fiduciary management services are provided predominantly to pension funds. In fiduciary management, the day-to-day management, including investment decisions, of either all or part of a pension scheme's assets is outsourced to the fiduciary manager.

#### **Providers and clients**

Different providers offer various combinations of investment advice, platform and portfolio optimisation services to institutional investors. Notable providers include:

- Investment consultants: offer investment advice services and may also provide portfolio optimisation services, largely through fiduciary management. Some also provide platform services.
- Asset managers: offer portfolio management services, as well as platform services. Where asset managers provide fiduciary management, they may also offer investment advice.
- Specialist fiduciary managers: offer investment advice and portfolio optimisation services.
   While fiduciary managers can also be investment consultants or asset managers, there are also some dedicated specialist providers.
- Insurance companies: offer platform services and portfolio optimisation services.

## **Drivers of change**

Change in the external environment can drive change within the investment management sector. In the following pages we consider the impact of the changing macro and socio-economic outlook, regulation and technological developments across the investment management sector.

#### Macro and socio-economic

Our assessment of macro and socioeconomic factors includes the effect of EU withdrawal on the investment management sector. There are a number of possible outcomes from the EU withdrawal negotiations. For the investment management industry the key issues are delegation of investment management activity, passporting of funds and segregated account arrangements for EU clients.

We considered what steps investment management firms may have to take if delegation of portfolio management becomes more restricted, or there are changes to passporting.

Note that this Sector View was compiled during the first half of 2017. This was before the announcement in December 2017 that, if necessary, the Government would legislate for a temporary permissions regime following withdrawal.

Regarding delegation, if EU funds become restricted in their ability to delegate portfolio management to UK asset managers, UK firms may choose to move portfolio management functions to the EEA.

On passporting, if the ability to market funds on a cross-border basis is limited, firms with EEA funds may choose to set up mirror fund ranges in the UK and vice versa.

In addition, if the ability to manage assets on a cross-border basis is affected, firms may need to set up new entities or alter contractual arrangements with segregated clients or funds.

Any of the above options may require firms to undergo relocation, repapering, IT and operational change programmes. In anticipation some firms are already putting contingency plans in place.

Other macro and socio-economic factors include the current low interest rate environment, ageing population, the decline of defined benefit pension schemes and the growth of defined contribution pension schemes and other retirement income products.

The first of these, the low interest rate environment, is driving a 'hunt for yield' to boost investment returns. This may have driven the growth of alternatives and investments into less liquid assets, eg real estate. Such funds may have a liquidity mismatch between the fund's regular, and in some cases, daily dealing facilities, and the illiquidity of the underlying assets.

The second, ageing population is changing the demographic of the UK. Baby boomers retiring could lead to a shift in the balance of assets under management from accumulation-orientated products to decumulation products, including complex income drawdown strategies. This shift is covered in more detail in the Pension Savings and Retirement Income Sector View.

The third factor is the decline of defined benefit pension schemes and the growth of defined contribution pension schemes and other retirement income products. This is leading to various changes in the sector. Investment consultants are offsetting the decline in their income stream from defined benefit schemes by diversifying into new areas such as fiduciary management. Master trusts are growing significantly in the defined contribution space and new retirement income products are being developed to meet retirees' needs. Other effects are again covered in more detail in the Pension Savings and Retirement Income Sector View.

#### Regulation

There are a number of regulatory developments that affect the investment management sector. These include the remedies proposed as a result of our Asset Management Market Study (AMMS), the Market in Financial Instruments Directive II (MiFID II), Packaged retail and insurance-based investment products (PRIIPs). Other regulatory developments include the various pension reforms (eg auto enrolment, the fee cap for defined contribution pensions default strategies, and pension freedoms).

Our proposed package of remedies will have wide-ranging impacts on the investment management sector particularly around fee levels, transparency, governance and investment consultant roles. These remedies will help address some of the harms that the Asset Management Market Study highlighted, namely the quality and value of investment products, and the roles of investment consultants. Investment consultants, as a result of our reference are now being investigated by the Competition and Markets Authority.

MiFID II introduces new rules that will affect asset managers in relation to inducements and payments for research, best execution, call taping, transaction reporting, and product governance. This includes identifying, selling to, and carrying out reviews of a product's target market and trading. PRIIPs, meanwhile, establishes standard disclosure obligations, including a requirement to disclose transaction costs for products under scope. It also introduces a key information document (KID) for most investment products.

The cumulative impact of multiple regulatory changes (including any resulting from the UK's withdrawal from the EU), may give rise to prudential and conduct risks which, in turn could lead to a range of potential harms.

Investment management

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## Technology

Technological advances are leading to various changes in the investment management sector. These could lead to efficiency improvements, but may also give rise to a number of concerns.

There have been significant developments in straight-through deal processing (STP) and distributed ledger technology (DLT). Asset managers continue to look for ways to increase efficiency in their front and back offices. Outsourcing investment administration processes to specialist providers plays an important part in this. The advent of DLT opens the potential for STP to become even more efficient Potential benefits include more efficient management of counterparty risk, enhanced reconciliation and lower collateral requirements. There are concerns around investment managers' ability to supervise DLT, STP and other technology-related outsourcing arrangements effectively. There are also questions around accountability, if interruption to these services results in any losses for investors.

Another area of growth is the increasing use of artificial intelligence (AI). Areas using AI include risk management, compliance, investmen decisions, securities trading and monitoring, and client relationship management. Investment managers may have to increase their technology spends to keep up with AI developments. Supervision of artificial intelligence remains a challenge and may also raise issues of accountability.

Robo-advice for investments is becoming increasingly available and used. This presents a potential issue for effective supervision and accountability.

Growth of online distribution channels and the potential channel consolidation could lead to fewer routes to market being available for asset managers. If online distribution is dominated by only a few online

distributors their market power may change the value chain dynamics. This could in turn lead to a reduced range of investment products available to investors. Our Platform Market Study, which will publish an interim report in summer 2018, will shed more light on this area.

## Areas of focus

This sector view identified seven areas of focus. These are set out below.

# Investment product quality and value

The key findings of the Asset
Management Market Study showed
lack of price competition, weak
demand side pressure on fees and
poor value for money as potentially
harmful. These, combined with a lack
of clarity and transparency around
investment communications, make
assessing products difficult for
investors. The result is three harms:

- too high prices being paid for products
- inappropriate product purchases because of difficulties in product assessment
- products that do not deliver or behave as expected

AMMS proposed remedies seek to address the drivers of these harms. Further work will be needed to consider widening the remedies to address all the drivers identified. This is particularly the case for products such as unit-linked and with-profits funds.

#### Investment consultants

The Asset Management Market Study (AMMS) highlighted issues of conflicts of interest, ineffective competition and a lack of transparency on fiduciary management performance and fees in the investment consulting market. These result in two harms:

 inappropriate purchase decisions and possibly too high prices being paid for fiduciary management services  poor service levels and too high fees for investment consultancy services as a result of ineffective competition

We have referred investment consultants to the CMA, and now await the outcome of their investigation.

#### Governance

Across the investment management sector there are a few FCA regulations that are being interpreted or applied in inappropriate ways, such as those applying to Appointed Fund Management Boards and Authorised Corporate Directors and noncompliance with the Remuneration Code. Poor governance may result in a wide range of consumer harms. AMMS proposed remedies partly address this harm. Work across the FCA is investigating other remedies further. Ongoing supervision work is also focused heavily on governance.

## Technology and cyber

Technological advances give rise to a number of both opportunities and risks. These include the implications and governance of automated decision-making and algorithmic trading, increasing outsourcing to a small number of providers, technology resilience risks and cyber-attacks. This theme comprises four harms:

- the potential for systemic risk to result from increasing use of technology-led decision making
- the potential for systemic risk to result from poor governance of outsourced technology service providers
- investors suffering financial or data loss from cyber-attacks
- market integrity being damaged

There is ongoing monitoring of cyber and technological resilience in the investment management sector.

#### **EU** withdrawal

The impact of EU withdrawal negotiations is uncertain. There are a number of potential harms if passporting and delegation rights are changed:

- UK investors may be less able to assess products effectively if funds are subject to different regulatory regimes
- UK investors may receive a poorer service, depending upon the level of EU withdrawal-driven structural changes
- the UK investment management sector may be adversely impacted if asset managers lose talent and some degree of access to overseas investors following EU withdrawal

## **Custody banks**

We remain focused on the resilience of custody bank IT systems and service packaging practices particularly in a relatively concentrated sector. There are a number of harms:

- systemic risks for wider markets and UK economy from dependency on a small number of custody banks and investment administration providers critical to UK infrastructure
- investors may suffer loss because they are unable to exit their funds or funds do not behave as expected if there is a disruption to custody bank or ancillary services
- custody bank clients being unable to assess bundled services and fees effectively and thus may not be receiving value for money
- smaller firms may be unable to find suppliers of custody bank services
- investors may be unable to seek redress for financial or sensitive information loss if accountability is unclear following DLT roll-out

## Liquidity

Investment in non-liquid assets is increasing as a result of the search for yield in a low interest rate environment. In some funds there is a liquidity mismatch. This happens when dealing frequency is not aligned with the average time period needed to realise funds from sales of underlying assets at an expected price. This could result in market access being limited if a spike in redemptions in these funds results in asset managers using appropriate liquidity management

tools, such as fund suspension. Potential harms include:

- investors being unable to sell funds when they wish to.
- financial stability of the wider UK economy and confidence in wider markets may be threatened if contagion spreads if issuers selling underlying non-liquid assets to meet redemption demands sell too many of these at too low a price.

Our investigation into the effects of property fund suspensions following the EU referendum suggests that the potential for these harms to occur is low.





## Wholesale financial markets

## Sector view

## Wholesale markets may be significantly affected by the

UK's withdrawal from the EU, and also by developments in technology and regulation. The implications of EU withdrawal may include longer-term structural changes and potential near 'cliff-edge' impacts. Middleware and outsourcing, LIBOR transition, primary market effectiveness and protection of client assets are coming into focus

We observed the growing reliance of many firms on individual middleware and outsourced IT providers. This increases the risk of disruption if one of these providers fails. An orderly transition from LIBOR is important given the potential market disruption that could otherwise arise. At the time of writing, before the introduction of MiFID II, business models continued to evolve in the broking market. We observed that large investment banks dominated client order flows. High frequency trading has continued to expand its reach while providing significant levels of liquidity to the market

## Introduction to the sector

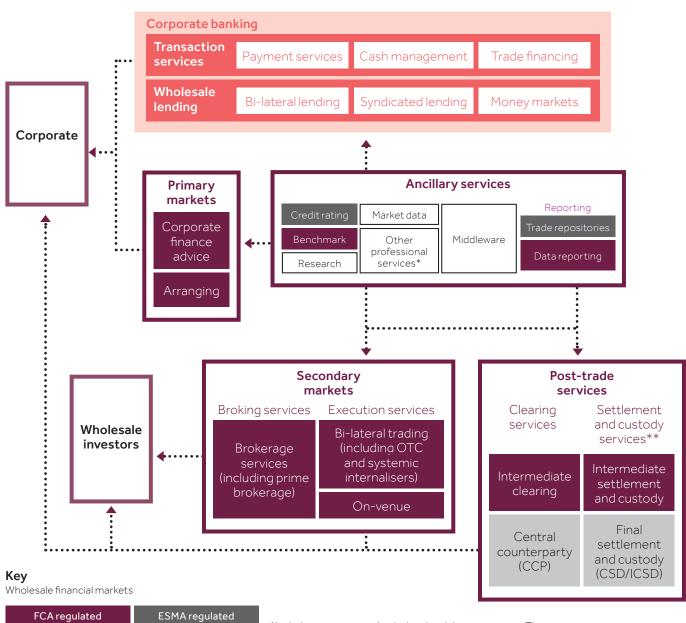
Healthy wholesale financial markets are important to the global economy and a major contributor to the UK economy. They fulfil a broad range of financial needs for non-financial companies, governments and financial institutions including:

- making and receiving payments
- financing investment, innovation and growth
- financing operations and managing cash

- facilitating domestic and international trade
- providing opportunities to invest
- managing financial and other risks

Wholesale financial markets are complex and large, as illustrated in the stylised representation in the diagram below. In this section we assess the drivers of change across all these activities and outline our areas of focus within wholesale financial markets.

Figure 46: Overview of the wholesale financial markets sector



FCA regulated ESMA regulated

Bank of England (only)
regulated Outside FCA perimeter

<sup>\*</sup>Includes accountancy/audit, legal and documentation. These services are not examined in this Sector View.

 $<sup>{\</sup>rm **Custody\, services\, are\, covered\, in\, the\, Investment\, Management\, Sector\, View}$ 

# Key developments in the sector

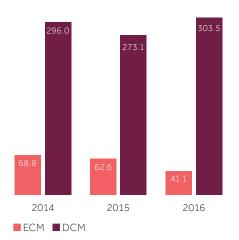
By far the most important recent developments in wholesale markets have been firms' preparations for MiFID II and for leaving the EU. There have, however, also been a number of changes not directly related to these issues.

In primary markets, we have been working to improve market efficiency and effectiveness, including through interventions on the IPO process and the release of our Consultation Paper on effectiveness of primary markets.

We have continued to see the evolution of business models in the broking market in part driven by low volumes and volatility but also regulatory and technical changes. Large investment banks continue to dominate client order flow and are generally working to maintain this, for example through investments in technology and seeking to gain authorisation as Systematic Internalisers (SIs). The introduction of MiFID II will bring material change in this area, which we cover below.

Principle trading firms, including high-frequency traders (HFTs), continue to provide significant amounts of liquidity in certain markets eg spot FX and listed equities. A number of these firms are looking to expand into new areas as well as trading on their own account. These areas include providing services to other market participants, such as best execution technology solutions,

Figure 48: Total UK equity and debt issuance (\$bn, by issuer nationality)<sup>2</sup>



as well as trading in other asset classes, such as corporate debt.

There are a number of competition related developments affecting trading venues. Most notably, the European Commission prohibited the proposed merger between the UK's largest exchange group, LSE Group (which owns both LSE and Turquoise), and Deutsche Börse AG, under the EU Merger Regulation. The Commission's investigation concluded that the merger would have created a defacto monopoly in the markets for clearing fixed income instruments. In addition, some smaller derivatives trading venues closed after they failed to gain traction in the UK. We have also seen the introduction of new industry codes, most significantly FX, partly in response to Fair and Effective Markets Review (FEMR).

The way wholesale markets use information is also changing, with algorithms and big data increasingly driving trading strategies.

- 1. Fidessa Fragulator data.
- 2. Dealogic data.
- 3. Dealogic data.

Figure 47: Trading venue share of UK listed equity trading (2016)1

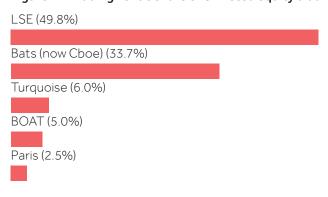


Figure 49: UK global ranking in equity and debt issuance (by issuer nationality)3



## **Drivers of change**

We have grouped the key drivers of change we see in the next three to five years into three categories:

- macro and socio-economic (including EU withdrawal)
- regulation
- technology

# Macro and socio-economic including EU withdrawal

Our assessment of macro and socio-economic factors focused largely on the impact that the UK's withdrawal from the EU could have on the wholesale sector. The impact of EU withdrawal negotiations is uncertain and there are a number of potential harms if, for example, there are changes to passporting rights or co-operation arrangements:

- A loss of passporting rights under, for example, MiFID II, the Central Securities Depositories Regulation (CSDR) and the Capital Requirements Directive (CRD) could result in firms (eg trading venues, banks) having to set up EU subsidiaries to service EEA clients.
- Without an agreed approach, there could also be impacts on the ability to use cross-border benchmarks and ratings by credit ratings agencies.

#### Regulation

A number of recently implemented or upcoming regulations have the potential to drive significant change across the wholesale sector. Within the UK's large equity and derivatives markets, MiFID II introduces trading obligations, transparency requirements, and a new trading regime. Broker Crossing Networks (BCNs) are expected to be replaced with SIs. Increased electronic trading creates opportunities for highly technology- driven participants, such as HFTs, to provide liquidity in new asset classes.

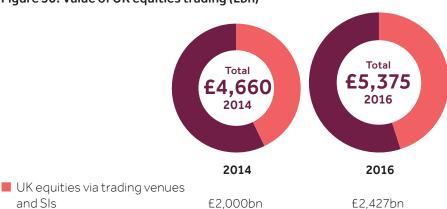
MiFID II also strengthens requirements on firms for transaction reporting and best execution publication. These requirements may lead to changing competition dynamics as brokers may withdraw from markets where transparency exacerbates risk. Brokers will also be affected by new rules around research which will require them to separate charges for research from broking commission, with which they have traditionally been bundled.

MiFID II introduces conflicts of interest rules for underwriting and placing services, as well as a new Data Reporting Service Providers (DRSP) regime.

£2,948bn

Figure 50: Value of UK equities trading (£bn)4

UK equities via OTC trading



£2,660bn

<sup>4.</sup> Fidessa Fragulator data

At the same time, the ongoing implementation of the European Market Infrastructure Regulation is improving transparency and risk management. This includes a continued trend towards derivatives clearing, and the expansion of margin requirements which is driving demand for margin optimisation services.

The EU Benchmarks Regulation will bring all benchmark administrators under regulation, ensuring common standards are met. In advance of its introduction, both authorised and unauthorised firms will need either to vary their permissions, become authorised, or cease providing benchmarks.

#### **Technology**

Technology is having a significant impact on trading and liquidity provision. Across different asset classes, there is an increased share of trading on electronic platforms or venues, and a growing proportion of trade is being driven by algorithms. Greater proportions of liquidity are provided by highly technology-reliant, non-bank proprietary trading firms. Brokers and dealers are also using more outsourcing and buying third-party software.

Distributed Ledger Technology (DLT) offers different ways to carry out financial activities. Developments in DLT have the potential to change the way firms have traditionally provided custody and settlement services. Several commodity trading firms have tested blockchain-based solutions to replace legacy trading processes.

There is greater use of middleware in derivatives trading for connectivity, matching, credit, and margining services. This is the result of regulatory requirements, such as margin rules, the complex interactions between market participants (such as venues, CCPs, dealers, and trade repositories) and advances in middleware such as better compression algorithms. Firms are developing new 'RegTech' products which have significant potential to improve the efficiency and quality of regulatory reporting.

#### Areas of focus

We have identified 14 areas of focus. Some of the themes represent drivers of harm in the sector (eg financial crime). Others represent major drivers of change in the sector that could subsequently lead to harm (eg technology).

#### Conflicts of interest

These can affect the incentive for dealers to act in their clients' best interest. Clients may purchase products or services unsuited to their needs, that expose them to unexpected risks, or that are overpriced. While MiFID II introduces new conflict management requirements, we do not see EU withdrawal or technology significantly changing this area of focus.

#### Market abuse

Traders can damage market confidence by illegally making use of asymmetries of information that disadvantage law-abiding market participants. MiFID II and MAR will improve the depth and scope of reporting, and improve our ability to monitor markets. The increasing complexity of transactions and the pace of technological innovation make detection challenging. Conversely, technology may also provide new means of detection

### Financial crime

Money laundering, terrorist financing and sanctions breaches can harm the broader economy. They can reduce tax revenues, and can help fund organised crime, terrorist activity or antagonistic states. Technology can make detection more challenging, but may also provide new means of monitoring and detection.

## Technology and IT systems

Company failures, successful cyber-attacks and market turbulence, including flash crashes, harm the wider economy and reduce confidence in the financial system. MiFID II introduces a new regime for HFTs and algo traders, and will lead to increased levels of trading across electronic venues. New

#### **Financial Conduct Authority**

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technology may increase stability and resilience but the adoption of untested technologies and use of algo-trading may increase vulnerability.

#### **Information asymmetries**

Product complexity and pricing opacity can mean products are mis-sold, may be unsuitable, or expose clients to unexpected risks or higher prices. MiFID II will enhance the level of information available to market participants by introducing large increases in pre and post trade transparency. It will also require firms to disclose alternative financing arrangements.

#### Adverse consequences of regulation

Regulation to address other market failings can sometimes result in unintended consequences that dent market confidence. The effect could be higher costs of trading, greater volatility, reduced transparency, lower liquidity, or reduced access to products. The current volume of regulatory change presents significant operational, change management and technological challenges to firms. New regulatory technology developments and use of middleware may help firms meet their regulatory obligations more efficiently.

#### Market power

This can arise in trading, clearing and other wholesale activities as a result of network effects. The resulting lack of competition can mean incumbents charge higher prices or fail to invest in meeting their clients' needs. MiFID II aims to level the playing field between various types of trading venue, but it may result in consolidation in some areas. The shift to more on-venue trading and clearing will also increase the market power of these infrastructure providers. Technology provides the potential for new market entrants to disrupt existing markets. Network effects and technological barriers may however create quasi-monopolies in some areas (eg middleware).

#### Misuse of confidential information

Participants leverage information that disadvantages others, but may not be illegal. If considered prevalent this could damage confidence in the market. Regulation will not significantly change this area of focus. The pace of technological innovation makes detection challenging, but may also provide new ways to identify misuse.

### Middleware and outsourcing

Middleware is included as an area of focus as it has become an increasingly important and distinct part of the market. This area often involves limited numbers of providers providing services to multiple institutions, raising the potential for harm to arise in the event that a provider or service is disrupted or fails.

### EU withdrawal - 'cliff-edge'

A lack of time, clarity or preparation could compromise firms' ability to manage restructuring. These could include repapering, relocating or connecting to new markets and infrastructure providers, such as exchanges and clearing houses.

### EU withdrawal – structural change

The cost of possible relocation of activities and the potential long-term impact of splitting UK and EU activities could adversely affect markets and participation, including by increasing costs, raising the potential for service disruption, or leading to important needs not being met.

#### Primary market effectiveness

Inefficient or ineffective primary markets can constrain growth in the real economy by causing unnecessary costs or delays to businesses looking to raise capital. Our research has found that while UK primary markets generally function well there are some areas where adjustments to the regulatory framework could improve their efficiency and effectiveness. This evidence comes from our investment and corporate banking market study, alongside the more recent Review of Effectiveness of UK Primary Markets (DP 17/2).

#### LIBOR transition

Industry is currently considering alternatives for LIBOR. In May 2017, the market-led Working Group on Sterling Risk-Free Rates announced SONIA (the Sterling Overnight Average Index) as its preferred near  $risk-free\,interest\,rate\,benchmark\,for$ use in sterling derivatives and relevant financial contracts. The Group's focus has now shifted to the broader adoption of SONIA in sterling markets as an alternative to LIBOR. It is likely that a significant amount of derivative, bond and loan markets will need to transition to reference near risk free rates. A failure to achieve an orderly transition from LIBOR could result in market disruption.

#### Client asset harm

Harm can arise from broking firms not segregating and protecting client assets. It can mean delays in the return of, or loss of client assets when a firm fails, and it reduces confidence in markets. Poor CASS controls can lead to extensive delays in clients' access to their assets, or to client losses if a firm fails. The importance of firms' CASS arrangements is an inherent issue in this sector. This issue may be exacerbated by EU withdrawal and the process of implementing MiFID II adding to the complexity of arrangements for appropriately segregating and protecting client assets.



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