Sector Views

Sector Views

Contents

Introduction

Welcome to the Financial Conduct Authority's Sector Views. Our Sector Views give us a picture – our view – of how each financial sector is performing. They also give our annual analysis of the way the financial environment is changing and the impact of these changes on consumers and market effectiveness. This analysis will contribute to our Business Plan 2020/21 and the decisions we make affecting consumers, market integrity and competition.

Sector Views describe actual or potential harm. They also look at the impact of macroeconomic developments and common drivers of change emerging across financial markets in each sector. We highlight some of the most significant of these in the Drivers of change chapter before looking at their effects on individual sectors in the Sector View chapters. They include:

- the macroeconomic environment
- the potential impact of Brexit
- societal changes and their impact on the financial needs of different generations
- technology developments

We aim to add public value by reducing harm in the markets we regulate. We use this principle to anticipate potential problems in firms and markets and to intervene to stop harm. When we analyse harm, we look at its impact both at an overall market level and on individual consumers. We identify what actions or events in the market are driving the harm and how likely it is to happen. This process enables us to identify both longstanding and developing issues that form our overall picture of harm.

Each Sector View helps us decide where to focus our attention. We tackle the harms we identify through a wide range of work. We expect firms to be similarly focused on preventing those areas of harm which involve their business model. Our Business Plan will set out which areas we want to focus on for the next 1-3 years. These Sector Views are based on data available at mid-2019.

How to read this document

In the first chapter, Drivers of change, we describe the common themes across sectors with a focus on those themes that are having the greatest impact on the sectors we regulate.

In the second chapter, in light of EU withdrawal and its impact on financial services markets, we give an overview of our position in the current international context.

The remaining chapters cover all the markets we regulate. We group these into seven sectors:

- retail banking and payments
- retail lending
- general insurance and protection
- pensions savings and retirement income
- retail investments
- investment management
- wholesale financial markets

Each Sector View contains the following sections:

- Sector introduction: the markets covered in the Sector View and key drivers of change.
- What we found on harm: the issues we have identified where there may be a negative impact on consumers or the integrity of the financial system in that sector. We set out why these issues may be important and consider what factors are driving this harm. We also consider how the harm may develop over time.
- What is driving change within the sector: how factors such as the macroeconomic environment, technological developments, regulation and societal developments are driving change in the sector.
- How the sector is changing: notable trends and developments we have observed within those markets.
- The consumer perspective (retail sectors only): insights into consumer experiences including those from our Financial Lives Survey data.

Drivers of change

Understanding how markets are changing allows us to identify areas where we may need to focus our work.

The UK economy faces both challenges and opportunities from Brexit, as well as global headwinds, such as US-China trade tensions and more recently the possible impact of the coronavirus. These can affect consumer confidence and decision-making, as well as the environment firms operate in.

Demographic and societal changes including increased longevity and higher levels of student debt are leading to major transitions in the UK economy. Significant challenges face each age group. Older people are grappling with how to ensure they have adequate retirement funding, while younger age groups find it difficult to build up savings to meet unexpected expenses as well as to buy a home. At the same time, sustainability and the low carbon economy will make environmental considerations more important in some consumers' financial decisions while others may be left behind. Policies to deal with the move to zero carbon may affect some asset prices.

Technology is changing how some consumers engage with and use financial services products. The shift to digital services has meant data are increasingly harnessed to develop valuable insights and provide tailored solutions. This raises new risks such as the potential for data misuse, cybercrime and mis-selling, as well as ethical issues over data use.

Financial markets will have to adapt to these transitional shifts, new business models and market developments as well as societal changes. Consumers should be enabled to make the best choices, while innovation should aim to increase competition and improve consumer outcomes, foster inclusion and reduce consumer vulnerability.

Economic

The macroeconomic environment has an impact on both the firms we regulate and the consumers we aim to protect. We aim to understand these impacts, how they drive change and how this may cause harm.

GDP

Economic conditions remain challenging.

- UK GDP quarter on quarter growth in Q4 2019 was flat. UK GDP growth has been relatively volatile over 2019 as a result of Brexit-related uncertainty. Overall over the year it has slowed materially relative to previous years and underlying conditions remain weak.[1] The economic outlook continues to depend on the nature and timing of the Brexit process, the trading arrangements agreed with the EU amd broader trade tensions as well as how consumers, businesses and financial markets subsequently react.
- The Bank of England's current central forecast of GDP growth is 0.75% in 2020 (revised down from 1.5% in February 2019), 1.5% in 2021 (revised down from 1.9% in February 2019) and 1.75% in 2022.[2,3] Slower GDP growth has reflected weaker investment as heightened uncertainty has caused investment decisions to be delayed or cancelled.

Figure 1.1: GDP year on year growth (%)

Search

- Trade arrangements between the US and China, wider geopolitical tensions and slowing GDP growth rates[4] across regions may affect the global economy by reducing business confidence and investment spending by firms.

Monetary policy

Sustained low interest rates have led to a continued search for yield, with some movement towards riskier products.

- The Bank rate remains low by historic standards at 0.75%, having been raised from 0.5% in August 2018. Financial markets, which had been anticipating a cut in the Bank rate to 0.5% in 2020, no longer anticipate any cuts over the forecast horizon.[5] The Bank of England has stated that the monetary policy response could be in either direction and if growth recovers as forecast, rates may need to rise.[6]
- Persistent low interest rates and the resulting search for yield have led to higher prices for some asset classes, eg corporate bonds. In the search for yield, extra risk has been taken on in various ways. These include investments into riskier assets, use of leverage, and weaker standards for riskier products such as leveraged loans.[7]
- The continued global low-for-longer interest rate environment has been accompanied by clear shifts in asset markets and investor behaviour. Some institutional investors have increased their exposures to less liquid asset classes such as high yield bonds, leveraged loans, real estate and unquoted securities.[8]
- While low interest rates can reduce the cost of funding for firms, this environment does put pressure on some firms' business models. The likelihood that lower interest rates are here to stay may challenge the ability of some firms to generate returns and develop long-term sustainable business strategies.

Financial markets

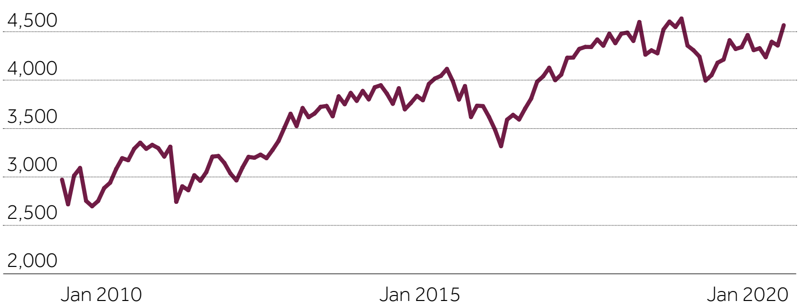
UK households have direct exposure to financial market conditions through retail investments and pension savings. Pension auto-enrolment has increased household exposure to financial assets.

- Auto-enrolment means the percentage of households with pension savings in defined contribution pension schemes has grown, rising from 17% (July 2012 – June 2014, average across the period) to 22% (July 2014 – June 2016).[9] Households are also exposed to financial market conditions through their holdings of stocks and shares ISAs which have also increased, although at a less significant rate, from 10% of households in the period 2006-2008 to 12% in 2014-16.
- The interest rate on longer-term instruments, such as ten-year Gilts, has declined steadily since the financial crisis and is now below 1%, down from about 4% in 2009. In its latest Global Financial Stability report[10], the IMF notes that large interest rate declines have created further incentives for investors to search for yield, leading to stretched valuations in some financial assets. Government bond yields and cash saving rates remain below the CPI inflation rate of 1.5% in October 2019[11], providing negative real rates of return on safe assets.

Figure 1.2: 10 year gilt yields (%)

- In equity markets, we have seen an overall trend of rising indices such as the FTSE All Share. Despite increased political and economic uncertainty, market volatility has been subdued.[12] Some households and firms may be underestimating potential future volatility.

Figure 1.3: UK FTSE All Share price index



Labour market and household finances

Although it has declined over the past decade, UK households' debt to income ratio stood at 126.6%[13] in Q3 2019. This remains high relative to historic UK levels: the ratio was below 90% in the 1990s and only rose above 100% in 2002. Some consumers therefore remain vulnerable to economic shocks and their debts may become unaffordable. It is important that firms are aware of consumers likely to become vulnerable and they treat them appropriately.

- According to the Office for National Statistics (ONS), there has been some recent growth in real wages, as the nominal annual growth of average weekly pay in the UK reached 3.2% in November 2019.[14] This, together with inflation slowing to 1.3% in December 2019[15], may have eased price pressures for households.
- Employment levels are at record highs of 76.3% in the three months to November 2019. Part of this comes from growth in less secure forms of employment and part time work.[16] This includes those working in the gig economy or on zero-hours contracts, who may struggle to access some financial products, such as affordable credit and mortgages and some insurance products, due to fluctuating incomes. Some of these individuals may not have the resilience to deal with financial shocks.
- Consumer credit lending is increasing at a slower rate than in previous years but total amounts outstanding have continued to grow since 2013.[17] As of November 2019, the overall annual rate of consumer credit growth was 5.7%.[18] This is lower than the peak of 10.9% in November 2016. Some households will find an increase in consumer credit is sustainable as debt servicing ratios are low due to low interest rates. However, other consumers could take on unaffordable debt if some firms lend without sufficiently considering individual circumstances. An economic downturn or slowdown could amplify these concerns, including the risk that consumers in arrears are not treated fairly.

Social

Intergenerational differences

Socio-economic factors have changed the financial needs across generations. The combination of an ageing population, a prolonged period of low interest rates, rising house prices, changes in the labour market and to student funding has reshaped the financial lives of consumers.

- Limited earnings growth of younger people could exacerbate the trade-offs between saving for shorter term and longer-term priorities. 54% of those working in the gig economy are between 18 and 34.[19] More variable and diverse working patterns mean younger people need products that take into account their irregular earning patterns.
- Housing market trends have seen fewer younger people owning property[20] due to the increased gap between average incomes and house prices. Policy makers have responded to stretched first-time buyer affordability by offering government schemes. There has also been a shift by providers towards increased availability of longer term mortgages.[21] For some consumers, this could lead to a higher debt burden for longer.
- Rising life expectancy can mean that those in Generation X (born 1966-1980) find themselves supporting ageing parents while also facing increased costs bringing up their own children. Generation X faces challenges from not having benefited from auto-enrolment for as long as millennials will have, and conversely not having benefitted from defined benefit pensions to the extent that Baby Boomers (born 1946-1965) have.
- Baby Boomers, meanwhile, will face challenges to manage their financial resources over a longer time horizon and may require more varied products to support this, including later life lending products.

Climate change and sustainable finance

The momentum behind climate change and sustainable finance policy in the UK and EU is accelerating.

- In July 2019, the Government published a Green Finance Strategy setting out its long-term objectives for green finance, including a view on how this can contribute to the UK's competitiveness when it leaves the EU.
- The Treasury will chair a Taskforce of UK regulators, including the FCA, to ensure a coordinated approach on climate-related initiatives and to examine the most effective way to approach disclosure. The Bank of England are also planning to conduct a stress test in 2021 that will test the UK financial system's resilience to the physical and transition risks of climate change.[22]
- These developments are likely to affect firms' and consumers' planning and decision-making.

Technology

Technology is a key driver of change across financial services. It has the potential to increase efficiency and improve access to products, but also to create harm for consumers. We have identified four inter-related themes by analysing common technology trends in each Sector View and undertaking wider research.

Open Banking and Open Finance

Both are in the early phase of implementation. They aim to transform the way that consumers engage with their finances. Open Finance has the potential to increase fairness in pricing as it will allow third-party providers to reach out to 'overpaying' customers with better deals. But older people who are less likely to use digital tools may be disadvantaged.

- Banks and other traditional financial institutions are working closely with emerging fintechs to implement Open Banking and the Payment Services Directive II (PSD2) which brings in new rules to improve consumer rights and online security. Open Banking gives fintechs the opportunity to access the infrastructure behind financial services and is likely to mean traditional institutions will face further competitive pressures to innovate.
- Open Banking presents some challenges for data security and sharing. While Strong Customer Authentication may improve security, this is balanced against vulnerabilities that greater data sharing could introduce, particularly with new entrant firms. Loyalty penalties and customer inertia may be more of an issue for older consumers if they are less able or likely to use digital tools such as Open Finance to find and get the best deals.

Big Data, Artificial Intelligence (AI) and data use

Use of Big Data and AI will increase the insight and data that firms have and is likely to affect pricing decisions. This could lead to concerns about unethical data use if more personalised pricing, particularly for insurance and credit products, leads to unfair pricing and/or some consumers being excluded from the market.

- Firms continue to build up their data capabilities through concerted efforts to mine traditional and alternative data sources, use of artificial intelligence (AI) and machine learning across sectors.
- Data privacy, ethical use of data, transparency and security are key themes from the growing use of AI and Big Data. Firms' increasing ability to personalise pricing and the resulting potential for reduced risk pooling could lead to financial exclusion for some consumers in some insurance and affordable credit products. In some cases this will affect more vulnerable or lower income groups. Unethical use of data can also create new forms of unfair pricing or algorithmic bias, and could exclude vulnerable consumers. Fair pricing will be important to ensure firms do not discriminate against the vulnerable or those who are less able to act. It will also be required to maintain overall trust in the market.
- How firms use data, who they share it with and on what basis, will be a key issue for consumers. Defining ethical use of data will be essential for the future development of Open Finance and whether consumers will be willing to share their data.

Fintech

The growth of fintech, alongside Big Tech (Amazon, Google, Facebook, etc), is reshaping customers' user experience but poses challenges for regulation and oversight. Growing participation from new financial services entrants may make firm liability and accountability more complicated. This brings into question the adequacy of protections for consumers. Consumers may also lack awareness around whether regulatory protections apply to certain products.

Global investment by retail banks in fintechs more than doubled in 2018, reaching £85.6 billion with 2,196 deals.[23]

Innovation is continually influencing how customers engage with financial services. The rise of digital platforms and robo-advice provides opportunities to encourage consumers and businesses to be more active in their financial planning. These changes may improve customers' experience or security but could also present challenges for oversight and the perimeter of what is and is not regulated.

New technologies and ways of interacting

New technologies and ways of interacting can make firms vulnerable to cybercrime, fraud and technology outages, but can also lead to improvements in these areas. Rapid innovation and change has raised questions about the adequacy of new firms' controls to both safeguard client funds and prevent misuse of their systems for financial crime, including fraud. We are concerned about social media advertising of and easy access to high risk investments or credit products.

- Cyber-incidents are growing in number, scope and sophistication. Recent data reveal that firms reported a 7% increase in technology outages in the year 2018 to 2019[24], although this could be partly due to increased awareness. Firms may not be testing changes to their systems before implementing them and may not be investing enough in cyber security and technology, increasing the likelihood of failures. While firms are working to prevent attacks and outages, high-profile incidents demonstrate the importance of investment and co-ordination between firms and regulators.
- Across all asset classes, firms are increasingly relying on third-party service providers, including for critical services, such as cloud computing or middleware. Outsourcing to specialists may increase resilience and security, but some third-party services providers may have less stringent security, controls and oversight.
- Social media advertising of high risk investments and credit and online distribution channels which give easier access make it harder for consumers to distinguish credible and legitimate providers from scams or high-risk products.

EU withdrawal and international

The UK has left the EU. Under the terms of the Withdrawal Agreement between the UK and EU, we are now in a transition period that is due to run until 31 December 2020.

The transition period provides time for the UK and the EU to negotiate their future relationship. European law will apply in the UK throughout the transition period, including new EU legislation that takes effect before the period ends. This means continuity for firms and funds, as they will continue to benefit from passporting throughout 2020. This will enable them to provide cross-border products and services for the duration of the transition period. For consumers, rights and protections from EU law continue to apply during this time.

Under the terms of the political declaration which accompanies the Withdrawal Agreement, the UK and the EU have agreed to closely cooperate on regulatory and supervisory matters when the transition period ends. Both have committed to seek to conclude equivalence assessments by the end of June 2020.

The transition period provides continuity until December 2020. The Government has confirmed it is aiming for the UK and the EU to reach agreement this year on the UK's future relationship with the EU. If agreement is reached, we would still expect changes, for example we expect 'passporting' in its current form to end. Passporting allows firms authorised in an EEA state to conduct business within other EEA states based on their 'home' member state authorisation. What will replace passporting will depend on what is agreed between the UK and the EU. Therefore, as things stand, firms will need to ensure they are prepared for a range of scenarios, including that the particular activities they conduct might ultimately not be covered by agreements reached between the UK and the EU.

Leaving the EU will also mean we have more responsibilities. It will affect how we oversee markets, supervise firms and make policy. While the close and interconnected nature of UK and EU markets means that changes to the EU regulatory framework will continue to affect UK financial services, the UK is no longer directly involved in EU decision-making. This places a premium on developing new ways to engage internationally and we are looking at how we can continue to work with EU institutions, including the European Supervisory Authorities, and other EU regulators after we exit.

Financial services markets are international and interconnected. We need to help ensure the UK continues to influence global regulatory developments, enable market access and maintain an effective relationship with EU counterparts. We support open markets underpinned by strong international standards. We will continue our work to ensure UK markets benefit from both by participation in global standard-setting bodies and engaging with European and other international counterparts. This will enable us to continue to shape the standards that affect UK markets, firms and consumers.

> **We are now in a transition period that is due to run until 31 December 2020**

Endnotes

1 ONS, GDP quarterly national accounts, Q4 2019, February 2020
2 Bank of England, Monetary Policy Report, January 2020
3 Bank of England, Inflation Report, February 2019
4 Bank of England, Monetary Policy Report, January 2020
5 Bank of England, Monetary Policy Report, February 2020
6 Bank of England, Monetary Policy Report, January 2020
7 Bank of England, July 2019, Financial Stability Report
8 IOSCO, September 2019, IOSCO Risk Outlook 2020
9 ONS, Wealth & Assets Survey: 2014 to 2016, February 2018
10 IMF, Global Financial Stability Report: Lower for Longer, October 2019
11 ONS, June 2019, Consumer price inflation: UK, June 2019
12 FTSE, January 2020
13 ONS, Households (S.14): Debt to Income ratio: percentage: NSA, December 2019
14 ONS, Earnings and Working hours report, January 2020
15 ONS, Consumer Price Index (CPI), January 2020
16 ONS, Labour market economic commentary, January 2020
17 Bank of England, Outstanding debt, September 2019
18 Bank of England, Lending to individuals: Consumer credit growth, December 2019
19 Department for Business, Energy & Industrial, The characteristics of those in the gig economy, February 2018
20 Resolution Foundation, 'Housing Tenure by Age', January 2019
21 FCA, Data Bulletin December 2017
22 Bank of England, Financial Stability Report, July 2019
23 KPMG, The pulse of fintech, 2018
24 FCA internal analysis

Retail banking and payments

Introduction

Retail banks are the gateway to financial services for most consumers and Small and Medium Enterprises (SMEs), while the payments market allows consumers to move money with increasing ease and speed. Current accounts often anchor consumers to particular firms, with many consumers holding several products with the same bank. There were about 77.4 million personal current accounts (PCAs)[1] and interest-bearing household deposits stood at £1,208 billion in June 2019.[2]

Technological advances give users greater control over their finances and allow banks to improve security and data analytics. Regulatory changes are also transforming the sector, and new rules for overdrafts will save more vulnerable consumers significant amounts. The second Payments Service Directive (PSD2) and Open Banking are giving firms opportunities to offer new services to consumers.

Current accounts and payment services play an important role in the everyday finances of consumers and businesses. Maintaining the integrity of the sector is vital. In payments, we are concerned that consumers may not know that some products and services have limited protections, especially if firms are not properly safeguarding customers' funds. In retail banking, poor value in overdraft and cash saving products are key issues. We have made, and are consulting on, several changes to address these concerns and will closely monitor their effectiveness. Factors that continue to drive this include consumer inactivity and competitive advantages of established retail banks.

Figure 2.1: Overview of the retail banking sector

The Retail Banking Sector View covers retail banking groups' structure, operation, governance, and business models

Demand

Consumers

Individual consumers

SMEs

Supply

Deposit markets

Retail banks portfolio

- **Current accounts** including overdrafts
- **Cash savings**

Payment services and e-money

Payments portfolio

- Money remittance
- Merchant acquiring
- Credit and debit card payments
- Account information services
- Payment initiation services

e-money portfolio

e-money

Retail lending sector

Consumer and business lending

- Mortgages
- Personal loans
- Credit card borrowing
- Business loans

■ Retail banking markets
■ Retail lending markets closely linked to retail banking

96%
of adults have a personal current account[1]
The total value of household assets held in non-interest bearing accounts has increased by 5% year on year since June 2018

56%
of adults hold a cash savings product[2]
The total value of household assets held in interest-bearing accounts by households has increased by 3% year on year since June 2018

77.4m
personal current accounts[3]
The total value of household assets held in non-interest bearing accounts has increased by 5% year on year since June 2018

Total value of household assets held, June 2019		
Non-interest bearing accounts	£171bn	▲ 5% vs June 2018
Interest bearing accounts	£1,208bn	▲ 3% vs June 2018

▼ **16%**
decrease in cash payment volumes year on year in 2018[4]

▲ **14%**
increase in debit card payment volumes year on year in 2018[5]

1. Ipsos MORI FRS, Current Accounts, 12 months ending June 2019
2. Ipsos MORI FRS, Savings Mass Market, 12 months ending June 2019
3. Bank of England, Total value of household assets held, June 2019
4. UK Finance, UK Payment Markets Summary, 2019
5. Ibid

What we found on harm

Inadequate protection or poor compliance by payments firms harms consumers

Regulatory changes have enabled many new payment firms to enter the sector and quickly grow their customer base. But consumers can suffer harm if they use products without regulatory protections or these firms fail to comply with regulations. For example, innovations in payments services, such as digital wallets, together with the complexity of the regulatory regime mean that consumers could suffer harm because they do not understand whether Section 75 or Financial Services Compensation Scheme (FSCS) protections apply to such products. We monitor and take actions on firms' financial promotions to ensure they comply with restrictions on these promotions.

1,493 new Financial Ombudsman Service cases on electronic money in FY 2018/19[3]

Payment firms failing to adequately safeguard customer funds can result in financial loss to consumers if there is a disorderly firm failure. This can be particularly problematic if safeguarding failures are combined with prudential weakness, or if firms act outside the scope of regulation. These concerns have resulted in our taking a pre-emptive approach in our supervision of these firms.

The scale of financial crime is growing – this can lead to direct consumer loss, particularly if firms do not reimburse consumers

Criminals can use the retail banking and payments sectors to commit financial crime. This can lead to consumer distress, financial loss and wider harmful impacts on society. While many fraud victims are reimbursed by their providers, victims of authorised push payment (APP) fraud have historically struggled to get reimbursement. This is because firms can rely on the APP victim's genuine authorisation to show that they intended to make the transaction. The growing scale and sophistication of this criminal activity means that this harm is increasing. The Lending Standards Board launched a voluntary Contingent Reimbursement Model (CRM) in 2019. This should reduce this harm by setting standards for reimbursing APP fraud victims. However, it is unclear how participants will fund reimbursement of fraud losses to consumers in the future in cases where neither the consumer nor the bank is at fault.

Consumers lost **£168.2 million** to authorised push payment fraud in H1 2019[4]

57,549 individual cases of authorised push payment fraud reported in H1 2019[5]

Service interruptions can undermine consumer confidence, cause inconvenience and lead to financial loss

There has been a significant increase in the number of reported incidences of interrupted services. This is due to several factors. Several retail banks are engaged in large-scale business transformations away from their legacy IT systems. Incidents at third-parties and application issues also drove an increase in interrupted services. Such incidents, along with data breaches, risk undermining public confidence. The growing number of financial firms using third-party technology providers, such as cloud service providers, where a small number of firms dominate the market, has increased the risk of technological disruption at one of these firms having widespread effects. These factors are also driving increased exposure to cybercrime.

Incidents of interrupted service have led to reduced access and inconvenience for consumers who increasingly expect 24-hour access to their finances. Firms' vulnerability to cybercrime can result in data breaches and confidential data being shared inappropriately. The interconnected nature of the sector makes the impact of the harm worse through knock-on effects.

We collect data from retail banks to monitor operational or security incidents affecting personal and business current accounts. This helps consumers compare the service they could receive from different providers. We focus on the resilience of systems and controls firms have in place, as well as how they treat their customers when disruptions occur.

Firms reported **459** technology and cyber incidents in the sector in 2019[6]

The **most common** root causes in the same period were change management issues, 3rd party failures, and failures in hardware or software[7]

Consumers and SMEs can receive poor value from overdrafts, savings accounts and some transactional services

We have carried out significant work on the fair treatment of customers. This has found that consumers and SMEs receive little or no interest on current accounts and associated savings accounts. Many consumers also pay high charges for overdrafts. For example, prior to our reforms of the market the price of unarranged overdrafts regularly exceeded the equivalent of an interest rate of 10% per day.[8] SMEs, meanwhile, can face high transactional costs and charges for services such as foreign exchange. This can work against loyal consumers who do not switch providers. Our work on cash savings has provided evidence that consumers with longstanding savings accounts get significantly poorer rates than new customers.

The fair treatment of overdraft users was a key theme of the High-Cost Credit Review (HCCR), which found that unarranged overdraft margins are higher than comparable credit products. We also found that this disproportionately affects vulnerable consumers. Our study into the market concluded that people living in deprived areas and hard-pressed communities, on low incomes, tend to pay more in unarranged overdraft charges and in refused payment fees than the general population. Our reforms have ended high unarranged charges, saving typical borrowers up to £55 per month on an unarranged overdraft of £100 over 7 days.[9]

We have seen the major banks and building societies setting very similar overdraft prices since the announcement of our remedies. We wrote to these firms in January 2020 to ask them to provide evidence of how they arrived at their pricing decisions. We expect firms to take positive steps to help customers who may be worse off or in financial difficulties as a result of these changes. We have also asked to see their plans for how they are dealing with the most affected customers.

Several factors drive this, including a handful of major banks having significant competitive advantages, allowing them to benefit from consumers not shopping around. Regulatory changes, including new rules for overdrafts and cash saving remedies will provide benefits to many consumers. Increased competition can also improve outcomes for many consumers.

In 2016, **1.5%** of customers paid **50%** of unarranged overdraft fees[10]

Banks' complex charging structures mean that **80%** of people cannot correctly choose the most affordable overdraft deal between Q1 2018 and Q3 2019[11]

Innovation in the sector drives inclusion, but we have concerns that an increasingly cashless society creates problems of access to financial services for consumers and SMEs

Consumer demand, new technologies and the cost of accepting cash payments is driving a shift to digital transactional banking. Innovations in digital payments decrease cost and increase convenience and safety for both businesses and consumers. At the same time, vulnerable groups may become digitally excluded and find it difficult to participate in the financial system.

As our society becomes increasingly cashless, cash-dependent consumers may find it difficult to access banking services, including getting cash. This also links to operational resilience, as cash is a backup during system outages and yet may be harder to access if access to ATMs and branches reduces.

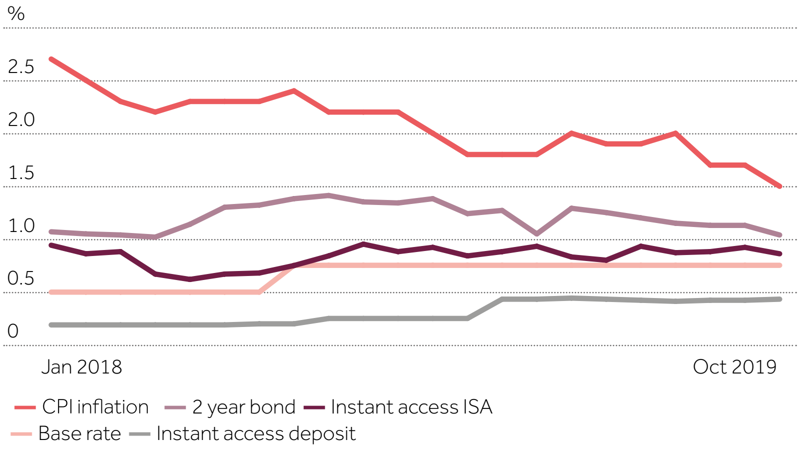
1.9 million customers continue to use cash predominantly[12]

Almost one-fifth of households live more than **3km** away from their nearest bank branch[13]

What is driving change

Macro-economics, regulation and technology are driving change in this sector. Continued low interest rates may create less incentive to save. New regulatory initiatives on overdrafts, savings rates and Strong Customer Authentication continue to improve overall consumer outcomes in the sector. New innovations, enabled by Payments Services Directive 2 (PSD2) and Open Banking, are beginning to embed both in the UK and internationally. These are slowly shaping the market.

Figure 2.2: CPI inflation vs interest rates[15]



Economy

Continued low interest rate environment reduces consumers' incentive to save

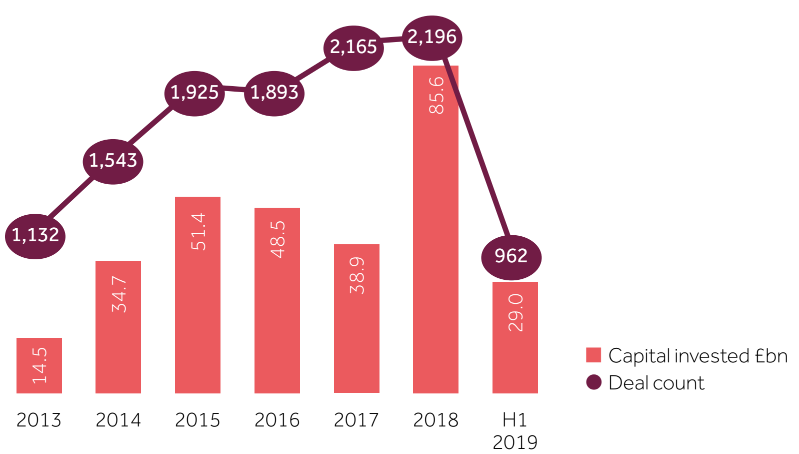
Interest rates remain low by historic standards despite the Bank of England base rate rising to 0.75% in August 2018. Bond and cash saving rates remain below the CPI inflation rate of 1.5% in November 2019.[14] This weakens consumers' incentive to save.

> **Interest rates remain low by historic standards despite the Bank of England base rate rising to 0.75% in August 2018.**

Firms continue to invest in fintech

Global investment in fintechs more than doubled in 2018 and reached £85.6 billion. Data from the first half of 2019 indicate that the UK continues to attract significant funding for fintech activities.[16] Many new digital challengers rely on investor funds to quickly grow their customer base and are continuing to seek further funds. These firms are often unprofitable in the early stages, while they seek to grow market share. They do this through a combination of expanding in other countries, offering higher savings rates or other products below cost and providing improved consumer experience.

Figure 2.3: Total yearly investment activity in fintech businesses[17]



£85.6 billion
global investment in fintechs in 2018

Policy and regulation

Regulatory changes continue to transform the sector

New rules for Strong Customer Authentication came into effect in September 2019. This will change how banks or payment providers authenticate the person requesting access to their account or making a payment, and should reduce fraud. To ensure firms implement these new rules successfully, we have given online banking firms until 14 March 2020, and e-commerce firms until 14 March 2021, to comply with them.

In 2019, we also introduced new rules as part of the HCCR to make overdrafts simpler, fairer and easier to manage. Firms cannot charge higher prices for unarranged overdrafts than for arranged overdrafts and we have also banned fixed fees for overdrafts. Banks must now publish overdraft price information alongside information on current accounts. This will allow consumers to make easier comparison between products, and increase the transparency of overdraft pricing.

In January 2020 we published a consultation on introducing a Single Easy Access Rate for cash savings accounts. If adopted, this would make the market simpler for consumers, improve competition and provide benefits to longstanding customers.

Open banking and PSD2 allow consumers to share their financial data more easily, and firms to offer new services. Since the introduction of PSD2, we have registered or authorised over 135 new firms offering account information and payment initiation services.[18] We are also considering the broader benefits of open finance, which could lead to new or improved and better value services and increased demand.

'Big Tech' entered the payments market in 2018-2019 although on a small scale so far. We authorised Google, Amazon, Facebook, and Alipay to carry out payment services and these firms have started to introduce mobile wallets, branded credit cards or payment accounts.

Development of new products by firms across the sector has created some uncertainties around our regulatory perimeter.

Together with the PRA and Bank of England, we are consulting on new joint policy proposals to strengthen firms' operational resilience. These aim to help firms manage any loss in their ability to deliver services and reduce the resulting harm to consumers and markets.

Consumers and society

The way consumers interact with banking and payment firms is changing

Customers experience instant and seamless digital services in industries like retail or travel, and expect the same from financial services. Firms are increasingly encouraging their customers to make transactions digitally.

Consumers are showing a growing willingness to share their financial data through open banking products and services. These changes allow consumers to understand their finances and make payments more easily.

Ongoing branch closures are, however, making it difficult for consumers who are less able or willing to adopt digital channels to access banking services. Our 2018 Strategic Review of Retail Banking Business Models found that older consumers and those with lower household incomes may be most affected, as they tend to use branches more.

1.9 million
consumers continue to use cash predominantly[19]

About 1.9 million consumers, who are likely to be vulnerable, continue to rely on cash payments[20]

Receiving cash payments may become increasingly difficult as the number of ATMs continues to fall. To address this, banks are experimenting with pilot schemes to allow access to cash through shared services, such as joint branches. In the meantime, other services such as the Post Office Banking Framework continue to be important to consumers and communities in providing access to cash.

We are working with other authorities, through the Joint Authorities Cash Strategy (JACS) Group, to support an end-to-end resilient, cost effective, and sustainable cash infrastructure that meets the needs of users.

One of the key objectives of our regulatory sandbox is access to financial services. The sandbox accepted 29 applications into its fifth cohort in H2 2019. They included ways to protect digital consumers from identity fraud and products that enable vulnerable consumers to access financial services.

Technology

Innovation gives consumers greater control, improved security and better authentication

Open banking means firms can introduce new products and services based on data sharing. For example, some providers allow consumers to see all their bank account information from different providers in one place. These new products also allow consumers to send payments directly from their bank account, help them avoid going into overdrafts or help them put money away in specific products.

New innovations, enabled by Payments Services Directive 2 (PSD2) and open banking, are embedding both in the UK and internationally. For example, there are over 1 million UK consumers using open banking services.

Firms also continue to implement biometric customer authentication, cloud-based data storage, and data analytics on payment transactions. Some traditional banking groups have also started to develop standalone digital banking products under new brand names in 2019.

Criminals misusing technology can cause financial loss to consumers

Mobile banking malware is a fast-developing threat. Crime involving fraudsters posing as official authorities, such as HMRC, also continues to grow, with victims persuaded to make payments or give out personal information. Identity theft is a key cause of both unauthorised and authorised push payment fraud.

The availability of cheap technology allows criminals to carry out number spoofing, which masks the caller's phone number. This means they can impersonate legitimate banks or public bodies, leading victims to be tricked into transferring money to fraudsters.

Criminals also use phishing attacks to get personal or financial information by targeting consumers via email, instant message, social media, or text messages that appear to come from legitimate sources.

UK Finance data indicate that there were over 8,000 cases of impersonation fraud in the first half of 2019, and consumers lost close to £40 million as a result. This is a significant increase from the nearly 4,000 cases in the first half of 2018, when consumers lost nearly £25 million.[21]

How the sector is changing

Demand for primary personal current accounts (PCAs) remains stable. Consumers are, however, increasingly taking out second and third accounts. Digital challengers are increasing their market share of newly-opened PCAs as well as savings accounts. A two-tier savings market is developing as a result. Established firms continue to offer low interest rates on savings, while challengers are gradually increasing their market share by offering higher rates, although their market share is still very small.

Personal current accounts

Consumers are opening multiple PCAs to try out new providers and functionalities

The PCA market share of the biggest 6 retail banks has stayed relatively constant – it was 85% in June 2019.[22] Primary current accounts have fallen as an overall proportion of total current accounts to 64.4%, as existing customers open second and third accounts.[23] The proportion of all PCAs that are second and third accounts has increased to 25.2% and 10.4% respectively in 2018.[24]

Digital challengers have particularly benefited from consumers' willingness to take out additional accounts. While they held just over 2% of all PCAs in June 2019, their share of new account openings in June 2019 was 14.3%.[25]

Overdrafts

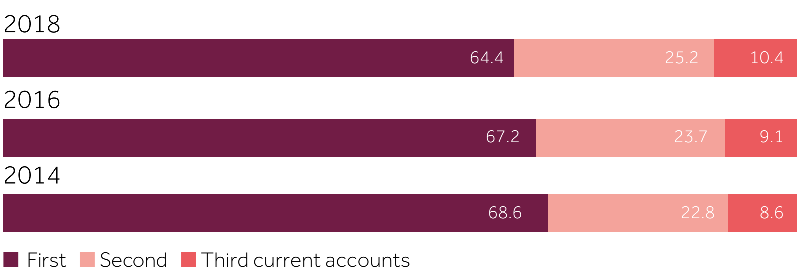
Regulation is changing how firms charge for overdrafts to improve outcomes for consumers

We announced new rules in June 2019 to reform the way firms charge for overdrafts. The changes include stopping banks charging higher prices when customers use an unarranged overdraft than those for an arranged overdraft, banning most fixed fees for overdraft borrowing, simplifying pricing, and requiring providers to advertise rates in a standardised way. We have also made rules requiring firms to do more to identify customers who are showing signs of financial strain or are in financial difficulty and implement a strategy to reduce repeat use.

While the rules will only come into force in April 2020, we are already seeing some providers increasing transparency of their overdraft pricing.

We expect this to improve outcomes for consumers in persistent debt. It could also benefit consumers with insecure employment, such as gig economy workers or employees on zero-hours contracts, and who need to use overdrafts to smooth out their short-term spending. The Living Wage Foundation estimates the number of consumers in this category is around 5.1 million.[27]

Figure 2.4: Market share of first, second and third personal current accounts[26]



Savings

Demand for cash savings remains level, and savers have increased their deposits

The proportion of UK adults holding a cash savings account stood at 56% in June 2019.[28] At the same time, the total value of deposits held in interest-bearing accounts increased 3%, from £1,167 billion to £1,208 billion.[29]

▲3.0%
increase in total value of deposits held in interest bearing accounts[30]

Competition from challenger banks is reducing the market share of incumbents in the savings market

Unlike PCAs, competition from new entrants has reduced the market share of incumbent banks. The combined market share for savings accounts of the biggest 6 retail banks fell to 61.9% in June 2019 from 70.5% in 2014, as challenger banks and NS&I premium bonds offer more competitive savings products.[31]

While incumbents continue to offer rates below the official Bank of England rate for retail deposits, challenger banks and building societies are competing by offering higher savings rates to attract new customers. New digital challenger banks are offering rates of around 1.35%, compared to an average interest rate of 0.62% for all easy access accounts in July 2019.[32]

Consumer perspective

Low levels of switching remain a defining characteristic of this sector. There is growing evidence, however, that consumers prefer to open multiple accounts to try out different products and providers. Some research also suggests that wealthier consumers may be more likely to switch, taking advantage of competition by actively pursuing higher introductory offers. Meanwhile, financial crime and fraud continue to harm consumers, and the value and volume of financial crime is growing.

Consumer inertia still limits competition in the sector

Our 2018 Strategic Review of Retail Banking Business Models analysis found that demographics affect the likelihood of customers switching current account providers. Switchers tend to be younger, more digitally active, and have lower personal current account and savings balances than non-switchers. They also hold fewer credit products and use arranged overdrafts less. Longstanding account holders tend to be older, have higher balances and are not digitally active.[33]

Previous Competition and Markets Authority (CMA) research has found that higher education, financial literacy, and digital skills increase the probability of customers searching for new current account providers.[34]

Open banking has led to the development of new products and services and is now embedding in the market

Since open banking was introduced, industry has shown promising levels of interest in developing it and there are over 1 million UK consumers using open banking services.

We published a Call for Input in December 2019 to lead the public debate on open finance, take stock of open banking and identify if there is more we can do. Open finance has the potential to transform the way consumers and businesses interact with their finances. It would enable automated price comparison and switching and give consumers greater access to support when making product choices. It could also lead to the development of new financial services that help consumers get the best returns from their finances.[35]

Consumers like to have different ways to engage with financial firms

3,312 bank branches closed between January 2015 and August 2019.[36] As a result of branch closures, 19% of households live more than 3km away from their nearest branch, resulting in potential access issues.[37]

At the same time, some consumers still prefer to use branches. The research showed that a large majority of survey respondents want access to a range of bank branches. Respondents also thought branches should stay open for those who are unable or unwilling to use alternatives, particularly in case there are technical problems with digital banking.[38]

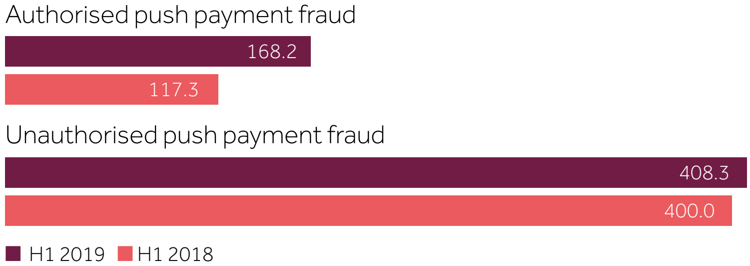
Research from Ipsos MORI indicates that 61% of current account holders visited a branch to manage their account in the 6-month period to June 2019.[39] This proportion has remained largely unchanged in the past 4 years. At the same time, the proportion of card and online payments is increasing. Card payments made up 47% of all payments in 2018, compared to 28% for cash.[40] The rapid growth in the use of contactless cards, wider acceptance of card payments at small retailers and the growth in online shopping drive this change.

Increasing financial fraud causes consumer harm through unrecoverable loss and weakened trust

In the first half of 2019, there were 57,549 reported cases of authorised push payment fraud, with consumer losses of £168.2 million.[41] The number of firms reporting this data to UK Finance has grown from 2018 to 2019, which means these numbers are not directly comparable to previous years. Firms do not always have consistent approaches to reimbursing consumers for this kind of fraud loss. The introduction of the Contingent Reimbursement Model means that this is beginning to change and will lead to setting common standards. It is not yet clear how participants will fund the reimbursement of fraud losses to consumers where neither the customer nor the bank is at fault. This raises concerns around the long-term viability of the scheme.

In the first half of 2019, the total money lost to unauthorised fraudulent transactions reached £408.3 million, an increase of 2% on the first half of 2018.[42] The theft of personal and financial data through impersonating authorities and the exploitation of data breaches drives this loss. Firms reimburse unauthorised fraud loss to consumers, but it can still lead to non-financial harm including anxiety, stress and other mental health issues.

Figure 2.5: Fraud loss to customers H1 2018 to H1 2019 (£m)[43]



Endnotes

1. Ipsos MORI FRS, Current Accounts, 12 months ending June 2019
2. Bank of England, Table A6.1, data to June 30 2019
3. Financial Ombudsman Service, Complaints data, April 2019
4. UK Finance, 2019 Half Year Fraud Update
5. Ibid
6. FCA internal analysis
7. Ibid
8. FCA, High-Cost Credit Review: Overdrafts consultation paper and policy statement, 2018
9. FCA internal analysis
10. FCA, High Cost Credit Review High-Cost Credit Review: Overdraft policy statement, 2019
11. FCA, High Cost Credit Review Press Release, 2019
12. UK Finance, UK Payment Markets Summary 2019
13. Which? Money, Is the last bank in your town under threat?, 2018
14. Ipsos MORI FRS, Savings Mass Market Insight Report, Data ending June 2019
15. Ibid
16. KPMG, Pulse of Fintech, H1 2019
17. Ibid
18. FCA, Call for Input: Open finance 2019
19. UK Finance, UK Payment Markets Summary, 2019
20. Ibid
21. UK Finance, Half Year Fraud Update, 2019
22. Ipsos MORI FRS, Current Accounts, data ending June 2019
23. Ipsos MORI FRS, Current Accounts, data ending December 2018
24. Ibid
25. Ipsos MORI FRS, Current Accounts, data ending June 2019
26. Ipsos MORI FRS, Current Accounts, data ending December 2018
27. Living Wage Foundation, Living Hours, 2019
28. Ipsos MORI FRS, Current Accounts, data ending June 2019
29. Bank of England, Table A6.1, data to June 30 2019
30. Ibid
31. Ipsos MORI FRS, Savings Mass Market, data ending June 2019
32. Moneyfacts Treasury Reports, UK Savings Trends, July 2019
33. FCA, Strategic Review of Retail Banking Business Models Annexes to the Final Report, 2018
34. CMA, Searching and switching in retail banking, 2018
35. FCA, Call for Input: Open finance, 2019
36. Which?, Bank branch closures: is your local bank closing?, 2019
37. Which? Money December 2018 - Is the last bank in your town under threat?
38. Which? Everyday Finances Statistics, 2019
39. Ipsos MORI FRS Current Accounts Key Measures Data ending June 2019
40. UK Finance, UK Payment Markets Summary 2019
41. UK Finance 2019 Half Year Fraud Update
42. UK Finance 2019 Half Year Fraud Update
43. UK Finance 2019 Half Year Fraud Update

Retail lending

Introduction

The retail lending sector includes lenders of all sizes, mortgage and credit brokers. It also includes businesses providing services to either consumers, eg debt advisers or claims management companies, or to other firms, including debt recovery firms and Credit Reference Agencies (CRAs). The sector allows consumers to borrow to meet their financial needs, from big purchases to everyday expenditure. Over 39 million people[1] have outstanding borrowing totalling £1.66 trillion[2] as of October 2019. This continues to grow, albeit more slowly than in recent years.

The rate of credit growth is slowing as the market reaches its peak and our interventions in the sector begin to take effect. In mortgages, high housing costs continue to stretch first time buyers while older homeowners look to release equity. For Claims Management Companies (CMCs), the PPI deadline and our new regulatory regime will shape the market.

Our Financial Lives data shows that 7.4m UK adults are over-indebted and find their financial commitment a burden. These consumers are more likely to face financial difficulties and some firms are not identifying this early enough. This problem can be made worse by poor value products, especially where firms target them at vulnerable consumers. Some mortgage customers are unable to switch to a better value product so we have introduced new rules to help them do so.

Figure 3.1: Overview of the retail lending sector

Demand

Consumers

Individual consumers

SMEs

Supply

Distribution*

- **Mortgage intermediation**
- P2P platforms
- Credit broking

Services

Mortgage administration services

Debt recovery
- Debt purchase
- Debt collection

Credit reference agencies

Claims Management Companies (CMC)

Credit information services

Debt advice
- Commercial
- Non-commercial

Lending

Mortgage lending
- Residential
- Buy-to-let
- Lifetime
- Second charge

Mainstream credit
- Credit cards
- Personal loans
- Motor finance
- Retail finance

High-cost credit
- High-cost short-term credit (HCSTC)
- Home-collected credit
- Pawn broking
- Guarantor lending
- Logbook lending
- Rent to Own
- High-cost instalment loans
- Subprime credit cards
- Subprime motor finance

■ Mortgage sector markets
■ Credit sector markets

£1,414bn
mortgage loans outstanding[1]
▲ 2.8% vs 2017

13.4m
mortgage accounts outstanding[2]
▼ 0.5% vs 2018

4,955
residential mortgage products[3]
▲ 9.2% vs April 2018

1.2m
number of new mortgage sales in 2019[4] (excluding internal transfers)

£72,854m
outstanding credit card lending[5]
▲ 2.8% vs April 2018

£500m
outstanding rent to own debt[6]

£1.1bn
average net monthly consumer credit borrowing since July 2018[7]

953
CMCs applied for authorisation[8]

1. Bank of England, Money & Credit March 2019
2. Bank of England, Money & Credit June 2019
3. Moneyfacts.co.uk, Number of mortgage products, October 2019
4. FCA, Product Sales Data
5. Bank of England, Money & Credit June 2019
6. FCA, Consultation Paper 18/12
7. Bank of England, Money & Credit September 2019
8. FCA internal analysis

What we found on harm

An increasing number of consumers are becoming overly indebted

Our Financial Lives data shows that 7.4m UK adults are over-indebted. We define this as when consumers consider keeping up with domestic bills and credit commitments a heavy burden, or missing any of these payments in three or more of the last six months.

As well as paying the direct costs of arrears and/or default, damaged credit scores and associated costs, overly indebted consumers can suffer non-financial costs, including mental illness, stress and relationship breakdown.

We are concerned some business models are designed to exploit vulnerable credit-dependent consumers. Where consumers' debt levels cause arrears and default, some firms do not treat customers in financial difficulties appropriately. This may be through poor creditworthiness assessments, failing to identify consumers in financial difficulty at an early stage or through subjecting them to oppressive debt recovery and collection techniques.

Through our High-cost Credit review we have intervened in the rent-to-own and home-collected credit markets. Our recent rule changes on overdraft pricing aim to increase transparency and improve outcomes for consumers in persistent debt. We examine this in the Retail Banking chapter.

7.4 million
UK adults are over indebted[3]

4.1 million
UK adults are in financial difficulty[4]

Poor value products or services

Many consumers could have found better value mortgages while some cannot switch products easily

A significant number of mortgage products are available, making it difficult for consumers to establish which they are eligible for and identify good value for money. Our Mortgages Market Study (MMS) estimated that around 30% of consumers (in 2015-2016) could have found a cheaper mortgage with the same key features.[5] On average, they paid around £550 a year more over the introductory period compared to the cheaper product.[6] The pattern is similar for all such customers, including those who used intermediaries and those who went directly to a lender. We have recently proposed policy changes to address this harm.

Some mortgage customers are unable to switch products. The MMS identified that up to 150,000 borrowers have difficulty switching when their mortgage rate reverts to the lender's standard rate at the end of any incentive or fixed rate period, even if they are up-to-date with payments.[7] We have estimated that up to 14,000 of these consumers are able to switch to a new deal.[8] This means they stay in products which are more expensive than alternatives. We have introduced a modified affordability assessment to help consumers, and to reduce switching barriers for consumers who are up to date with payments and not looking to borrow more.

30% of consumers pay £550 per year more than the cheapest like-for-like alternative during the initial period of a 'fixed' rate mortgage[9]

Consumer credit often offers poor value

In consumer credit we have taken specific action where products offer particularly poor value, for example High-cost short-term credit, or where consumers are using running account credit products (such as credit or store cards) inappropriately for long term borrowing.

While there is a cost to firms to supply credit to consumers that have low credit scores, some parts of this market exploit the reality or the perception of limited options to charge high prices. We have introduced new rules, including a price cap on rent-to-own, which came into effect between April and September 2019.

Rent-to-own customers are among the most vulnerable –2/3 are out of work and most others are on low incomes[10]

Disorderly firm failure in the Peer-to-Peer (P2P) market

P2P matches lenders, who are often retail consumers, with borrowers who want to raise money – typically through an internet-based platform. We have already seen examples of how inadequate wind-down arrangements can cause consumer loss and have begun enforcement action as a result. If P2P firms cannot achieve an effective run-off or transfer of business, consumers could suffer significant harm. This is particularly the case if they have invested in more speculative or illiquid asset classes such as funding property development. Investors may not recover all their investment, and it may be delayed if there is a disorderly wind-down.

In a worst-case scenario, consumers who have lent to P2P firms may have to seek repayment directly from the end borrowers themselves. Individual P2P agreements are usually only for small amounts of the total amount borrowed, so it is probably not economically viable for individual investors to enforce their rights against a potentially large number of individual borrowers. Failure of a large or well-known platform could also have a wider impact on confidence in this market.

Some claims management companies (CMCs) offer poor value

In the claims management market, many consumers are not aware that they can make a claim directly without the support of a claims management company (CMC) and so pay for a service they do not need. We have introduced new rules which require these firms to tell customers that they can make a claim on their own. Many CMC customers are not aware of the costs and limited range of CMC services or do not get regular updates about their claim.

We have found widespread poor practice across 200 Claims Management Company adverts[11]

What is driving change

Challenging economic conditions are reducing some households' resilience and the number of consumers becoming over-indebted is increasing.[12] Our regulatory interventions in this sector should deliver benefits for many. Home ownership continues to decline, particularly for younger generations, with the gap between earnings and house prices continuing to stretch affordability for first time buyers.

Economy

Overall borrowing amounts continue to increase but the rate of growth has slowed

The annual rate of credit growth (credit cards and other loans and advances) slowed to 5.9% in September 2019.[13] This compares to a peak of 10.9% in November 2016.[14] Some of this could be the result of our interventions in consumer credit beginning to take effect. It could also be the result of some growth in real wages over 2019.[15] This, together with inflation slowing to 1.3% in December 2019[16], may have eased price pressures for households and impacted the demand for credit.

Overall growth in individual debt is being driven by non-credit debts

Just over a third of the average person's unsecured debt is consumer credit debt. The growth in debt is being driven by 'other' types of debt, including council tax and utilities.[17]

Figure 3.2: Unsecured lending per person (£000)[18]

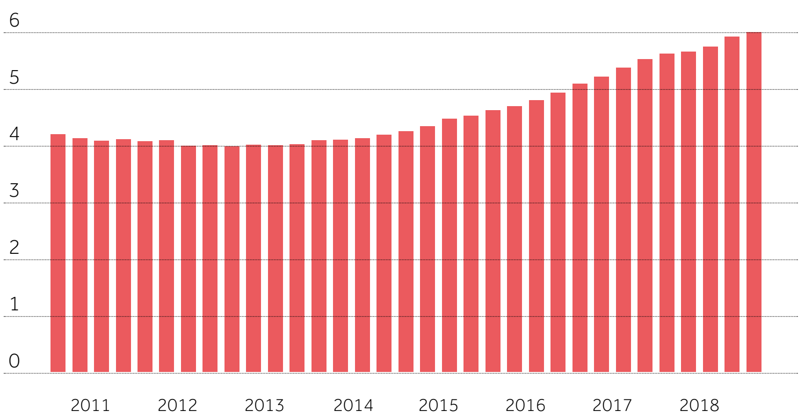
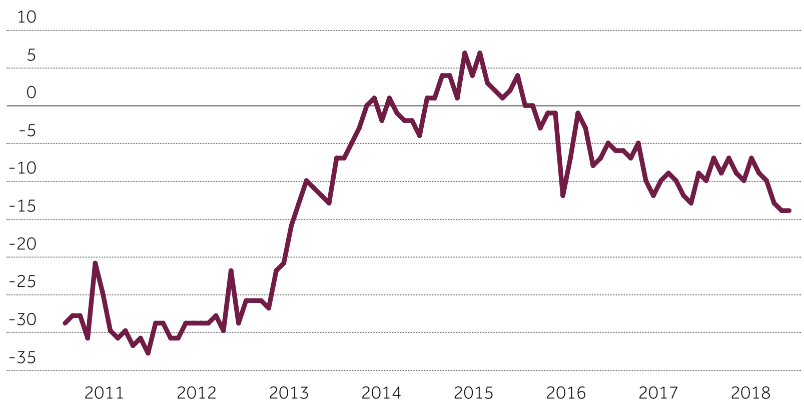


Figure 3.3: Consumer confidence[19]



Policy and regulation

Our interventions will deliver benefits for many consumers

Regulatory intervention such as the Mortgages Market Study remedies and High-Cost Credit Review are supporting innovation and competition, and are already delivering benefits to consumers.

Following from the Mortgages Market Study, policy changes have been made which are intended to reduce the harm to mortgage prisoners and to help consumers better navigate the mortgage market.

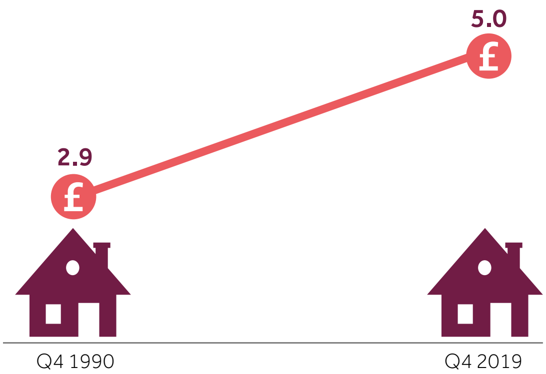
The High-Cost Credit Review and subsequent rule changes will deliver benefits to many consumers, particularly through changes to overdraft and buy now pay later pricing and the price cap in the rent-to-own market. These will lead to lower prices for these often vulnerable consumers. The impact of these changes on some firms' profitability should encourage them to change their business models.

Consumers and society

Home ownership continues to fall

Home ownership has continued to slow for most age groups, but the long-term change is greatest in those aged between 25-44. The fall in ownership is being driven by a range of factors, including high house prices and lenders having tighter affordability criteria. The only age band that has seen an increase in ownership is 65 and over.[20]

Figure 3.4: First-time buyer house price to earnings ratio[21]



The gap between earnings and house prices continues to stretch first-time buyer (FTB) affordability

The gap between average incomes and house prices has grown over the last 20 years, although in the last decade we have seen a slower rate of growth. Current first-time buyers now need to spend on average 5.0 times earnings to buy an averagely priced property (compared to 2.9 times in 1990).[22]

Both policy makers and mortgage providers have responded to stretched first-time buyer affordability. The government has implemented schemes such as Help to Buy, while mortgage providers have responded by lengthening loan terms, widening Loan-to-Values and starting to develop more innovative products.

Help to Buy continues to support property sales

By the end of 2018, 211,000 consumers had used Help to Buy (HTB) schemes to buy properties.[23] 60% of HTB first-time buyers paid the minimum deposit of 5%, compared to 40% of non-HTB first-time buyers.[24]

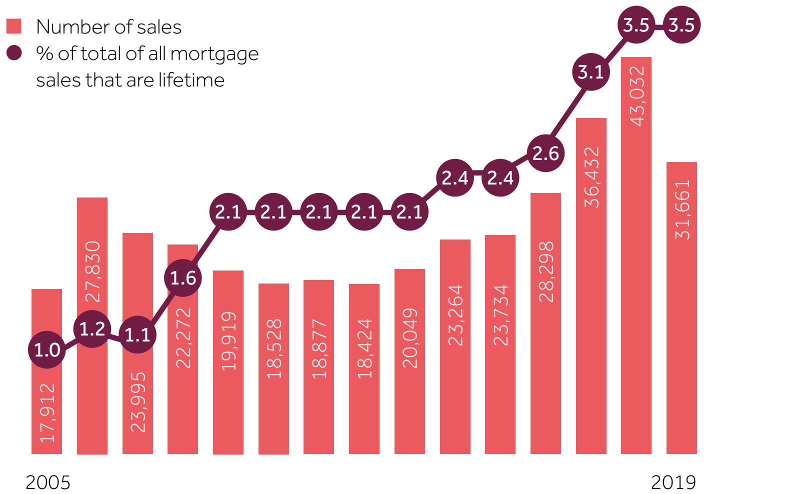
There is potential for these consumers to be more exposed to any change in economic conditions. A stagnant housing market, combined with the 'new build premium', could see a reduced number of re-mortgage options relative to a non-HTB property. They are also more likely to face negative equity if property prices begin to fall.

The number of products available to borrowers in later life continues to grow

Borrowing in later life is becoming more common and the number of products has grown rapidly. Lifetime mortgage options have also increased, with 287 products available to consumers (as of Autumn 2019).[25]

The mortgage market for later life borrowing is being driven by longer life expectancy, the accumulation of property wealth, paying off other debts (including maturing interest-only mortgages), supporting family members and regulatory changes.

Figure 3.5: Sales of lifetime mortgages (number and proportion of all mortgage sales that are lifetime)[26]



Note: 2005 covers Q2-Q4 only, 2019 covers Q1-Q3 only

How the sector is changing

Mortgages

Stronger competition in the mortgage market has led to better rates for consumers, with many firms chasing a shrinking pool of customers. This has led to some firms stretching their affordability assessments to lend to potentially higher-risk customers. Challenging conditions have also led some firms to leave the market with others expected to follow, especially as the trend for 5-year fixes is likely to reduce consumer activity in the mortgage market. We are seeing continuing growth in smaller markets such as later life borrowing.

Greater competition for fewer borrowers has seen smaller lenders increasingly targeting higher risk borrowers

Initial estimates suggest there were around 1.2m mortgage transactions in 2019, excluding internal transfers. This is broadly the same as in 2018 but significantly below the peak of 2.3m in 2006.[27]

Despite lower lending volumes, the number of firms in the market has increased by 30%, from 128 in 2008 to 167 in 2018.[26] Low lending volumes are being driven by several factors, including limited house supply and reduced demand for buy-to-let borrowing. Lower lending volumes, together with the funding advantages held by the largest bank lenders, and increased competition have led to many smaller mortgage firms increasing their risk appetite, or to stop lending.

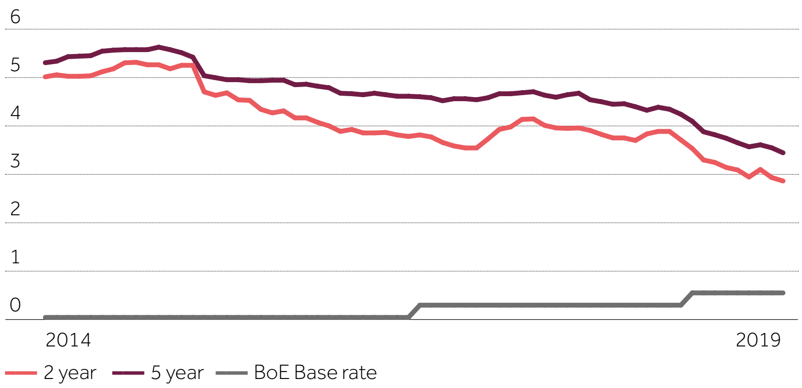
Competitive pressures have led to some firms leaving the market

Some ring-fenced banks are driving competition in the market as they now have increased liquidity for retail lending. This has contributed to reduced interest rates for consumers. More firms chasing a smaller number of consumers has led to four firms (Tesco, Sainsburys, Secure Trust and Magellan Homeloans) ceasing to lend. We expect to see further firms ceasing to lend in the near to medium-term.

Consumers are increasingly choosing 5-year fixed deals

In Q4 2018, 48% of new mortgage sales were 5-year fixed deals, an increase from 25% in Q4 2016.[27] This growth is being driven by the market dynamics highlighted above, an increased focus on keeping customers, reduced consumer confidence, and a smaller price differential between 2 and 5 year fixes.[30] UK Finance estimate that this trend will lead to a reduction in the number of consumers seeking mortgages in 2020.[31] Barring an unexpected increase in first-time buyers, this trend will place further competitive pressures on firms in the market.

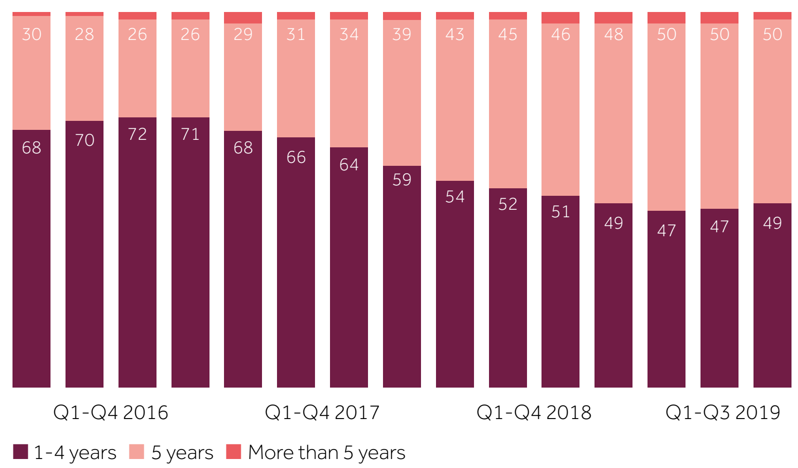
Figure 3.6: Interest rate of 2 year and 5 year (95% LTV) fixed rate mortgages, and Base Rate (%)[32]



Firms will need to take action to remove dependencies on LIBOR

Over 200,000 mortgage contracts are LIBOR-linked, but LIBOR is expected to cease to be available after 2021.[33] Firms need to consider how their contracts will operate when LIBOR no longer exists, and whether the terms allow the contract to be moved to an alternative benchmark. A small number of firms are still offering LIBOR-linked mortgages. We are monitoring this issue closely.

Figure 3.7: Term length on sales of fixed-rate mortgages (%)[34]



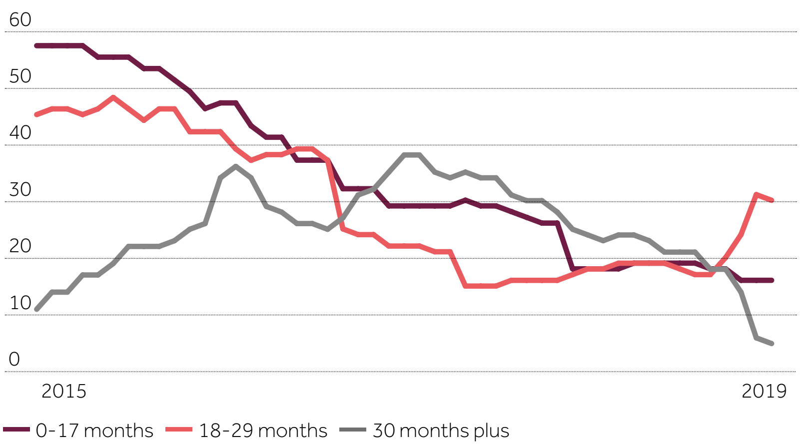
Consumer credit

Consumer credit firms are facing increasingly challenging trading conditions, particularly in the high-cost markets. This has led to some firms leaving the market and others facing existential difficulties. It has also led to an increasing number of firms lending to consumers with poor credit scores. The transfer of regulation of Claims Management Companies (CMCs) to us, together with business model changes following the PPI deadline, will shape this market in the short to medium-term.

Despite an overall increase in 0% credit card borrowing, the length of 0% deals and the number of products have decreased

As of September 2019, the longest 0% balance transfer deal was 24 months, down from 30 months a year earlier.[35] The average balance transfer period has fallen to 19 months in September 2019, down from a peak of 24.4 months in January 2018.[36] In the same period, the number of 0% balance transfer cards has reduced from 60 to 43.[37] These changes could be a response to the Bank's prompting on potential stability problems, and could also reflect a delayed response to interchange fee changes as well as evolving risk appetites. The interchange fee is a transaction fee paid by the merchant's bank to the card issuer when a customer makes a card payment.

Figure 3.8: Credit card 0% balance transfer period by introduction period (number)[38]



19 months
average balance transfer period in January 2019, down from a peak of 24.4 months in January 2018

High-cost firms face difficult trading conditions

High-cost short-term credit (HCSTC) providers have continued to struggle to be profitable, because of the impact of regulatory changes and redress repayments from poor practice. Redress payments have led to the failure of high profile firms such as QuickQuid, CashEuroNet UK, Wonga, The Money Shop and WageDay Advance. Wonga's administrator has received details of 40,000 complaints about past activity.[39]

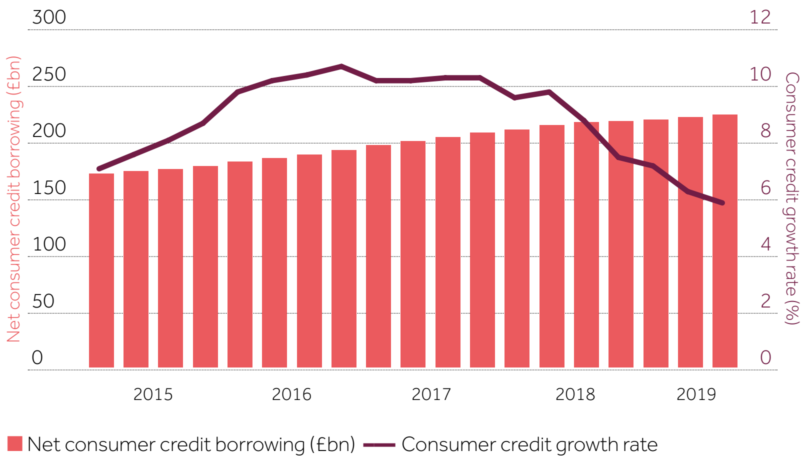
In February 2019, Brighthouse, one of two major rent-to-own providers, announced it would be closing a further 30 shops and start offering instalment loans as well as its core offering.[40] The other major rent-to-own provider, Perfecthome, entered administration in 2018, before being sold to new owners.[41]

Guarantor lending remains an area of concern, given the number of guarantors who make at least one payment and the rapid growth in the sector since 2016.

New market entrants are responding to social trends

While unemployment is generally low, the number of workers in less stable forms of employment has grown, especially among younger generations. Markets have responded to this trend by introducing income smoothing products, employee loans and products which allow consumers earlier access to earned income.

Figure 3.9: Net consumer credit lending to individuals (£bn) and growth rate (%)[42]



Peer-to-peer (P2P) providers are also facing more challenging trading conditions

Lendy, a prominent property development P2P platform, has entered administration. As the largest firm in this nascent market to enter administration, this could have a wider impact in confidence in this market. Another prominent P2P firm, Funding Secure, has also entered administration having issued loans used to fund property developed as well as pawnbroking style loans.

Claims Management Companies (CMCs)

The transfer of CMC regulation to us together with the PPI deadline is reshaping the market

On 1 April 2019, we assumed regulation of CMCs. The number of CMCs has fallen steadily from 2011, when there were over 3,000.[43] 953 firms have registered for temporary permission with us and will need to apply for authorisation to continue their activities.[44]

The passing of the deadline for PPI claims is likely to further reduce the number of providers, unless firms find alternative claims areas. Total market turnover for all CMCs was £762.6 million in 2018, of which £600.3 million related to financial services (including PPI).[45]

"The passing of the deadline for PPI claims is likely to further reduce the number of Claims Management Companies, unless firms find alternative claims areas"

Consumer perspective

There are signs that a growing number of consumers are facing financial difficulties and that household resilience for some is reducing. Younger borrowers, renters and those with low credit scores are most likely to be in financial difficulties. Lending to higher-risk consumers is growing. An increasing number of consumers are seeking advice about their financial liabilities, particularly about smaller and typically non-regulated debts.

Consumers with the lowest incomes are most vulnerable

According to our Financial Lives survey, 8% of UK adults are in financial difficulties.[46] This means they have missed bill or credit payments in at least 3 of the last 6 months.

Renters and those between the ages of 25-39 make up the majority of struggling consumers

By 2017, nearly 70% of callers to the National Debtline were renters, compared to under 20% who were homeowners.[47] This is despite renters making up only 37% of the adult population.[48] In 2018, 50.8% of StepChange clients were aged between 25-39, up from 41.6% in 2014.[49]

Consumers in the 'squeezed middle' also show signs of vulnerability

13.1 million people are financially squeezed. 43% of them have a household income under £20,000, and 21% are overly indebted.[50] Most do not have the savings buffer necessary to handle a prolonged income shock. According to Financial Lives Survey data, 35% of individuals have limited financial resilience, 27% would be able to meet their living expenses for less than a month if they lost their major source of income. 7% of households could do so for less than a week.[51]

Figure 3.10: Proportion of StepChange clients seeking advice (%)[52]

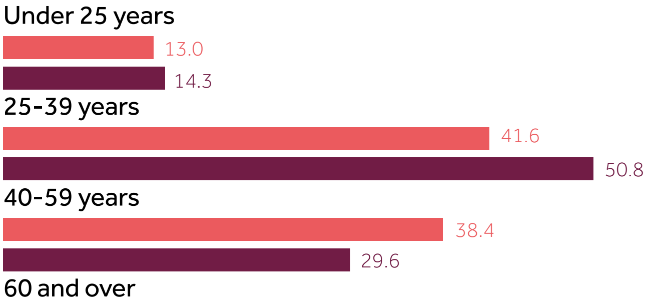
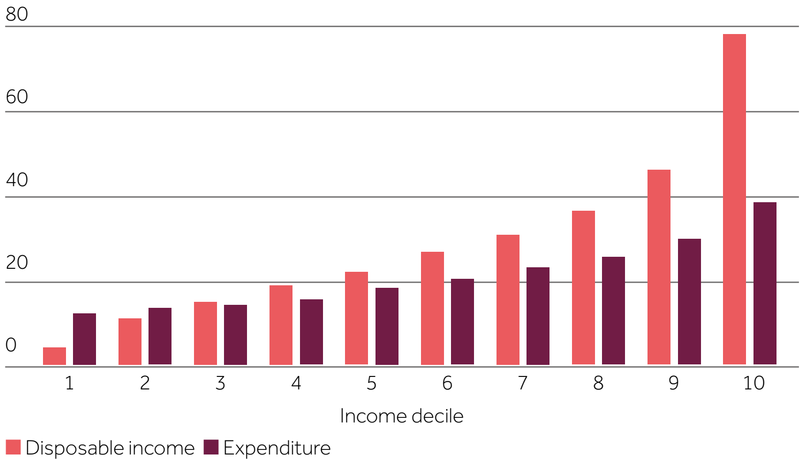


Figure 3.11: Income and expenditure per UK household (£000)[53]



(Disposable income is defined as the amount of money that households have available for spending and saving after direct taxes (such as Income Tax, National Insurance and Council Tax) have been accounted for – ONS)

Lending to high risk customers has been growing around 20% annually and more consumers have debt problems

Our analysis of Credit Reference Agency (CRA) data indicates that lending to consumers with poor or very poor risk scores has increased, rising from £11 billion in 2016 to over £16 billion in 2018. The amount of high-cost credit and 0% credit card borrowing also increased significantly in this period.[54]

Debt charity, Stepchange, recently reported the number of people in problem debt remains stubbornly high at over 3m.[55] 7 in every 10 people who came to the charity for advice said the primary reason they had got into problem debt was because of a life event or shock.[56]

Those seeking debt advice are doing so for smaller amounts and there is an increase in calls about non-regulated credit debt problems

50% of all calls to the National Debtline in 2018 were about debts of under £5,000, suggesting more consumers are struggling at an earlier stage.[57] Consumers may be struggling at an earlier stage due to the increase in unregulated debts which involve more aggressive debt collection practices. 331,337 people contacted Stepchange for debt advice in the first six months of 2019.[58]

Endnotes

1. FCA, "Getting affordability right in consumer credit", Speech by Jonathan Davidson 2018
2. Bank of England, Bankstats Tables
3. FCA, Financial Lives Survey, 2017
4. Ibid
5. FCA, Mortgages Market Study – Final Report, 2019
6. Ibid
7. Ibid
8. FCA, Understanding mortgage prisoners, January 2020
9. FCA, Mortgages Market Study – Final Report, 2019
10. FCA, CP 18-35 Rent-to-own and alternatives to high-cost credit, 2018
11. FCA, Press release Claims management companies must raise advertising standards, August 2019
12. FCA, Financial Lives Survey, 2017
13. Bank of England, Money & Credit Statistics 2019
14. Ibid
15. ONS, Earnings and Working hours report, January 2020
16. ONS, Consumer Price Index (CPI), January 2020
17. OBR, Economic and Fiscal Outlook - October 2018
18. ONS, Unsecured lending 2018
19. GfK, Consumer Confidence (research carried out by GfK on behalf of the European Commission)
20. FCA internal analysis
21. Nationwide, First Time Buyer House Price Earnings Ratios
22. Ibid
23. FCA internal analysis
24. Ibid
25. Equity Release Council, Autumn Report 2019
26. FCA internal analysis
27. Ibid
28. Ibid
29. Ibid
30. Bank of England, Quoted household interest rates
31. UK Finance, Annual Mortgage Speech – Richard Rowntree
32. Bank of England, Quoted household interest rates
33. UK Finance, Letter to the Bank of England re LIBOR
34. FCA internal analysis
35. Moneyfacts.co.uk
36. Ibid
37. Ibid
38. Ibid
39. Letter from Grant Thornton to Nicky Morgan MP
40. bbc.co.uk
41. retailgazette.co.uk
42. Bank of England, Database (LPQBI2O)
43. Ministry of Justice, Claims Management Regulation Annual Report 2017/18
44. FCA, Annual Report 2018/19
45. Ministry of Justice, Claims Management Regulation Annual Report 2017/18
46. FCA, Financial Lives Survey, 2017
47. National Debtline, A decade in debt - How the UK's debt landscape has changed from 2008 to 2018
48. ONS, UK Private Rented Sector 2018
49. Stepchange, Statistics Yearbook 2018 dataset – H1
50. Money Advice Service, Segmentation Infographics
51. FCA, Financial Lives Survey, 2017
52. Stepchange, Statistics Yearbook 2018 dataset – H1
53. ONS, Income and expenditure per household in the UK
54. FCA internal analysis
55. Stepchange, Understanding financial resilience in a world of uncertainty
56. Ibid
57. Money Advice Trust, A Decade in Debt: How the UK's debt landscape has changed from 2008 to 2018, as seen at National Debtline
58. Stepchange, 2019 Statistics Mid-Year Update

General insurance and protection

Introduction

A well-functioning insurance sector is vital for the health of the financial services industry. The importance of this sector is demonstrated by high consumer demand: more than 4 out of 5 UK adults have one or more insurance products. The UK economy as a whole is underpinned by wholesale insurance that provides cover for large and complex risks, enabling smooth functioning of businesses by protecting them against financial loss.

The main drivers of change in this sector are technology developments changing how consumers and insurers interact, EU withdrawal, and ongoing low interest rates, which continue to put pressure on insurers' margins.

Fair pricing continues to be a major problem in personal lines insurance. Consumers who stay with their existing insurer, and do not switch at renewal, almost always pay higher premiums than those who switch or negotiate. This is known as the 'loyalty penalty' and is most common in motor and home insurance markets. We are continuing work to improve access for consumers with specific insurance needs, such as travel insurance for customers with pre-existing medical conditions. We are also working to improve distribution chains by ensuring that all parties in the chain are considering value to the consumer. Looking forward, increasing use of personalised customer data can generate many benefits but could also pose risks for consumers. For example, use of biometric or genetic data for risk modelling could make some products unaffordable for some consumers. The well-publicised cases of non-financial misconduct in the London Market also raise questions about the culture at firms in the wholesale insurance sector.

Figure 4.1: Overview of the general insurance and protection sector

Demand

Consumers

Individual consumers

SMEs, large corporates and insurers as buyers of reinsurance

Supply

Distribution

Retail protection
- Direct
- Independent and other financial advisers

Personal lines (retail general insurance)
- Brokers
- Direct
- Appointed representatives (of insurers and intermediaries)
- Banks and mortgage brokers
- Price comparison websites
- Employee and workplace schemes

Commercial lines and wholesale
- Brokers
- Direct
- Banks
- Price comparison websites

Insurers and reinsurers (underwriting and risk transfer)

Life insurers
(long term protection products)

General insurers and reinsurers
- UK insurers and reinsurers
- EEA insurers and reinsurers
- UK branches of non EEA insurers
- Lloyd's (including managing agents)

NB some business is underwritten on behalf of the above by managing general agents (MGAs)

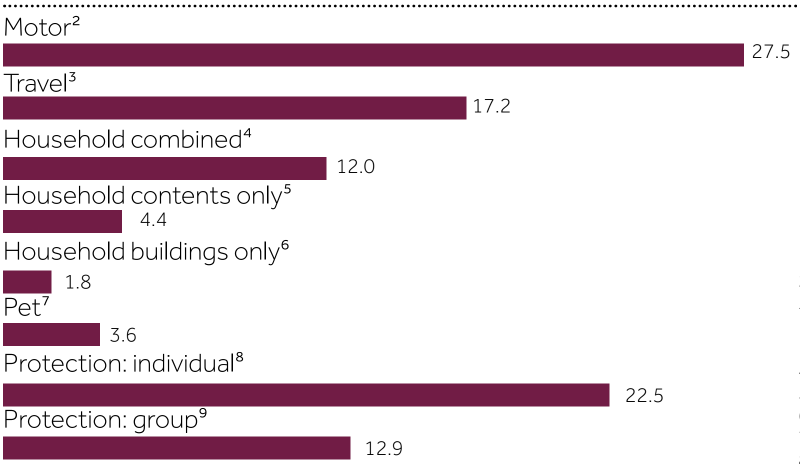
■ General insurance and protection markets ■ Market players in other sectors which distribute in the general insurance and protection sector

£99.9bn
total UK gross written premium (GWP), 2018[1]

37%
Lloyd's Gross Written Premium of total UK GWP[1]

62%
UK annual loss ratio[1]

Figure 4.2: Number of policies (million), 2018



1. ABI, Total Market Statistics 2018
2. ABI, Quarterly Motor Premium Tracker, January 2019
3. ABI, Travel Insurance Data, June 2019 *Please note that the travel data provided by the ABI has been scaled up to represent a market estimate
4. ABI, Household Insurance Premium Tracker, October 2019
5. Ibid
6. Ibid
7. ABI, Pet Insurance 2018, April 2019
8. Swiss Re, Term & Health Watch 2019
9. Swiss Re, Group Watch 2019

What we found on harm

We categorise harm in this sector in 5 retail and protection themes, and 2 wholesale themes. The 2 common drivers for much of the identified harm are poor culture and low consumer engagement. This leads to several negative customer outcomes.

Pricing practices in personal lines still penalise loyal customers

Fair pricing is the most publicised issue in this sector. The 'loyalty penalty' in home and motor insurance cost 6 million longstanding consumers an extra £1.2 billion in 2018.[1] This is despite our recent renewal rules saving consumers £185 million a year.[2] Increased digitalisation or misuse of data may lead to personalised price discrimination which could see this harm increase.

1 in 3 consumers who pay high prices show at least one characteristic of vulnerability[3]

£1.2 billion additional cost paid by long-standing customers in 2018[4]

Add-on prices continue to cause harm to consumers

In 2015 we started requiring firms that sell Guaranteed Asset Protection (GAP) insurance to give customers more information and allow them 2 days to consider the cover before buying it. This reduced the harm by up to 23% from 2015 levels,[5] but intelligence reports suggest it remains significant. Effective implementation of the Insurance Distribution Directive (IDD) should address this further, although it is too early to tell if this has led to improvement in the value for money of add-on products. Examples of where this harm occurs are car hire excess insurance and rent-to-own accidental damage insurance.

Complex distribution chains and products are contributing to poor value

We are seeing instances of poor value products, including poor claims outcomes, in personal and Small and Medium-sized Enterprises (SME) lines. Our work (Thematic Review 19/2) shows that this is most common where insurance is linked to another non-financial purchase.[6] The harm comes from parties in the distribution chain receiving remuneration which appears to be significantly above the costs incurred in distributing the products. This results in consumers paying potentially excessive prices.

The complexity of protection products, compared to other insurance products, increases the threat from poor value products as it is difficult for those with lower financial literacy to understand what they are purchasing. Our Financial Lives Survey found that 46% of UK adults report low knowledge about financial matters.[7]

We are also seeing long distribution chains and weak product oversight by firms leading to poor customer value. Longer chains may also slow the pace of innovation as adopting a new idea requires coordination between all parties in the chain.

Consumers with specific needs are facing barriers to insurance products

It can be harder for consumers with specific insurance needs to find or get cover, especially when using online mass market distribution channels. If consumers cannot easily get meaningful information about alternative insurance providers, or lower-cost policies, they may assume they are uninsurable or cannot afford cover and may effectively exclude themselves from the market.

Some cancer survivors report facing a 'life-time penalty' of expensive travel insurance. About 3 million people with disabilities have been denied insurance or charged extra because of their condition, affecting long-term illness, critical illness, income protection, life and travel insurance.[8] We have consulted on introducing a new 'signposting' rule for firms to give consumers details of a directory of travel insurance firms that are willing and able to cover consumers with more serious pre-existing medical conditions.

About **3 million** with disabilities have been denied insurance or charged extra[9]

Protection products are only held by **35%** of UK adults[10]

Misuse of customer data can harm consumers, particularly vulnerable consumers

Misuse of customer data can compromise the wider social benefits of insurance, especially if it is used to single out vulnerable consumers.

There are also ethical considerations around consumers consent to sharing their data with firms and their ability to negotiate what is shared and what they get in return.

Additionally, increased use of data is leading to personalised risk modelling and pricing, which reduces risk-pooling across customer groups. This can have implications for harm that falls outside our regulatory remit. For example, risk modelling of individuals may make some products unaffordable to high-risk consumers while reducing the cost for low-risk consumers. Where this happens, we will clarify publicly why it falls outside our remit.

Non-financial misconduct in the London Market poses a threat to market integrity

The publicised cases of poor non-financial conduct, including cases of bullying and harassment in the London Market, pose harm to market integrity. Despite being non-financial misconduct, it raises concerns of whether the broader culture in the London Market is able to proactively identify poor financial conduct leading to other harm, such as managing conflicts of interest. Drivers of poor conduct may include remuneration and other incentives and a lack of diversity.

71% of insurance professionals believe that culture needs to change[11]

Higher prices from inefficiencies in the London Market

Inefficiencies in the London Market lead to higher prices for commercial customers and their end-users. The higher expenses of the London Market are driven by higher acquisition costs, reflecting the more complex and specialty products being sold in London but also the slower adoption by these firms of technological solutions that deliver more efficient processes.

Some senior executives in the London Market have criticised the culture and short-term strategies in parts of the market. These could slow the implementation of more efficient and innovative business models.

What is driving change

Current low interest rates mean access to capital is less costly, allowing increased capacity in the insurance sector. However, this is putting pressure on insurers' margins. While lower capital costs may mean consumers pay lower premiums, restructuring in preparation for EU withdrawal has driven up one-off costs in the industry. There are risks around ensuring continuity during EU withdrawal for firms and customers.

Economy and political environment

Continued low interest rate environment puts pressure on insurers' margins

Continuing low interest rates help the insurance industry access capital at a lower cost. But the increased industry capacity this creates is reducing insurers' margins. In theory, lower capital costs should benefit consumers through lower premiums. But how far this has actually happened is difficult to assess and the market may be hardening, with both premium and rate increases reported.

Contract continuity is the main risk from EU withdrawal

EU withdrawal poses a risk for insurance in the form of contract continuity. Firms are restructuring operations to reduce disruption to their customers, including setting up new European entities to exclusively service their EU businesses. They also need to ensure these contracts remain valid at the end of the transition period and so may need to amend them ('repapering'). For brokers, this means ensuring registration is valid in the relevant jurisdictions and 'repapering' the terms of engagement where necessary. Both brokers and insurers will have to consider GDPR during this process.

These changes could increase industry costs, which are typically passed on to consumers. While the increase would theoretically be a one-off, the ongoing uncertainty around EU withdrawal could increase these costs further. Insurance firms have highlighted there is little consistency in regulatory regimes across the EU, which also drives up costs. This underlines the need for continued international cooperation between regulators.

Society and demographics

Increasing numbers of people are living with long-term illness

More than 15 million people currently have a long-term condition, and this is projected to increase in the next 10 years.[12] The industry will need to ensure that these individuals understand the importance of protection products, such as income protection, and to ensure that products are accessible and fairly priced.

Insurance needs are changing across generations

UK adults are buying their first home later than earlier generations, which is increasing demand for rental properties. Many of these renters choose not to insure their contents while renting.

The UK also has 11.8 million people aged 65 and above. The insurance needs and access to insurance products for this group may vary considerably from other generations. With 59% of adults aged 80 and over having a disability[13], the funding of long term health care is a major social issue to be addressed by government and other relevant policymakers.

Technology

Insurance is becoming more bespoke

Technology is changing the way consumers interact with insurance. Rather than a product, insurance is being promoted as a service. This has led to the development of products more tailored to individual consumers, for example, usage-based motor insurance.

Use of customer data is increasing, bringing both benefits and threats

Customer data is the backbone for insurance risk modelling and pricing. Technology is enabling firms to use more personal and diverse data for algorithmic pricing and risk modelling through artificial intelligence and machine learning. It is reasonable to expect the sector to increase its use of customer data. This can help insurers and brokers improve their processes and tell customers how to reduce their risk exposure. However, it can also increase the scope for price discrimination. For example, if genetic data were used for risk modelling, it could discriminate against customers who have a higher likelihood of developing certain diseases.

Our Open Finance initiative, partly inspired by Open Banking set up by the CMA, aims to improve competition and speed up innovation in insurance by using the data economy. If they sign up, Open Banking allows customers to see their payment account data from participating banks in one place, as well as allowing approved third-party providers to offer tailored products or information services to the customer.

More granular data can also create more personalised risk, so reducing risk-pooling across customer groups. This may not be an issue if data relates to something an individual can control, for example, safer driving rewarded by a lower motor premium. Where a consumer cannot change something, such as their biometric or genetic data, risk modelling based on these could make protection unaffordable or inaccessible to many, and especially to more vulnerable consumers.

Long value chains can raise costs for consumers

Technological advances are yet to significantly disrupt value chains in this sector. These are often long and potentially erode value to consumers in wholesale and retail general insurance.

> **Technology is changing the way consumers interact with insurance**

How the sector is changing: retail general insurance

General insurance – personal lines

Personal lines providers are facing increased calls for fairness in pricing. New technologies are improving customer experience in processes for applying and handling claims but there is still uncertainty over whether digital solutions will be able to reach all consumer groups or just the tech-savvy.

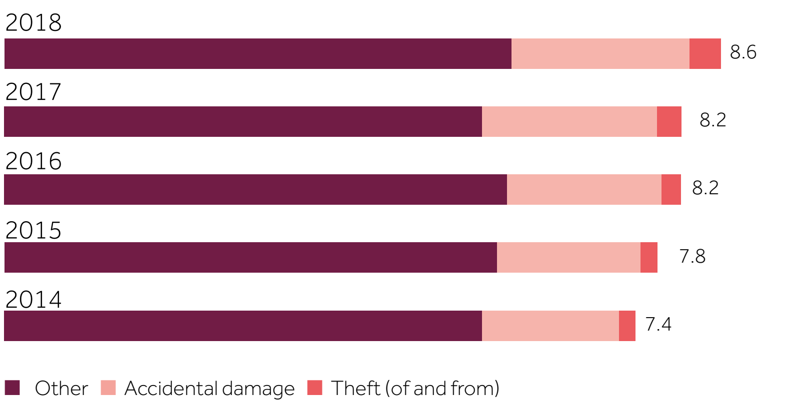
Home and motor insurance remain the largest markets while take-up of protection insurance lags behind

Home and motor insurance are often compulsory, as either a requirement for a mortgage or by law, so their market share is unsurprising. Compulsory insurances like these meet immediate needs, but there is lower take-up of protection products, which meet more long-term needs.

Home and motor insurance customers often pay a 'loyalty penalty'

In 2018 we launched a market study to look into the issue of firms offering a discount to new customers while increasing the premiums of existing customers year-on-year. In home insurance, as many as 2 in 3 customers pay a 'loyalty penalty' for staying with the same provider for over 5 years, paying as much as 70% more than new customers. Consumers aged over 65, on low incomes or with disabilities were more likely to be affected.[14] We found a less extreme but similar issue in the motor insurance market.

Figure 4.2: Motor claims costs (£bn)[15]



Some insurers in these markets have responded by launching products to address this issue by offering a single price to new and longstanding customers. It is unclear how consumers will respond to this development.

Premiums decrease despite claims costs increasing

Private car insurance premiums decreased for the first three quarters of 2018, with a £3 year-on-year reduction in the average premium.[16] The decrease in car insurance premiums could be partly driven by a change, in July 2019, to the Ogden rate, the discount rate used for personal injury claims. This change had been in the pipeline for some time although it was not as significant as expected when it came. The change means payouts in personal injury claims will be smaller going forward, but still larger than the market had planned for.[17]

Claims costs were up across the market for a variety of reasons. These include extreme weather in 2018 prompting more domestic property claims[18] a rise in car theft and increasing levels of technology in cars raising repair costs[19] and airline failures causing more cancellation claims.[20]

Consumers are increasingly using price comparison websites (PCWs)

Consumers are using the big 4 price comparison websites (PCWs) more than previous years. In 2017, the CMA investigated potential challenges to competition in the home insurance market. More recently, it launched another study into online platforms and the UK digital market to see how far these platforms have influence over the consumer and the market.[21] At the same time, PCWs are also affected by the implementation of the Insurance Distribution Directive, which requires more careful assessment of a customer's needs.

Ghost broking on the rise

Ghost broking, fraudsters selling fraudulent insurance by many different means, is an increasing trend. In 2018 the Insurance Fraud Enforcement Department (IFED, part of City of London Police), reported 850 reports of ghost broking to Action Fraud in the previous 3 years, which caused a total of £631,000 in customer losses.[22]

Changes in society are changing the insurance environment

Younger adults are less likely to have insurance at all. Home insurance take-up is lower partly because younger adults are struggling to get on the property ladder, creating less demand for buildings insurance and because many renters choose not to take out contents insurance.

New technology, together with a broader shift to a sharing and gig economy, is leading to the development of new products. Technological solutions are enabling faster application and claims processes as well as on-demand flexibility. On-demand products give flexibility through an easy on/off switch in a phone app. Similar usage-based products include motorists paying for cover based on the amount they drive and pay-per-day travel insurance.

UK is a good place for insurtech investment

The vast majority of insurtech products focus on personal lines. In 2018 UK insurtechs received over $1 billion in investment, up from $792 million in 2017, and a sixth of global insurtech deals.[23]

$1bn
invested in UK insurtechs[24]

How the sector is changing: protection

The protection products market continues to grow, but lags behind other personal lines insurance with only about 35% of UK adults having a protection product.[25] More sophisticated use of data in this sector can improve processes, but there is a risk that more personalised insurance products could exclude some consumers through higher premiums or denial of cover.

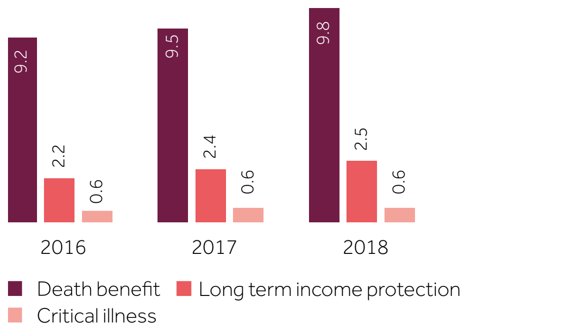
Protection

Protection policies meet the longer-term needs for financial protection for individuals and families in the event of death (whole-of-life and term assurance), illness (critical illness, income protection) or accident (personal accident).

Low levels of take-up but protection sector is growing

Life insurance is the most popular type of product for policies taken out by individuals. Individual and group protection sales are seeing growth across all policy types.[26]

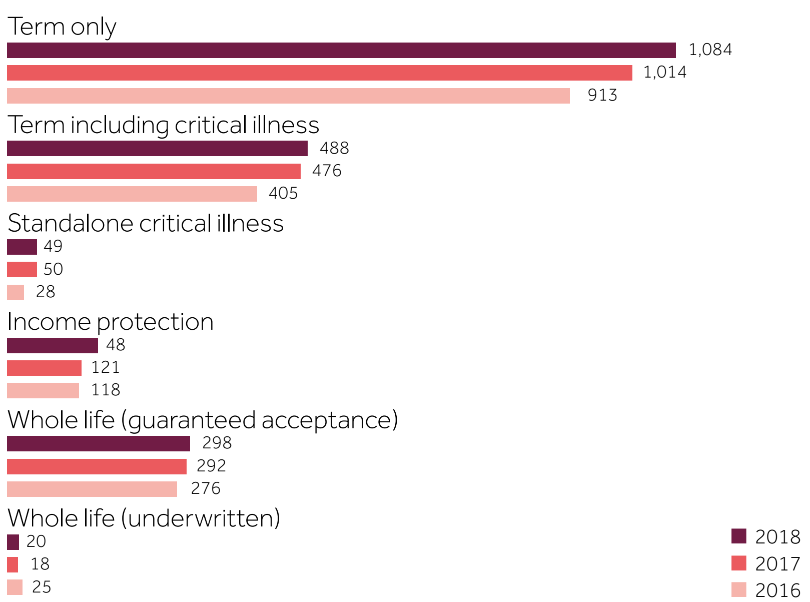
Figure 4.4: Group protection: number of people covered (m)[28]



However, only 35% of UK adults hold a protection product. This is about 15 million people,[29] compared to 17.6 million who hold phone, gadget and extended warranty insurance products in 2017.[30] Take-up is lowest for younger consumers under 35.[31] Renters and the self-employed are also less likely to have cover.

The reasons for lower take-up of protection products vary. They include consumers consciously choosing not to buy these products because of cost, behavioural biases including consumers underestimating the likelihood of having to claim and over-optimism about their financial resilience. A report commissioned by the Financial Services Consumer Panel found that the complexity of products makes people less likely to buy them. For example, because critical illness

Figure 4.3: Individual protection - new sales (000)[27]



products are easier to understand, consumers buy them more often than income protection products.[32]

Providers have tried to attract new customers by offering more flexible products, including income protection policies that only pay for a limited amount of time, and so can be up to 45% cheaper than a product that pays indefinitely.[33] They are also offering hybrid policies that combine features from life, critical illness, income protection and guaranteed acceptance plans, allowing consumers to take out a single policy rather than several.

Access to and availability of insurance for consumers with health conditions remains an issue

Access to travel insurance is a well-publicised issue, with 23% of customers with pre-existing medical conditions saying they faced inflated premiums.[34] There is also a lack of availability of products for consumers with mental health problems seeking income protection, where mental health related exclusions often leave them with no options.

Advances in the use of data has advantages and disadvantages

More effective data use can help insurers and brokers improve their processes, both at the point of underwriting and at the point of claiming. Developments in biometrics and genetic testing are particularly relevant in protection. They could lead to a much higher level of understanding of an individual's risk characteristics. This could, however, result in the reduction of risk-pooling across customer groups and make insurance unaffordable or inaccessible to many.

General insurance and protection – Small and Medium-sized Enterprise (SME) lines

SME lines grow with inflation

The SME insurance market grew 1.4% in 2017 to £7.8 billion.[35] Public liability remains the most frequently purchased commercial insurance product, with 75.3% of SMEs buying cover in 2018. This was followed by employers' liability (63.4%) and property insurance (63.1%).[36]

Like personal lines, SMEs are increasingly using price comparison websites (PCWs), while the likelihood of using a broker increases with the size of the firm. Brokers remain the most popular channel with 44.8% of policies bought this way. This is followed by direct to insurer (25.9%), PCWs (15.5%) and banks (13.8%).[37]

Insurers need to have a good understanding of the needs of their SME clients. The increasing diversification and number of SMEs means there is a growing role for the Demands and Needs document, which stipulates individual insurance requirements for customers. This is as true across the wholesale insurance market as it is to SMEs.

How the sector is changing: wholesale and cross-sector

Non-financial misconduct in the London Market poses risks to market integrity and raises questions about its ability to tackle inappropriate financial conduct. This could affect recruitment and attraction of staff. Deloitte found that a positive culture is one of the two most likely traits to attract and retain Millennials and Gen Z staff.[38] Poor culture has an impact on wider society by reducing the appeal of the London Market to a diverse group of people and reduces trust in financial services. Additionally, slow modernisation through technological solutions is resulting in high costs. Across the sector, acquisition is trending as a way to obtain technology.

Wholesale

Wholesale is a term that describes the London Insurance Market and related bodies that participate in underwriting of large-scale, complex commercial and specialty risk. This includes the Lloyd's of London marketplace.

> **Access to and availability of insurance for consumers with health conditions remains an issue**

London Market – global leader today but what in the future?

The London Market remains the leading global insurance hub, due to its extensive expertise and the diverse set of client needs it services.

The future of its prime position is, however, being challenged as many clients see it as more expensive than non-London alternatives. This view is reinforced by the market's slow adoption of technological solutions to reduce high expense ratios and some complex distribution chains that do not contribute to the value of the product.[39]

Maintaining London's competitiveness is not one of our objectives, but ensuring a well-functioning market is. And a well-functioning market is characterised by a competitive and sustainable business model.

We are seeing a trend in legacy books (where no new policies are sold) with 'long-tail claims' (where claims could be made years after the policy was taken out) being sold to run-off specialist companies. Some of these companies are new entrants and often have less diversified investments than their 'traditional' insurer counterparts. This could make them more exposed to extreme shocks to the market which could affect their ability to pay out on claims. These transfers may also present risks in the form of data loss or unauthorised access to the records.

Inefficiencies in the London market make it expensive and highlight the need for modernisation

The London Market's operational expense ratio makes it expensive. In 2014 it was reported to be 9% higher than similar global insurance centres.[40] Lloyd's stated this is still the case for the Lloyd's market, which is a significant proportion of the overall London market, as highlighted in the recent 'The Future at Lloyd's' prospectus. The prospectus also shows that Lloyd's operating expenses are about the same as in 1990.[41] There are efforts to improve expense ratios both in Lloyd's, and the wider London market, but questions remain about whether enough is being done to address the issue. One of the initiatives

Lloyd's will be introducing to tackle costs and modernise the operation of the Lloyd's market is developing 2 electronic risk placement platforms for complex and standardised risk placements.

Poor culture remains a concern in wholesale insurance

71% of insurance professionals believe that culture needs to change.[42] Both the London Market Group, a market-wide body of specialists from the London insurance market, and Lloyd's recognise that poor culture is a barrier to attracting and keeping talent for a market that is facing complex global challenges.[43]

Non-financial misconduct raises questions about the London Market's ability to identify and challenge poor financial conduct, such as managing conflicts of interest. It also poses a threat to market integrity if it affects the image of and trust in the sector.

To improve culture there is a need for leaders to create a culture of understanding that recognises the views of all employees. Whistleblowing can act as one channel in some cases. In November 2019, Lloyd's announced new measures to tackle this culture with their 'Speak Up' Campaign which includes a new support phone line for staff in the Lloyd's marketplace.[44]

Significant cross-sector developments

Capital provision through insurance linked securities (ILS) is increasing

The insurance sector can access capital from alternative sources, such as catastrophe bonds, equity investment, and more recently, insurance linked securities (ILS). This creates benefits to the sector as it may lower the cost of capital.

ILS are becoming more established. They are an efficient way to reinsure large portions of risk and can have specific capital requirements benefits under Solvency II. As they are linked to insured losses, they are not normally correlated with the general financial market, making them attractive to investors who want to diversify risk.

Desire for cross-border assets and strategic acquisition of technology drives consolidation

Globally, 71% of insurance executives say they will actively pursue mergers and/or acquisitions in the coming year, as they look for assets to address technology, convergence and activist shareholders. Three quarters of those pursuing M&A say they will be targeting cross-border assets.[45] This may create better adoption of technology and innovation from which consumers may benefit. At the same time, risks could come from several areas, such as reduced competition.

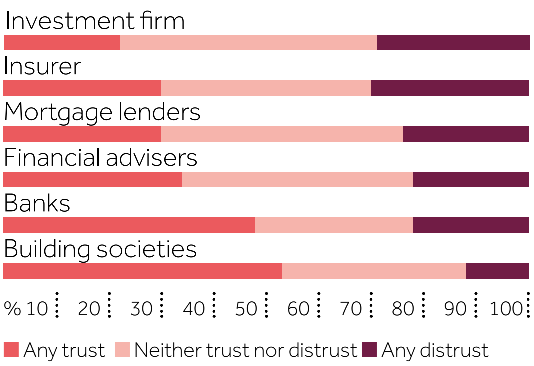
Consumer perspective

This sector is associated with the lowest levels of consumer trust among financial services, with 30% of customers reporting mistrust. Misleading terms and conditions and unclear content are the primary reasons for lack of trust. Low understanding of the product leads to many people opting out of insurance, especially protection products.

Consumer trust in insurers is low

Trust in insurers is significantly less than in banks and building societies. The main reason for distrust was misleading terms and conditions (53%). Unclear content was the second most common factor (34%).[46]

Figure 4.5: Consumer trust by financial institutional type (%)[47]



Trust in price comparison websites (PCWs) is even lower, despite rising from 15% to 20% in the year to December 2018. Customers over 65 are less positive about this channel.[48]

Unfair pricing has received a lot of public attention, with 90% of consumers saying that the 'loyalty penalty' is unfair.[49] Many consumers with pre-existing medical conditions say they have been discriminated against and have had to pay more for cover or been denied travel insurance altogether, while just 30% of motor customers think insurers can be trusted to pay out fairly on claims.[50]

90%
of consumers say loyalty penalty is unfair[51]

Price dominates decision-making in home and motor

Price is the main driver when choosing a motor (83%) or home (76%) insurance provider – only 15% of motor and 14% of home customers chose a provider based on the features of the policy.[52, 53] Standardised policies and limited differentiation contribute to this focus on price, as other product features can be difficult to distinguish. Compulsory requirements for motor and many home contracts also mean that many choose the lowest price regardless of what else the product offers.

In protection products, consumers are often able to choose what level of cover they would like which decides the premium. 45% of customers chose a provider based on price and 37% on level of cover or policy features.[54] The difference here possibly explains the fact that protection is often bought out of choice rather than necessity, unlike motor insurance.

Insurance policies remain unclear and consumers have mixed knowledge and understanding of policies

Insurance remains an opaque product although 84% of customers with home insurance say it covers everything they need, indicating a high level of confidence in the product.[55] Just 33% of motor policyholders, however, agree insurers make it easy to understand policies and renewal quotes.[56] A separate report indicates that 10% of motor customers do not know who they are insured with.[57]

Almost half of income protection customers (47%) find policies hard to understand, with Millennials the most likely to admit lack of understanding of income protection.[58] Employers also struggle to understand policies, as 45% are unaware of the payout terms of group life policies.[59]

Complexity is an issue across the sector. 55% of those without life insurance said that simple, low cost cover would be the benefit that would most encourage them to take it out.[60] 89% of SME customers also value simple, clear and concise policy information the most.[61]

SME loyalty higher than for personal insurance lines

Over 53% of motor insurance customers have been with their provider for longer than 2 years.[62] Only 30% of home insurance customers say they feel loyal to their provider and 58% say they feel they need to switch each year to get the best deal.[63] This is unsurprising, given that new policies are often priced as much as 30% below the actual cost of provision while longstanding customers pay as much as twice the price for new customers.[64]

Unlike personal lines, loyalty among SME customers is high. Over 80% renew with their existing provider, with larger commercial customers the most likely to remain loyal.[65] This could be explained by the many different types of products that SMEs buy.

Importance of digital as a key channel to access insurance is growing

Accessing insurance online is increasingly important to consumers, with 75% of new motor, 67% of new home and 68% of new non-advised life polices arranged this way.[66, 67, 68]

59% of survey respondents said they would prefer to manage their home policy, including claims, online. This rises to 67% for those aged between 18 and 44.[69]

The higher tendency for SMEs to remain with their provider means online purchases (39%) are lower than in other markets.[70]

75%
of new motor policies are arranged online[71]

Endnotes

1. FCA, Market Study 18/1: General insurance pricing practices market study
2. FCA, Evaluation Paper 19/1: An evaluation of our general insurance renewal transparency intervention
3. FCA, Market Study 18/1: General insurance pricing practices market study
4. Ibid
5. FCA, Evaluation Paper 19/1: An evaluation of our general insurance renewal transparency intervention
6. FCA, Thematic Review 19/2: General insurance distribution chain
7. FCA, Financial Lives Survey, 2017
8. National Audit Office, Vulnerable consumers in regulated industries, 31 March 2017
9. Ibid
10. FCA, Financial Lives Survey, 2017
11. 2017 research by Dive In – global festival for diversity and inclusion in the insurance sector
12. Department of Health & Social Care, 2010 to 2015 government policy: long term health conditions
13. Age UK, Later life in the United Kingdom, April 2017
14. Citizens Advice, 'The insurance loyalty penalty Unfair pricing in the home insurance market'
15. ABI, Quarterly Motor Statistics, November 2019
16. ABI, Quarterly Motor Premium Tracker, March 2019
17. ABI, Open Letter 'Discount Rate Impact Assessment "misleading and wholly disingenuous"', July 2019
18. ABI, Property Claims, January 2019
19. ABI, Quarterly Motor Premium Tracker, March 2019
20. ABI, Travel Insurance Data, December 2018
21. Competition and Markets Authority, Online platforms and digital advertising market study, Launched July 2019
22. City of London Police, The Insurance Fraud Enforcement Department (IFED), 'Cost of car insurance fraud to victims revealed in new police campaign', 05 February 2018
23. KPMG, 'UK insurtech bucks the global trend, attracting $1bn of investment in 2018', 15 February 2019
24. Ibid
25. FCA Financial Lives Survey, 2017
26. Swiss Re, Term & Health Watch 2018
27. Swiss Re, Term & Health Watch 2019
28. Swiss Re, Group Watch 2019
29. FCA, Financial Lives Survey, 2017
30. ABI, Detailed Analysis of General Insurance, November 2018
31. FCA, Financial Lives Survey, 2017
32. Financial Services Consumer Panel / Bdifferent, Understanding the protection gap in the UK, April 2018
33. Swiss Re, Term & Health Watch 2019
34. Which?, 'The travel Insurance Lottery', March 2019
35. GlobalData, UK SME Insurance: Market Dynamics and Opportunities 2018
36. Global Data, UK SME Insurance: Distribution Dynamics 2018
37. Ibid
38. Deloitte, 2018 Deloitte Millennial Survey
39. rtimis.bm, Business as usual is not sustainable, says Lloyd's Chairman, 21 March 2018
40. London Market Group and Boston Consulting Group, London Matters, November 2014
41. Lloyd's, The Future at Lloyd's Prospectus, September 2019
42. 2017 research by Dive In – global festival for diversity and inclusion in the insurance sector
43. Lloyd's, 'Lloyd's announces signature actions to drive cultural change', 24 September 2019
44. Ibid
45. EY, Insurance Global Capital Confidence Barometer, January 2019
46. Mintel, 'The Role Of Trust In Financial Services UK,' October 2018
47. Mintel, 'The Role Of Trust In Financial Services UK,' October 2018
48. Ipsos Mori, Financial Research Survey – Motor Insurance, Dec 2018
49. Citizens Advice, 'Excessive prices for disengaged consumers', 28 September 2018
50. Mintel, Motor Insurance UK, March 2019
51. Citizens Advice, 'Excessive prices for disengaged consumers.' 28 September 2018
52. Ipsos Mori, Financial Research Survey – Motor Insurance, December 2018
53. Ipsos Mori, Financial Research Survey – Home Insurance, December 2018
54. Ipsos Mori, Financial Research Survey – Life Insurance, December 2018
55. Mintel, Home Insurance UK, December 2019
56. Mintel, Motor Insurance UK, March 2019
57. Ipsos Mori, Financial Research Survey – Motor Insurance, December 2018
58. Mintel, Income Protection UK, March 2019
59. Cover Magazine, 'Employers 'do not accurately' understand group life policies – GRiD', 7 August 2018
60. Mintel, Term Assurance UK, March 2019
61. GlobalData, UK SME Insurance: Distribution Dynamics 2018
62. Ipsos Mori, Financial Research Survey – Motor Insurance, December 2018
63. Mintel, Home Insurance UK, December 2018
64. FCA, Thematic Review 18/4: Pricing practices in the retail general insurance sector: Household insurance
65. GlobalData, UK SME Insurance: Distribution Dynamics 2018
66. Ipsos Mori, Financial Research Survey – Motor Insurance, December 2018
67. Ipsos Mori, Financial Research Survey – Home Insurance, December 2018
68. Ipsos Mori, Financial Research Survey – Life Insurance, December 2018
69. Mintel, Home Insurance UK, December 2018
70. GlobalData, UK SME Insurance: Distribution Dynamics 2018
71. Ipsos Mori, Financial Research Survey – Motor Insurance, December 2018

Pensions savings and retirement income

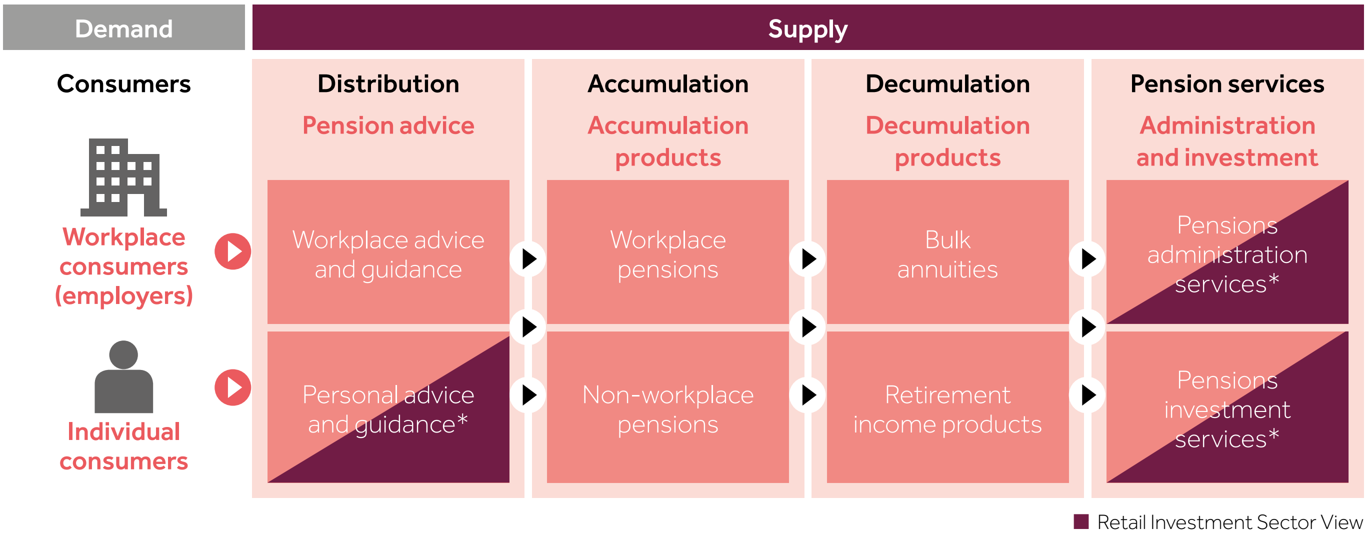
Introduction

The pensions savings and retirement Income sector covers all workplace, non-workplace and retirement income products. It also covers pension advice, guidance services and pension administration services. There are currently £2.8 trillion assets under management in the sector, held by over 35 million consumers.

The past year has seen several major policy changes. In accumulation (saving into a pension), the minimum contributions for auto-enrolment (AE) have been raised to 8% and The Pensions Regulator (TPR) introduced its new master trust authorisation regime. In decumulation (using pension savings), a key policy change in 2019 was our proposal to introduce investment pathways to help consumers who do not get advice make their drawdown choices, following our final report on our Retirement Outcomes Review.

Key issues causing consumer harm include unsuitable advice, the sale of unsuitable products, poor value across the value chain and pension scams. The retirement income market is a key area of our focus, particularly the suitability of both products and advice as the industry adapts to pension freedoms. From a wider perspective, the prospect that consumers may not get a retirement income that meets their needs or expectations remains the central challenge.

Figure 5.1: Overview of the pensions savings and retirement income sector



Accumulation, 2018

£197bn
assets held or invested in contract-based defined contribution workplace pensions[1]
▲ 10% 2018 vs 2017

£1,774bn
other assets held or invested in workplace pensions[2]

20m
workplace pension consumers[3]

£420bn
non-workplace pensions savings market[4]

6-10m
non-workplace pension consumers[5]

Decumulation, 2018

£297bn
assets backing annuities[6]
► 0% 2018 vs 2017

£116bn
assets held or invested in drawdown[7]
▲ 22% 2018 vs 2017

9m
retirement income consumers[8]

1. Broadridge, UK DC & RI Market Intelligence 2018.
2. Broadridge, UK DC & RI Market Intelligence 2017 and PPF, The Purple Book 2018.
3. FCA estimate based on Annual Survey of Hours and Earnings (ASHE) and Labour Force Survey (LFS) from ONS, 2018.
4. FCA estimate based on FCA, Retirement Income Data, 2017 and Broadridge, UK & RI Market Intelligence 2018.
5. FCA estimate based on FCA, Financial Lives Survey, 2017 and Mintel, Personal Pensions, 2017.
6. Broadridge, UK DC & RI Market Intelligence 2018.
7. FCA, Retirement Income Data, 2018.
8. FCA, Financial Lives Survey, 2017.

What we found on harm

Consumers risk lower living standards in retirement due to inadequate savings and the removal of defined benefit (DB) schemes

The prospect that consumers may not get a retirement income that meets their needs or expectations remains the central harm for the sector. Many of the main causes of this harm lie outside our remit. For example, the level of mandatory minimum contributions employers and employees are required to make in auto-enrolled schemes is set by the Department for Work and Pensions (DWP) and tax incentives to save are the Treasury's responsibility. Pensions and Lifetime Savings Association (PLSA) forecasts suggest that current minimum contributions are insufficient for most consumers to maintain similar living standards in retirement.[1] However, we are working with TPR and the Money and Pensions Service (MAPS) to address low levels of consumer engagement, improve consumers' experience and value for money.

15.1 million UK adults are not retired and are currently not saving into a pension[2]

The vast majority of UK adults saving into a pension have a greater than **60%** chance of seeing their living standards fall significantly when they retire[3]

Unsuitable defined benefit (DB) to defined contribution (DC) transfers and retirement income advice see consumers give up valuable guarantees and take on significant risks

Unsuitable DB-DC transfers remain a significant source of harm. The cost of getting this wrong can be very high, as consumers are giving up valuable guarantees and must then manage longevity and investment risks on their own. We have also identified the potential for significant harm from unsuitable retirement income advice.

Unsuitable non-workplace pensions (NWP) products make effective comparisons harder and give consumers features they are unlikely to need at extra expense

In accumulation, potential harm exists when consumers invest in pensions product wrappers, such as Self-Invested Personal Pensions (SIPPs), that are overly complex and include fees for services they are unlikely to need.

Unsuitable retirement income products give consumers difficult investment decisions and expose them to risk of significant investment losses

Since the introduction of Pensions Freedoms, more consumers are entering drawdown and having to make complex investment decisions. Unsuitable products or investment choices can cause significant consumer harm.

Unsuitable transfers out of DB schemes could, collectively, result in losses of up to **£20 billion** worth of guarantees over 5 years[4]

Consumers making unsuitable product choices in retirement could also, collectively, lose **£20 billion** from unsuitable investment strategies over 5 years[5]

Poor value products or services in non-workplace pensions and retirement income erode both savings and the chances of having an adequate retirement income

In NWPs and retirement income products, consumers often face a choice between products with complex features and unclear charging structures. This makes it hard for even the most informed consumers to effectively assess value for money. To help address this we are working with TPR to enable Independent Governance Committees (IGCs) and trustees to develop a more systematic way to assess and drive value for money.

More than **15 million** consumers of non-workplace pensions and retirement income products could be affected by poor value pension products[6]

The compound effect of high charges could lead to consumers' benefits being reduced by more than **£40 billion** over five years[7]

Pension scams are robbing consumers of their lifetime savings

Pension scams continue to be both a cause of significant consumer harm to victims and a threat to wider consumer confidence and market integrity. Our ScamSmart campaign has used TV, radio and online advertising to give consumers the warning signs to help spot when a proposed investment or pensions opportunity is a scam.

Consumers who are scammed lose an average of **22 years'** pension savings or £82,000[8]

More than £5bn over 5 years could be lost by consumers fully cashing in their pension at retirement and reinvesting it. This cost comes from increased tax penalties, reduced tax relief and missed employer contributions[9]

Lack of confidence is causing consumers to opt out of the pension sector

High profile failures of defined benefit (DB) pension schemes, changing pensions legislation and platform or administration failures can undermine consumer confidence in the pension savings market. This can lead consumers to opt out of pensions savings or to cash in their pension, even when it is not in their interest to do so.

Unregulated markets beyond our perimeter are a cause of concern

Advisers to employers about workplace pensions and some third-party service providers operate outside our regulatory perimeter. Both are a potential source of significant consumer harm. For instance, the workplace advice market is currently unregulated and smaller employers may end up getting unsuitable advice on which pension scheme to choose for their employees. Market concentration in relatively few third-party service providers could also lead to poor value due to a lack of competition, resulting in higher consumer charges or poor service.

The UK can learn lessons from Australia's more mature defined contribution market

The Australian DC Superannuation experience offers us insights into how a more mature DC workplace market may evolve. The Australian Royal Commission has identified several harms with the Australian system which could also emerge in the UK in time:

- cost savings from economies of scale in providing and managing Superannuation funds not being passed on to consumers
- poorly governed investments in alternative asset classes, leading to lower investment returns
- high costs associated with the proliferation of small pots, created each time a worker changes jobs

Between **4-5 million** new pots could be created every year as auto-enrolment means workers who switch employer start new pensions and old pensions are not automatically consolidated[10]

A typical Australian full-time worker was 6% ($51,000) worse off at retirement due to the higher collective administration costs of having multiple pots[11]

What is driving change

There have been major accumulation policy changes in the past year, including the increase in automatic enrolment (AE) minimum contributions and the TPR's master trust authorisation framework. Strong nominal wage growth may have helped keep AE opt-outs low despite some households being financially stretched. Pension freedoms continue to shape decumulation. We have proposed investment pathways to support non-advised consumers' drawdown choices.

Economy

The nominal annual growth of average weekly pay in the UK was 3.6% in September 2019, maintaining a recent 10-year high

If this trend continues, it could allow consumers to start improving their saving rates. However, household borrowing levels remain high so consumers may have more urgent financial issues to tackle before savings. Initial analysis showed AE opt-out rates did not materially increase after the first increase in contributions in April 2018, possibly because of wage growth.

Despite a modest rise in the Bank of England base rate to 0.75% in 2018, interest rates remain close to historic lows

This continues to limit income from annuities, reduce returns in 'safer' asset classes and increase the attraction of high risk investments and scams. Stock market falls could leave consumers with significant investment losses. Consumers in drawdown could be forced to reduce their withdrawal rates and live with less or risk running out of money if they continue to withdraw at current rates.

Policy and regulation

In April 2019 auto-enrolment (AE) minimum contributions rose from 5% to 8% of qualifying earnings

This meant an increase in employee contributions from 3% to 5% and employer contributions from 2% to 3%.

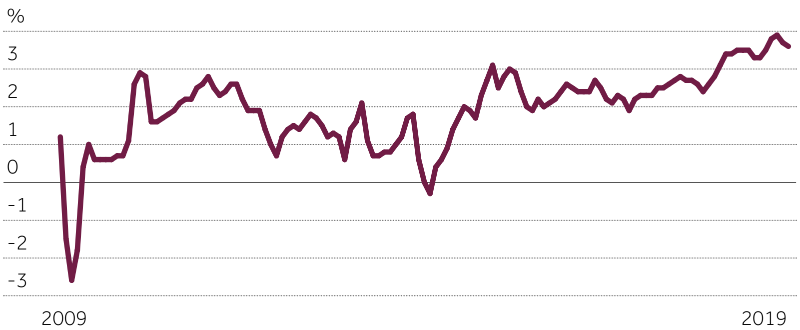
Pension freedoms continue to be a key driver of change in the sector

The trend for consumers choosing to enter drawdown or cash in their pension rather than buy an annuity continues. Our proposal to introduce investment pathways is designed to support non-advised consumers' drawdown choices.

In 2018 the FCA and TPR, published a joint pensions regulatory strategy to tackle key pension risks in the next 5-10 years

As well as announcing joint work in areas such as reviewing the consumer pension journey and driving value for money in pensions, the strategy also laid the ground for closer

Figure 5.2: UK weekly average earnings growth (year on year %)[12]



strategic co-operation between the two regulators.

2018/19 also saw TPR's continued roll out of its new master trust regulation framework

In April 2019 the TPR reported they had authorised 5 schemes and had 29 applications submitted for authorisation with a decision pending. By November 2019, 31 schemes had been authorised with a further 8 awaiting responses to their applications.

The Work and Pensions Select Committee (WPSC) launched an inquiry into advisers' contingent charging models and the maturing AE market

We have consulted on rule changes to contingent charging for DB-DC transfer advice. The auto-enrolment inquiry examined the adequacy of current contribution rates, lowering the AE age limit from 22 to 18 and removing the £10,000 lower earnings limit. It also explored whether AE should include self-employed workers and the impact and cost that implementing AE is having on small and micro-employers. DWP has promised to review the rules for auto-enrolment after evaluating the effects of increasing mandatory contribution levels.

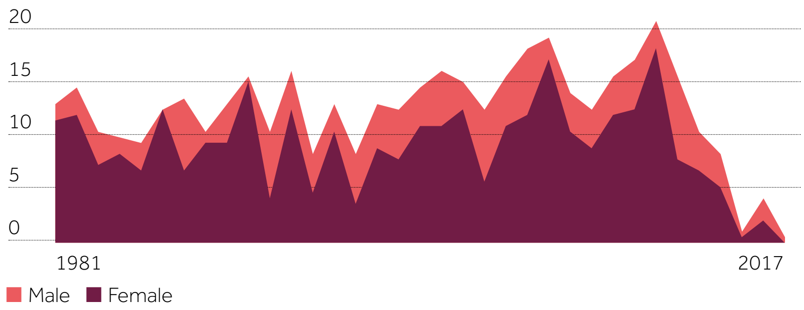
Consumers and society

Our Discussion Paper on intergenerational differences shows a widening wealth gap

All groups under the age of 60 have accumulated less wealth than those of the same age 10 years earlier. Those over 60 have accumulated significantly more. The paper identifies 4 main socio-economic trends to explain this:

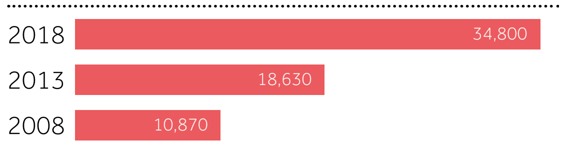
- **Demographic change:** the post-war 'baby boom' and decades of rising life expectancy mean a growing share of the population is at or above traditional retirement age. The real cost of retirement provision has grown significantly and the size and volatility of actuarial provisioning has made funding growing DB scheme liabilities a difficult ongoing problem for employers to manage. Most DB schemes have now closed to new members and future accrual and pension savings accumulation has increasingly become the responsibility of the individual. Recent data suggests the trend for increasing life expectancy may be slowing down or even reversing.

Figure 5.3: Annual change in life expectancy at birth in weeks[13]



- **Increasing house prices:** lower rates of home ownership and higher rates of private renting are likely to prevent many younger consumers accumulating wealth through housing equity. Over the past decade the number of households living in private rented accommodation has increased by around 63%.[14] This could increase the amount that consumers need to save to cover renting costs in retirement. In comparison, a large number of retired homeowners have paid off their mortgage and face lower living costs as a result. In addition, for those that do buy a house, real house prices are not increasing as they have in the past.
- **Labour market developments:** the average retirement age has increased for both men and women over the past 20 years. There has also been significant growth in less secure forms of employment. From 2010-2017 the number of self-employed UK adults increased by 20%, with the proportion of self-employed people who work part-time rising by 42%.[15] These workers are largely not covered by auto-enrolment and could face a substantial pension savings shortfall.
- **Growth of student debt:** growing participation in higher education has driven higher levels of student debt, potentially making it hard for today's younger generations to build up savings compared to previous generations.

Figure 5.4: Average student loan balance on entry into repayment cohort (£)[16]



Technology

Pensions dashboard development a key pension technology trend in 2018-19

In December 2018 the Department for Work and Pensions (DWP) confirmed that the project will be industry-led and will result in both industry dashboards and a non-commercial dashboard hosted by the Money and Pension Service (MAPS). The 2019-20 Pension Schemes Bill contained provisions to allow the creation of pensions dashboards.

Younger generations begin to demand more 'holistic' services leading to slow but steady progress in pensions technology

The supply of robo-supported/transactional pension advice is still limited. Meanwhile, PWC's 2018 Pension Technology Survey shows that while 68% of employers claim to be encouraging pension engagement, many are failing to invest in technology to enable this. For example, 30% do not provide online access. It also found that 53% of Millennials and 62% of Generation Z want holistic financial planning tools linked to their bank account, rather than standalone pension tools.[17]

Reliance on regulated advice has decreased over time as consumers make growing use of platforms

A growing proportion of non-workplace pensions are sold without regulated advice. In the period 1988 to 2012, 92% of accounts were advised at point of sale. Since then, the proportion of advised sales has dropped to 72%. A key driver of this has been advances in digital and platform technology offering easy online accounts and the 'do-it-yourself' nature of SIPPs.[18]

Our Pension TechSprint in November 2018 explored how technology can support pension consumers

8 teams competed for 4 prizes and follow-up workshops have since been held with 3 of the winners:

- DB Mag: an interactive information tool for users transferring their pension
- Pension Fit: an app aimed at helping improve consumers' financial wellbeing by promoting habit-forming activities that lead to a positive retirement
- T-Pot: a user-friendly tool to help individuals connect their retirement goals to their investment strategy

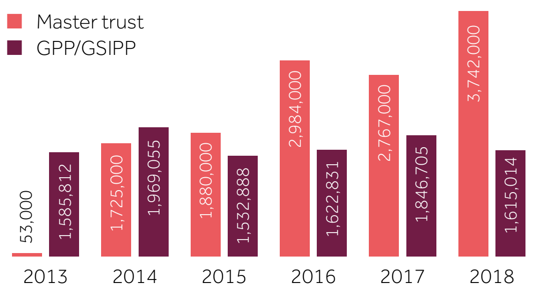
How the sector is changing: accumulation

The gap between new master trust memberships and contract-based workplace memberships widened in 2018, suggesting master trusts remain on course to be the main vehicle for mass market workplace pensions. There is little evidence so far of increased auto-enrolment opt-outs as a result of minimum contribution increases. Meanwhile evidence from our discussion paper on non-workplace pensions shows the market may be increasingly shifting from individual personal pensions (IPPs) to streamlined SIPPs.[19]

New master trust memberships continue to outstrip contract-based, and the gap is growing

In 2018-19 there were 13.9 million master trust memberships, and 25.6 million contract-based memberships, including non-workplace. However, at 3.8 million in 2018, new master trust memberships were more than double the number of group personal pensions (GPP) and group self-invested personal pensions (GSIPP) sales, which were 1.7 million. This suggests that master trusts remain on course to be the main vehicle for mass market workplace pensions.

Figure 5.5: Annual GPP sales vs annual change in master trust membership[20]



Potential proliferation of pension pots

As auto-enrolment staging has ended, a new normal is emerging. This suggests employee turnover and employer scheme switching is likely to result in 4-5 million new pension memberships annually.[21] Evidence from Australia suggests that, without ways to help consumers consolidate their pension pots, the cost of administrating multiple pots across the industry may end up costing consumers substantial amounts in higher charges.

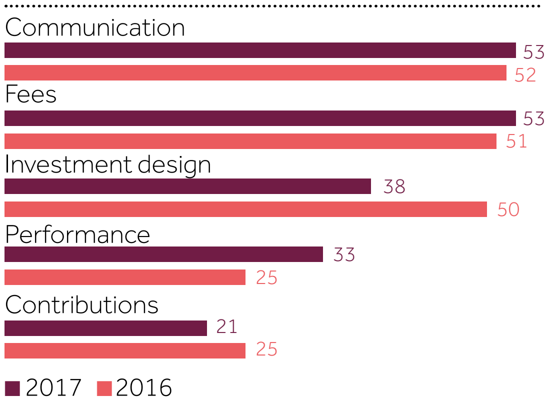
Auto-enrolment contribution level rises have yet to impact opt-out rates

Fears that the 2018 increase in minimum contribution rates could lead to increased consumer opt-outs from workplace pensions have, so far, not materialised. Opt-out rates following the increase in the AE minimum contributions from 1% to 3% for employees in April 2018 remained low, at around 9%.[22] It remains to be seen whether this will hold true for the subsequent increase to 5%, introduced in April 2019.

Providers grappling with consumer engagement

Low member engagement continues to be the main challenge for DC scheme trustees. Research published by Broadridge in 2018 showed that trustees selected communications and fees as the two most common defining features of a 'good' DC scheme. Meanwhile the evidence suggests providers are trying to implement more 'tactical' communications, timed to coincide with when members might be more ready to engage with their pensions (eg pay increases/bonuses).

Figure 5.6: Key features of a 'good' DC workplace scheme (%)[23]



Non-workplace pensions study shows a wide range of charges and difficulty in comparing costs between products

In 2018 we gathered detailed information about charges in NWPs. This showed a wide range of charges for all varieties of products. The research highlighted a lack of consistency in how charges are named, calculated and applied, which continues to hamper cost comparisons between products and providers. Our analysis was not designed to identify whether charges in this market were excessive but it did identify some instances where the charges may be higher than caps or benchmarks on other pension products. This creates the concern that some consumers' pensions are at risk of being invested in poor value products.

Providers setting up new non-workplace schemes seem to choose streamlined SIPPs over IPPs

Our non-workplace pension study also showed that individual personal pensions (IPPs) currently have the highest percentage of accounts (over 70%) and assets under management (50%). However, over the past five years over 40 new streamlined SIPP schemes have been started compared to just over 20 IPPs.[24]

Unsuitable SIPP investments are increasingly targeted by claims management companies (CMCs)

With the end of PPI claims, there is growing evidence that some CMCs are targeting SIPP operators for future claims. The Financial Ombudsman Service said complaints about SIPPs rose 86% to nearly 4,000 in 2018/19. 60% of these claims were for due diligence by providers and around two-thirds originated from claims managers, law firms or other third-parties.

▲ 86%
increase in Financial Ombudsman Service complaints about SIPPs 60% of these claims were for provider due diligence, and around two thirds of SIPP complaints originated from claims managers[25]

After years of rapid growth, the average size of newly opened personal pensions fell from £74,000 to £65,000

After 4 consecutive years of rapid increases, the average size of new personal pensions being opened fell in 2018.[26] This fall coincided with a slowdown in DB-DC transfers and an increase in the number of advised SIPPs being opened, often as a vehicle to access pension freedoms. Meanwhile the average size of pots moving from accumulation to decumulation and entering the retirement income market continued to increase.

How the sector is changing: decumulation

DB-DC transfer numbers stopped growing in the second half of 2018, subsequently dropping over the next six months. Meanwhile DC providers and advisers are focusing on the 'at-retirement' market to capitalise on large pots. Equity release and stocks and shares Individual Savings Accounts (ISAs) continue to grow as significant alternative sources of retirement income to traditional pensions. Our own intelligence suggests that levels of 'new' reported pension frauds are starting to fall.

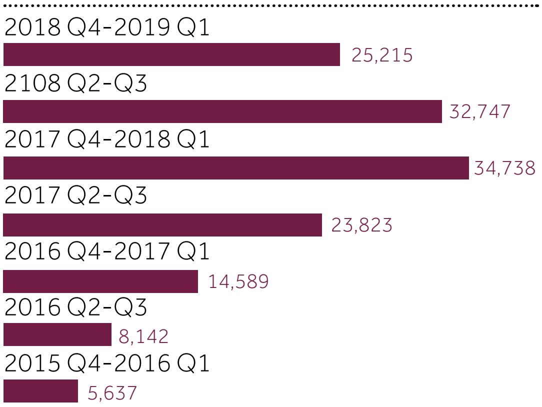
Introduction of investment pathways for non-advised drawdown consumers

Our Retirement Outcomes Review recommended the introduction of investment pathways for non-advised consumers. These changes will ensure non advised consumers will be able to choose their options based on their objectives for that money. The aim is to improve the choices of products consumers make when accessing their retirement savings through a drawdown wrapper.

After increasing rapidly, DB-DC transfer volumes have fallen

DB-DC transfer volumes fell in the 6 months to March 2019, down from 35,000 to March 2018 to only 25,000. Product sales data indicates that a substantial volume of assets continues to move from DB schemes into the non-workplace market. Our review of pension transfer advice found that 29% was unsuitable and 23% was unclear.[27]

Figure 5.7: DB-DC transfers[28]



Firms see the at-retirement market as a key opportunity

Research from Broadridge shows that competition for consumers and assets in the 'at-retirement' market has intensified. Providers and advisers are targeting consumers as they reach a point in their retirement journey when their pension pots are at a peak and workplace charge caps cease to apply.

Only 29% of non-advised drawdown customers pay below 0.75% (the workplace pension charge cap)[29]

Our survey of 7 non-advised drawdown providers showed a wide range of charges, with clustering around 1%. 6 had a median charge of over 0.75% and 3 of these were over 1%. We have committed to reviewing the market after investment pathways are introduced to assess the charges providers are applying.

Restricted adviser networks continue to increase their share of the non-workplace pension market

Some large adviser networks, which have their own products, continue to have a large share of the non-workplace pensions market by sales volume. When consumers take advice on retirement income products, these firms have been able to direct advised client assets to their own products. Traditional pension providers are responding to this challenge by creating their own in-house 'at-retirement' advice offerings.

Ongoing charging models for advice, especially in retirement, could lead to unsuitable choices

There is a clear trend for advised consumers to choose drawdown more often than annuities, compared to non-advised consumers. We have concerns that advisers may be recommending products with an ongoing advice requirement, potentially instead of more suitable options that do not have ongoing fees. This may be exacerbated by the consolidation of adviser firms, which has been a trend in the past few years. Consolidator valuations of advice firms are based on recurring revenue streams, which incentivises IFAs to recommend ongoing advice if they are planning to sell their business in the near future.

Our intelligence suggests a fall in new pension fraud cases, as fraud shifts to other retail investment wrappers

While the Pension Scams Industry Group (PSIG) described SIPPs as 'the scammers' vehicle of choice', our intelligence suggests that newer fraud cases are increasingly occurring outside the pension sector. This may indicate that higher awareness, driven by our joint ScamSmart campaign with TPR and our tighter supervision, are reducing scammers' ability to target pension consumers. But it could also indicate that scammers are identifying easier targets in consumers of other investment products.

The equity release market grew rapidly in 2018 with evidence that over 65s hold significant assets in stocks and shares ISAs

Consumers continue to use equity release and ISAs to supplement their retirement incomes. The value of equity release sales grew 35% to over £3.5 billion in 2018, while analysis from Broadridge suggests assets in stocks and shares ISAs exceed drawdown assets for older retirees.

Figure 5.8: value of equity release[30]

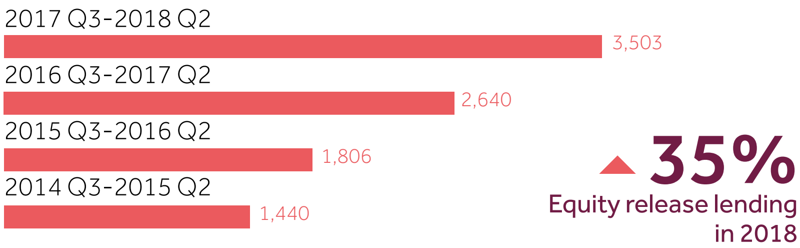
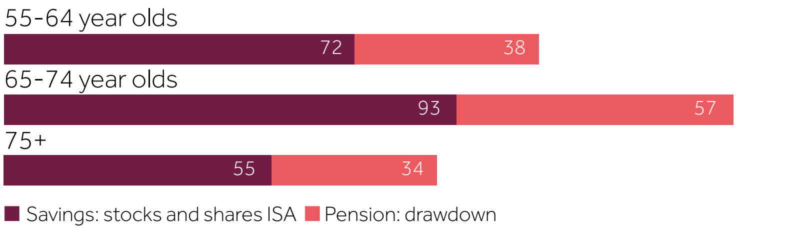


Figure 5.9: Estimate of assets (£bn) held by over 55s in drawdown vs stocks and shares ISAs (as at end 2017)[31]



How the sector is changing: ancillary pension 'services' markets and cross-cutting issues

Despite the move away from annuities, 38% of default lifestyle pension strategies still target annuity purchase.[32] Smaller employee benefit consultants (EBCs) have been the main beneficiaries of the auto-enrolment driven increase in demand for advice from smaller employers. Concerns remain about the concentration of third-party service providers, as well as over data quality and security, but reported operational resilience incidents remain low compared to other sectors.

38% of default strategies still target annuities

We analysed the strategies of 12 leading contract-based workplace providers. Our analysis showed that 60% of consumers were in defaults that targeted drawdown or a 'universal position' – a middle position to balance the potential that a consumer may enter drawdown or buy an annuity. However, 38% were still in default lifestyle strategies targeting annuities.This is high, given that current data suggest only 10-15% of consumers entering retirement choose an annuity.[33] This may result in a significant mismatch between DC workplace default strategies and the choices that consumers will make when they come to choose their retirement products.

The investment consultant/employee benefit consultant (EBC) market is seeing more competition from smaller EBCs and IFAs as the market grows to cover smaller employers

Large employers often rely heavily on their investment consultants when choosing DC schemes for their employees. While these employers often rely on the 'big three' investment consultants, demand for advice from smaller employers, driven by auto-enrolment, has led to growth in business for mid-level EBCs. However, the 2018 acquisition of one of these mid-level EBCs, JLT, by Mercer suggests the 'big three' may be beginning to expand their target market to include smaller employers.

Figure 5.10: Summary of default investment strategy lifestyle 'targets' for 12 leading DC workplace contract-based providers' lifestyle strategies[34]

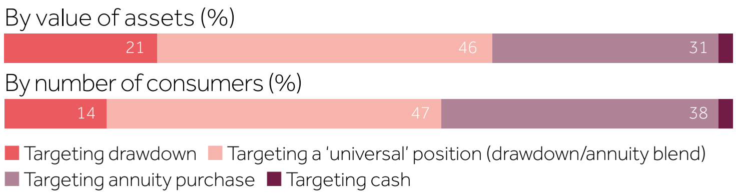
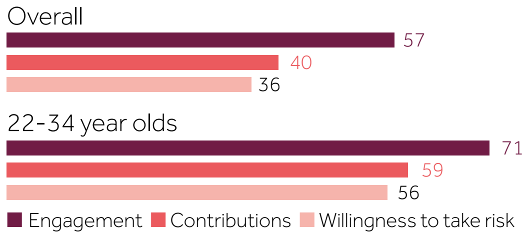


Figure 5.11: Percentage of members agreeing to engage, contribute or take more risk if pension savings are 'responsibly' invested[35]



Environmental, social and corporate governance (ESG) continues to make headlines in investment services

With rising concerns around climate change, the focus on ESG continued as a key theme in 2018. While a large number of funds have been launched, trustees remain sceptical of the level of consumer demand for ESG investments in pensions. Despite this scepticism, there is some evidence that ESG investments may increase engagement and be of particular appeal to younger pensions savers. Trustees' and governance committees' ability to implement good stewardship standards that ensure pension investment strategies consider ESG factors is also an area of concern.

Cost transparency is still a core regulatory objective

Cost transparency remains a key focus for both European and UK regulators. Pension products are exempt from the enhanced disclosure requirements of the Packaged Retail and Insurance-based Investment Products PRIIPs. But we have introduced enhanced disclosure requirements in retirement income products as part of our Retirement Outcomes Review remedies. Our non-workplace pensions study also found a wide range of charges and poor cost transparency disclosure. We are currently consulting on how the industry can address these issues in non-workplace pensions.

Concerns remain over concentration risks in the outsourced pensions administration services market

We continue to closely monitor this market, as the number of outsourced administration and technology providers remains limited and there is potential for further market consolidation.

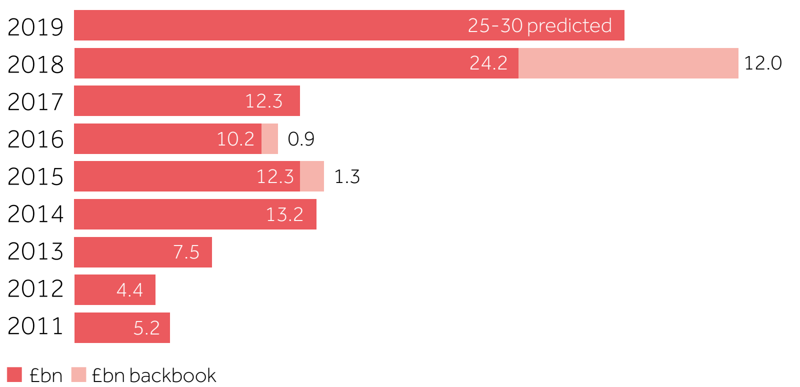
Data quality and security risks continue to exist in pensions

Both Aviva and Aegon had significant difficulties with re-platforming projects in 2018. Security incidents in pensions, however, remain low when compared to sectors such as retail banking. Potential future risks for the sector may increase as firms upgrade their technology. Our cyber and technology resilience report recently highlighted poor change management of IT projects as the biggest cause of pension service outages.

2018 was a record-breaking year for bulk annuities

2018 was the first year that over £20 billion of bulk annuity transactions were made, nearly doubling 2017 values. Record equity release sales values may have given reinsurers more assets to match liabilities against, potentially allowing them to improve bulk annuity pricing. The trend of increasing life expectancies also reversed this year. This, combined with good investment performance and improved pricing levels meant FTSE100 firms saw affordability of buy-outs improve by over 10% from 2016 to 2018. Buy-outs are where the scheme transfers liability to the insurer and removes the employer/sponsor responsibility for the pension. Backbook transactions, where a reinsurer buys another provider's outstanding business, were also high in 2018.

Figure 5.12: Bulk annuities (£bn)[36]



Consumer perspective

Our consumer research shows low consumer engagement is just as much a problem in non-workplace pensions as in workplace pensions. Consumers are slow to identify pension problems and tend to complain only after bad headlines. Retirement income provider switching rates are up, but remain below those of other sectors.

Consumers who set up non-workplace pensions (NWPs) are disengaged

While low levels of consumer engagement are a longstanding issue in workplace pensions, this is also a problem in NWPs. MG consumer research in 2018, undertaken as part of our NWP study, shows that around two-thirds of consumers who set up non-workplace pensions do not continue to engage after setting them up.[37]

Low financial capability was found to be a driver of low consumer engagement

This research found that consumer engagement is driven by several factors including strength and clarity of need for a non-workplace pension, their understanding of its benefits, financial capability and use of financial advisers.

> **Engagement is highest when a strong need and drive to plan for the future is evident, financial capability is high and the benefits of pension saving are clear**[38]
>
> NWP consumer research

Consumers who do take advice to set up their own pensions often disengage over time

Advised respondents who took transactional (one-off) advice several years ago to establish their NWP are rarely engaged. Many have since had no contact with their adviser. Engagement can also be low among ongoing advised respondents who delegate all decision-making to their adviser. The research demonstrates that measuring the levels of take-up of advice is not sufficient to determine levels of consumer engagement. This means that higher levels of advice in non-workplace pensions are not an indication that consumers are more engaged or more sophisticated investors in this market.

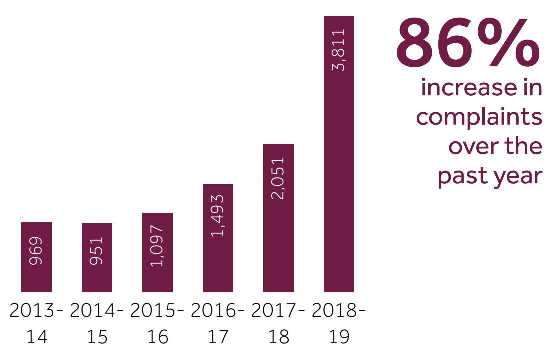
Financial Ombudsman Service complaints data shows a sustained increase in SIPP complaints

There has been an 86% increase in open Financial Ombudsman Service complaints about SIPPs in H2 2018 compared to H2 2017. Overall SIPP complaints have a comparatively high uphold rate of 61%. Income drawdown products also show a 36% year-on-year increase and have a 52% uphold rate, albeit from a much lower starting volume.[39]

Despite this upward trend, overall complaint volumes for pensions remain low

Consumer complaint levels are comparatively low in pensions, at around 2.9 complaints per 1,000 accounts.This compares to an average of 6.3 complaints per 1,000 accounts for retail banking products. Complaints about advising, selling and arranging pensions have fallen from over 40,000 a year to around 10,000 a year. When consumers do complain, their complaints are upheld at a high rate (62%), which is higher than all other sectors. This could indicate poor historic treatment or poor record-keeping means firms cannot effectively contest complaints. Most complaints opened in H2 2018 are about general administration/customer service, accounting for 68% of all complaints in 2018 H2. £37 million of redress was paid to consumers in 2018 H2, up from £20 million this time last year, with over £23 million paid to consumers with non-workplace pensions.[40]

Figure 5.13: New Financial Ombudsman Service complaints cases about SIPPs[41]



The proportion of consumers switching provider at retirement has increased slightly for both annuities and drawdown

This increase is notable for annuities, where consumers have increasingly taken an annuity without taking advice. This perhaps indicates that the annuity information prompts, a requirement since March 2018, have had some impact in increasing consumers' tendency to shop around. However, most consumers still do not switch provider at retirement even though this could often significantly increase their retirement income. Low switching rates suggest that shopping around is lower than in most other sectors. For example, 71% and 67% of customers report shopping around for their Cash ISA and credit card provider respectively in Financial Lives.[42]

Figure 5.14: Percentage of consumers who switch provider when selecting their retirement income product (%)[43]

Endnotes

1. PLSA, Retirement Income Adequacy: Generation By Generation, 2016
2. FCA, Financial Lives Survey, 2017
3. PLSA, Retirement Income Adequacy: Generation By Generation, 2016
4. FCA estimate based on FCA Retirement Income Data, 2019
5. FCA estimate based on FCA Retirement Outcomes Review, 2017
6. FCA, Financial Lives Survey, 2017
7. FCA estimate based on FCA Effective competition in non-workplace pensions, 2019; FCA Retirement Outcomes Review, 2017
8. FCA/TPR Scamsmart campaign, 2019
9. FCA estimate based on FCA Retirement Outcomes Review, July 2017
10. FCA estimate based on FCA product sales data 2019; ONS Labour Market Overview 2019
11. Australian Productivity Commission, Superannuation: Assessing Efficiency and Competitiveness, 2018
12. ONS, Wages and salaries annual growth rate, 2019
13. ONS, Annual change in life expectancy at birth in weeks, males and females, 2018
14. ONS, UK private rented sector: 2018, 2019
15. ONS, Trends in self-employment in the UK, 2018
16. Student Loans Company and Department for Education, Statistics Publication, 2018
17. PWC, Pensions Technology Survey, 2018
18. FCA, Effective competition in non-workplace pensions (FS 19/15), 2019
19. Ibid
20. FCA, Product sales data, 2019; The Pensions Regulator, DC trust scheme data, 2019
21. FCA estimate based on FCA product sales data 2019; ONS Labour Market Overview 2019
22. DWP, Automatic Enrolment evaluation report, 2018
23. Broadridge, Navigator: UK Defined Contribution & Retirement Income, 2018
24. FCA, Effective competition in non-workplace pensions (FS 19/15), 2019
25. Financial Ombudsman Service, complaints data, 2019; Money Marketing, "FOS SIPP complaints up 86%", 2019
26. FCA, Product sales data, 2019
27. FCA, Key findings on our recent work on pension transfer advice, 2018
28. FCA, Retirement income data, 2019
29. FCA, Retirement Outcomes Review: final report, 2018
30. Broadridge, Navigator: UK Defined Contribution & Retirement Income, 2018
31. Ibid
32. FCA, Supervision data request, 2018
33. FCA, Retirement income data, 2019
34. FCA, Supervision data request, 2018
35. ShareAction, as shown in Broadridge, Navigator: UK Defined Contribution & Retirement Income, 2018
36. LCP, Pensions De-Risking Report, 2019
37. FCA, Effective competition in non-workplace pensions (FS 19/15), 2019
38. Ibid
39. Financial Ombudsman Service, complaints data, 2019
40. FCA, Complaints data, 2019
41. Financial Ombudsman Service, complaints data, 2019
42. FCA, Financial Lives Survey, 2017
43. FCA, Retirement income data, 2019

Retail investments

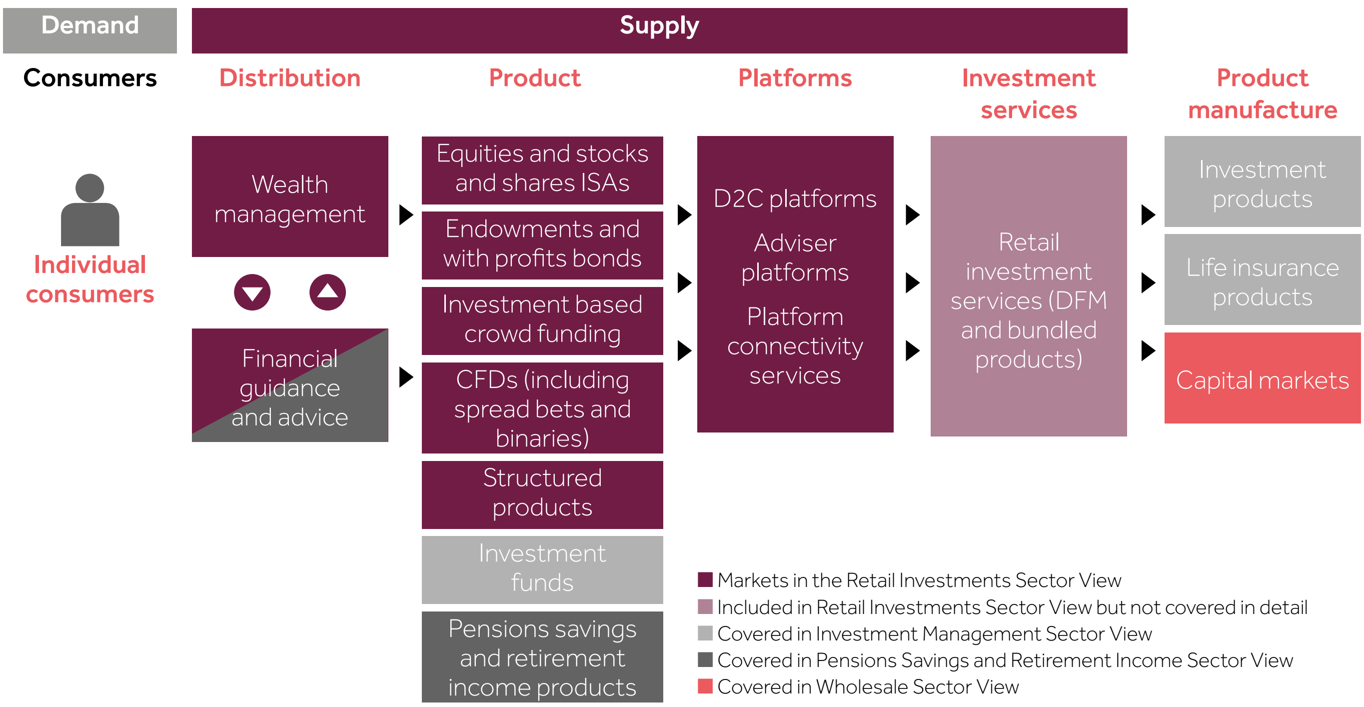
Introduction

The retail investments sector covers the distribution of investment products to consumers through a range of different channels, including financial advisers, wealth managers and platforms. It also covers retail investment products sold directly to consumers, such as stocks and shares Individual Savings Accounts (ISAs), retail bonds and contracts for difference (CFDs).

Macroeconomic factors continue to drive change in the sector. Sustained low interest rates have suppressed returns in safer asset classes, resulting in many consumers deciding to take on more risk in the search for yield. It has led to some being tempted by promised returns from high risk, and sometimes fraudulent, investments. Regulatory action has also had an impact on this sector, as we have moved to prevent retail investors being exposed to products with excessive levels of risk such as CFDs and unlisted speculative mini-bonds.

The most significant consumer harm has come directly from growing consumer exposure to investment risk. Some consumers have ended up in products that exposed them to more risk than they expected or can afford. The process through which these products are distributed, and the support network around it, has not always worked well enough to enable consumers to make good decisions.

Figure 6.1: Overview of the retail investments sector



£761bn assets held or invested by wealth managers 2018[1]

£191bn assets held or invested by wealth managers, execution only 2018[2]

£222bn assets held or invested on D2C platforms Q1 2019[3]

£496bn assets held or invested on adviser platform 2019[4]

1. Compeer, UK Wealth Management Quarterly Update, Q4 2018
2. Ibid
3. Platforum, UK D2C: Market update July 2019
4. Platforum, UK Adviser Platforms: Issue 38, May 2019

What we found on harm

High-risk retail investment products exposing consumers to more risk than they can absorb

The sale of unsuitable or fraudulent high-risk products is the most significant harm in this sector. Over time, risky investments have been directly targeted at consumers, leaving them more directly exposed to risk. To tackle a key part of this harm, we have recently issued a temporary product intervention on the marketing of speculative mini-bonds to most retail customers.

Key drivers of this harm have included the complexity of products, meaning consumers may not understand the risks they are taking. These risks are much greater for investments that offer high returns compared to more mainstream products.

The way these products are sold has also driven this harm. Some of the highest risk products are offered by companies that are not regulated at all, while others are sold by firms that are only regulated for other activities. These are often marketed directly to retail consumers, often with poor communication of the real risks and implying that the investments are regulated, when they are not.

> At the end of 2018, **1.2%** of British adults held retail or mini-bonds – many with little regulatory protection[1]
>
> An estimated **78%** of active retail client accounts in CFDs are loss-making[2]

Poor consumer support including unsuitable advice leading to consumer harm

Consumers are taking on more responsibility for complex investment decisions because of the shift from defined benefit (DB) to defined contribution (DC) pensions, the introduction of pension freedoms and the search for yield in a low interest rate environment. The proliferation of products, providers, intermediaries and charges across the investment supply chain contributes to this complexity and creates concerns around value for money.

> **The most significant consumer harm has come directly from growing consumer exposure to investment risk**

Advice, guidance and information all play important roles in supporting consumers when making investment decisions. But the process through which retail investments are distributed, and the support network around it, has not always worked adequately to enable consumers to make good decisions.

There is some evidence that there is a gap in the availability of one-off transactional advice and support for mass market consumers, which may limit consumers' ability to make good investment decisions. We are doing further work to explore these issues, through our evaluation of the Retail Distribution Review and Financial Advice Market Review, and will publish the findings in Autumn 2020.

In addition to access to advice, advice suitability remains a concern. Financial advisers help consumers understand their financial needs and navigate the complex services and products available.

Unsuitable advice can, however, cause significant consumer harm. We are particularly concerned about the high levels of unsuitab ility of DB-DC transfer advice. We cover this in greater detail in the Pensions Savings and Retirement Income chapter.

Financial crime and scams causing significant harm

Financial crime remains a significant harm in the sector, both when it directly affects consumers and where it has an impact on market integrity. Levels of scams and financial crime, including money laundering, continue to be high in the sector.

Investment scams are increasingly sophisticated and the impact on consumers can be devastating. Financial crime such as cybercrime and money laundering through wealth managers also has a significant impact on society and confidence in the sector. Key drivers of this harm include inadequate firm systems and controls and poor cyber and technology resilience.

Action Fraud reported over **£197 million** reported losses to investment scams in 2018[3]

Adviser firms escaping liabilities to consumers

Liabilities and redress from firms giving unsuitable advice can lead to claims which exceed firms' capital resources or professional indemnity insurance (PII) cover. This can lead to adviser firms being unable to pay redress resulting from upheld complaints and subsequent Financial Ombudsman Service claims. Some advisers are deliberately avoiding these potential liabilities by leaving the market but then seeking to phoenix back in. Phoenixing, in this context, involves firms and individuals deliberately seeking to avoid their liabilities to consumers or poor conduct history by closing down firms or resigning senior positions only to attempt to re-emerge in a different legal entity. We are working with the FSCS and Financial Ombudsman Service to prevent this.

Platform concentration risk and difficulties in switching between platforms

In addition, as platforms and outsourcing play a growing role in the sector, administrative failures could affect many retail investors. For example, in 2018 some of the largest providers had significant problems with their re-platforming projects. Potential risks for the sector in the future may increase as firms upgrade their technology.

While our Investment Platforms Market Study found competition in the market is generally working well, some consumers may face difficulties when shopping around between platforms, and when switching platforms.

Charges may be unclear – **19%** of platform consumers do not know whether they pay charges for investing via a platform, while **10%** think they do not pay anything.[4]

What is driving change

Macroeconomic factors continue to drive change in the sector. Sustained low interest rates have suppressed returns in safer assets classes and meant many consumers have taken on more risk in the search for yield. It has led to some being tempted by promised returns from high risk, and sometimes fraudulent, investments. Regulatory action has also had an important impact on this sector, as we have moved to prevent retail investors being exposed to products that expose them to excessive levels of risk such as Contracts for Difference (CFDs) and unlisted speculative mini-bonds.

Economy

Interest rates remain close to historic lows

This has the effect of suppressing returns in 'safer' asset classes, and has meant that consumers have opted to take on more risk. Historically low bond yields and high equity market valuations, especially in the US, indicate heightened risks of market corrections. As consumers are more exposed to investment risk, a downturn could expose them to potentially significant losses.

Figure 6.2: Inflation rate (CPI) and interest base rate (%)[5]

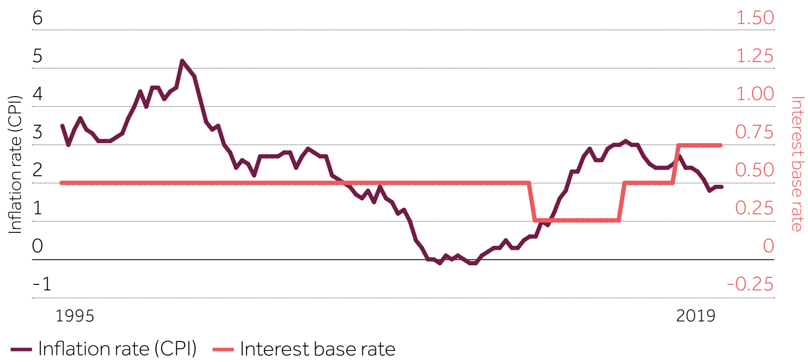
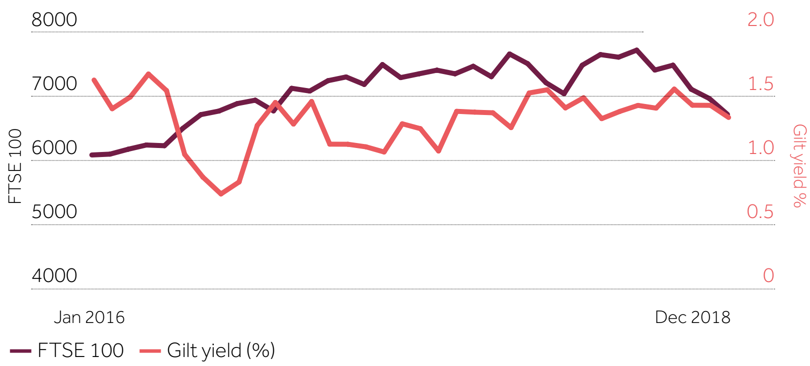


Figure 6.3: FTSE 100 vs 10-year gilt yield (%), 2016-18[6]



UK household saving rates reached 5.4% in Q3 2019[7]

Savings rates remain low by historical standards despite a small increase in 2019. Although the year did see a slight decrease in inflation, the continued low saving rate suggests that households remain squeezed, possibly restricting consumers' ability to enter the retail investments market.

The incomes of the poorest fifth have risen the most in percentage terms since 2008 (+11.6%) while the incomes of the richest fifth have risen the least (+4.9%), but this trend has recently reversed[8]

The average income of the poorest fifth fell by 1.6% in 2018, while it rose 4.7% for the richest fifth. This could signal higher net worth clients having more to invest, but make it even more unlikely for the poorest to get on the long-term savings ladder.

Policy and regulation

The impacts and supervision of MiFID II continue to be an important theme for the sector

Firms in this sector have particularly been affected by requirements for new costs and charges disclosures, ensuring best execution for retail investors, enhanced investor protection and suitability reporting, increased transaction reporting and the unbundling of investment research costs. This has led many firms to review and update aspects of their distribution model. The full impact on consumers is still to be seen.

Our activity continues to drive regulatory change in areas such as platforms, mini-bonds and CFDs

Following our Investment Platforms Market Study, the industry led UK Platforms Group has committed to start tackling issues of disclosure and transparency on costs. The Transfers and Re-registration Industry Group's (TRIG) STAR initiative will also address issues around the switching process. Meanwhile our policy statement on CFDs outlined rules that restricted the selling, marketing and distribution of CFDs and CFD-like options to retail consumers. We have also banned the promotion of unlisted speculative mini-bonds to retail investors.

The Financial Ombudsman Service award limit increased from £150,000 to £350,000 in 2019

This allows consumers and small businesses to receive more compensation when things go wrong. But some have said this increase could lead to a fall in the numbers of those providing advice, making access to advice even more difficult. This is due to possible increases in premiums for advisers' professional indemnity insurance cover. This could be passed onto consumers in the form of higher costs or simply make the insurance unaffordable for smaller advice firms, who then leave the market.

Consumers and society

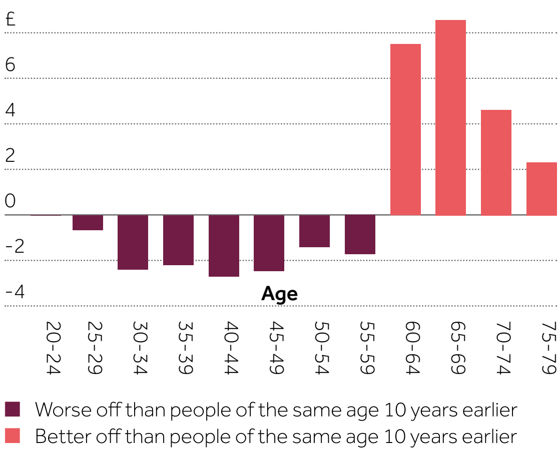
Our Discussion Paper on Intergenerational Differences shows the intergenerational wealth gap is widening

The paper showed that patterns of wealth accumulation and decumulation have changed in the last decade. Comparing the periods 2006-2008 and 2014-2016, it found:

- People of working age saw a slight reduction in financial wealth compared with people of the same age 10 years earlier. In particular, some Generation X (born 1966-1980) are more financially stretched than before.
- Those who already held significant wealth from 1975 to 1995 benefitted from increases in its value.
- Those who only started accumulating wealth more recently are seeing low and often negative real rates of return compared to previous generations, which may discourage long-term savings.[9]

Given this, firms may struggle to attract younger generations to the sector. Consumers who do choose to invest in the retail investments market may be significantly less likely to accept the risk of losing all their capital compared with earlier generations. Retail investments may also remain a largely unfeasible option for poorer consumers who, by necessity, prioritise day-to-day cashflow.

Figure 6.4: Change in median net financial wealth between 2006-08 and 2014-16 (£000)[10]



Technology

Weak demand saw early UK robo-advice market entrants (UBS and Investec) withdraw in 2019[11]

The withdrawal of UBS and Investec from the market follows a trend of robo-advisers withdrawing from Europe. The German market in particular has seen a number of robo-advisers closing their operations and some large banks including Commerzbank and Hamburg Sparkasse, Germany's largest savings bank, withdrawing or stopping robo-advice. BlackRock also ended a partnership with German robo-adviser, Youvestor, less than 18 months after it launched.[12]

Younger generations appear to be demanding more 'holistic' services

If this trend is established, in time elements of robo-advice technology are likely to be incorporated into broader service offerings of large retail banks, life insurance companies and advice providers. However, in the medium term this could lead to a gap in services for younger consumers.

International developments

The effect of EU withdrawal is likely to be indirect

The impact of EU withdrawal on this largely domestic sector will depend on changes in the sectors that manufacture the products and funds which retail investment firms sell or advise on. Consumers may also be affected by broader changes to the wider economy, such as changes to growth, employment, tax regimes or market volatility. Any increase in prices and/or decrease in asset values as a result of EU withdrawal are likely to affect both consumers and firms.

Late communications from providers to intermediaries could leave customers poorly informed

After EU withdrawal, intermediaries will depend on clear and timely information about changes to products and funds from providers and asset managers, so that they can pass this on to their customers. They will also need to consider if it changes the suitability of their advice.

Contract continuity is the main concern but only small numbers are likely to be affected

In the current deal scenario, firms will be able to continue to use existing passporting provisions during the transition period, while the free trade agreement (FTA) will establish the detail of provisions after the transition.

"The impact of EU withdrawal on this largely domestic sector will depend on changes in the sectors that manufacture the products and funds which retail investment firms sell or advise on"

How the sector is changing

Revenue for advisers increased by 11.7% in 2018, with that from ongoing advice showing the sharpest increase (19%). Wealth managers saw small decreases in invested assets, almost certainly as a result of market volatility at the end of 2018. In the platform market, assets invested via adviser platforms grew faster than those from direct-to-consumer (D2C) platforms, although market concentration is higher among D2C platform providers.

Revenue from advice increased almost 12% in 2018[13]

Advisers' revenues rose 11.7% in 2018, compared to a 21.4% rise in 2017. Commission, at 20% in 2017 and 17% in 2018, has been steadily decreasing as a share of revenues since the Retail Distribution Review. Ongoing charges have helped to fill the gap, as their value increased by 19% to £3.4 billion in 2018, while revenue from initial advice charges increased by only 6% to £1.9 billion.[14]

More consumers are paying for ongoing advice

There were 1.3 million initial advice services in 2018, a 5.5% rise on 2017, while 3 million clients paid for ongoing advice, a steeper rise of 11%.[16]

Adviser profits have continued to grow

Total reported pre-tax profits for all reporting financial adviser firms were £872 million for 2018, up 25% from 2017. Overall, 96% of firms were profitable. However, only 73% of firms with over 50 advisers reported a profit, indicating lower levels of profitability among larger firms. This was largely due to some of the largest firms making significant losses.[17]

Wealth management assets fell in 2018

By Q4 2018, wealth management investment assets were £942 billion, made up of £761 billion through wealth managers and £181 billion from execution-only. This was down from £958 billion in Q4 2017, as a result of market volatility towards the end of 2018.[18]

Figure 6.5: Total revenue earned from retail investment business (regulated intermediary activities)[15]

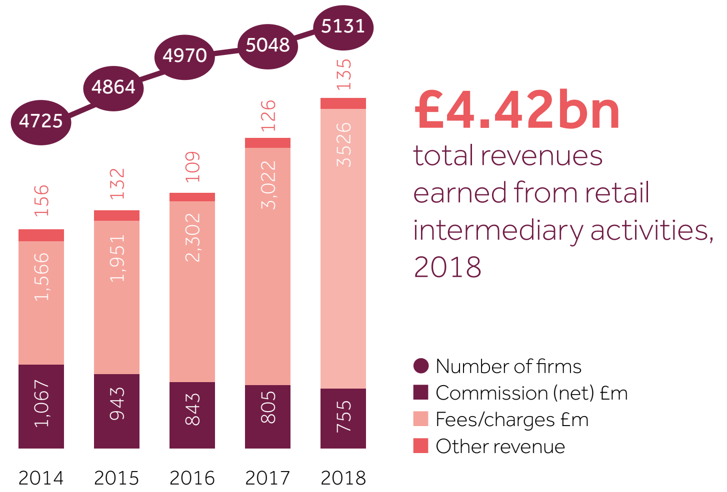


Figure 6.6: Investment assets at wealth managers (£bn)[19]

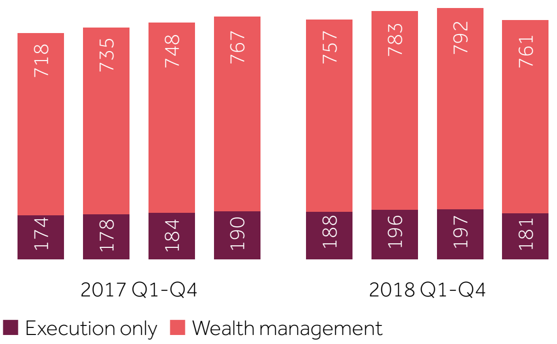
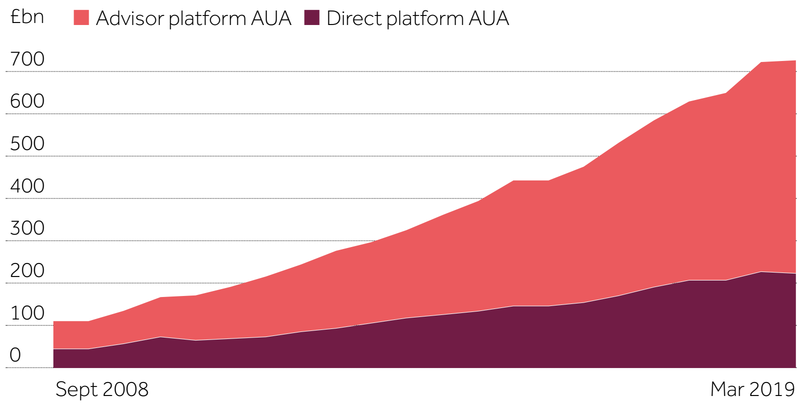


Figure 6.7: AUA at direct and adviser platforms (£bn)[22]



But wealth management revenues remained flat

Despite falls in investment assets towards the end of 2018, revenues were flat from Q3 to Q4 in 2018 at £1.8 billion.[20] There was a very slight decrease in execution-only revenues which was cancelled out by an uptick in wealth manager revenues.

Adviser platforms grew faster than D2C platforms

Year-on-year growth figures at Q1 2019 showed assets under administration at adviser platforms grew more (13.3%) than those at D2C platforms (7.4%). This left D2C platforms with a 31% share against 69% for adviser platforms.[21]

Over the last decade, stocks and shares ISAs have seen a stready increase in amounts subscribed – from £9.7 billion in 2008/09 to £28.7 billion in 2017/18

Stocks and shares ISAs have grown rapidly

Over the last decade, stocks and shares ISAs have seen a steady increase in amounts subscribed – from £9.7 billion in 2008/09 to £28.7 billion in 2017/18.[23] Meanwhile cash ISAs subscriptions peaked at £61 billion in 2014/15, falling back to £40 billion in 2017/18.[24]

The number of subscriptions to stocks and shares ISAs in 2017/18 rose almost 10% compared to 2016/17, to over 2.8 million. The amount of money subscribed in 2017/2018 was 29% higher than in 2016/17.[25] Average stocks and shares ISA holdings were £10,124 in 2017/18, up from £8,623 in 2016/17. For cash ISAs, the average holding was £5,114, up from £4,622 for the same periods.[26]

Newer markets exist for Innovative Finance and Lifetime ISAs (LISA)

Innovative Finance ISA subscriptions grew from 5,000 in 2016/17 to 31,000 in 2017/18. The amount subscribed increased more sharply, from £36 million to £290 million. Meanwhile in 2017/18, their first full year, Lifetime ISAs saw 166,000 subscriptions. £517 million was subscribed in total, amounting to an average of £3,114 per person, close to the annual ceiling of £4,000.[27]

Ipsos MORI data show 9% of British adults are currently invested in 'alternative' assets

This figure includes holdings in peer-to-peer lending, equity and debt crowdfunding, buy-to-let property, cryptocurrencies, and collectable assets. The UK Alternative Finance market saw total sales of £6.2 billion in 2017, a 35% increase on 2016 sales.[28]

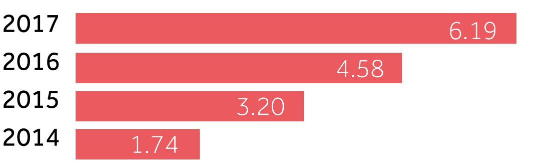
1.2% of British adults hold retail or mini-bonds versus 2.4% invested in peer-to-peer/crowdfunding

Ipsos MORI data show that, although still small, the percentage of British adults with holdings in retail bonds or mini-bonds has grown steadily from 0.8% in 2016 to 1.2% in 2018. This was smaller than the percentage of British adults invested in peer-to-peer or crowdfunding, which stood at 2.4% in 2018.[29]

Our interventions have tackled harm in the contracts for difference (CFD) market

We have intervened to address harm in the retail CFD sector by restricting how firms market, distribute and sell these products to retail consumers. Before this intervention, there were an estimated 800,000 active client accounts holding a total of £1.5bn in client money. We estimated that, overall, retail clients lost £1.07bn per year trading these products. Following the introduction of leverage limits and other investor protection measures, total losses for retail clients of UK firms reduced by £77m between August and October 2018 alone. We estimate that our final rules will save retail consumers between £267m and £451m overall per year. Retail consumers are still at risk, and should be alert, as some CFD firms are encouraging retail clients to opt up to 'elective professional status' or contract with affiliated third country firms to circumvent our leverage restrictions.

Figure 6.8: Total UK alternatives market volume (£bn)[30]



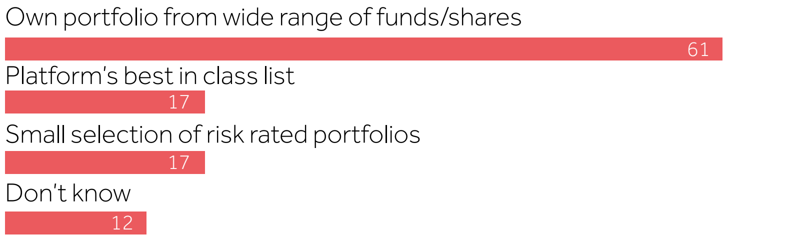
Consumer perspective: platforms

Our Investment Platforms Market Study found that, while 40% of consumers said price was the single most important factor in choosing a platform, very few shopped around. Even fewer could say how much they paid in fees. Consumers also rarely switched platforms and, when they do try to switch, they often struggle with long wait times of up to a few months.

Consumers value the convenience offered by platforms

Our research found platform consumers have significantly different characteristics and motivations for using platforms to invest. Most consumers value the control that platforms give them over their investments as well as their access and convenience, while the breadth of investments is another commonly given reason.[31]

Figure 6.9: Preferred investment solution for non-advised (%)[32]



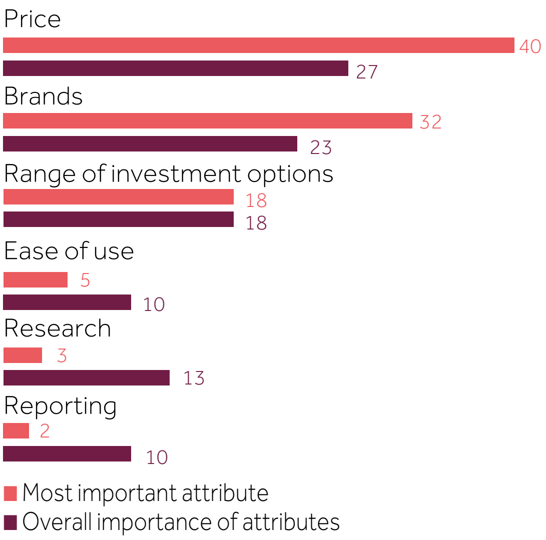
Many platform consumers are knowledgeable about finance

60% of non-advised consumers said they used platforms to build their own portfolio from a wide range of funds and shares. Others are less confident investors or prefer to use an adviser who then invests through a platform. Multihoming, where consumers use more than one platform is common: 37% of all consumers in our sample were on more than one platform.[33]

Price was an important factor, but not the only one

40% of respondents said price was the most important factor in their choice of platform. However, many consumers prioritised other factors, with brand recognition also scoring highly at 32%.[34]

Figure 6.10: FCA conjoint analysis of implied preferences for platform price and non-price attributes (%)[35]



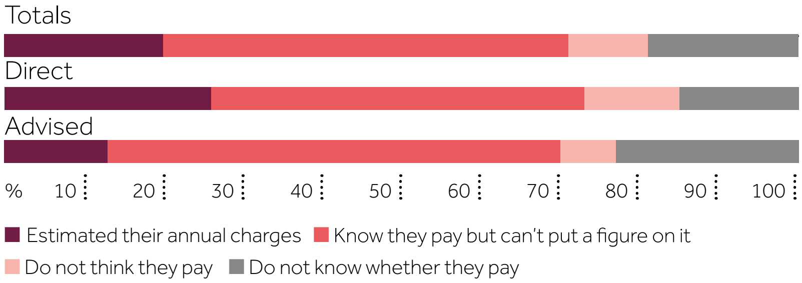
Non-advised consumers do not shop around for platforms

When choosing a platform, less than half (44%) of non-advised consumers have researched more than 1 platform. Most non-advised consumers either have not shopped around, cannot remember whether they did, or were moved onto the platform without making an active choice, eg where the relationship predates the platform's existence.[36]

Despite the importance of price to many consumers, their awareness of platform charges is low

Despite consumers stating that price is important, their awareness of the charges being paid was low. 19% of consumers do not know whether they pay charges for investing via a platform while 10% think they do not pay any. Meanwhile, although 51% of consumers knew that they paid a fee, they could not put a figure on this. Even the 20% of consumers that could put an estimate on their annual charge made significant errors in estimating how much they paid.[37]

Figure 6.11: Awareness and estimation of platform charges (%)[38]

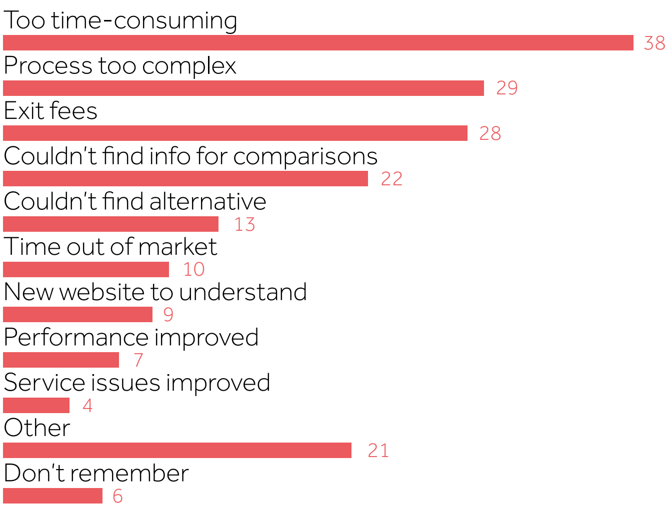


Platform switching is low

We found significant barriers to switching. Both firms and consumers say the time involved, complexity and exit fees create these barriers. Data from firms suggests that switching times vary, depending on which investments and wrappers the consumer is switching and the process. Generally, switching takes time, ranging from a few weeks to a few months.

A small number of consumers, just over 3% a year on average, have switched directly in the last 3 years without an adviser's help. Around 6% of consumers a year have added another platform rather than switched fully. 7% of consumers have tried to switch 'directly' at some point, but failed to do so.[39]

Figure 6.12: Actual barriers to switching experienced (%)[40]



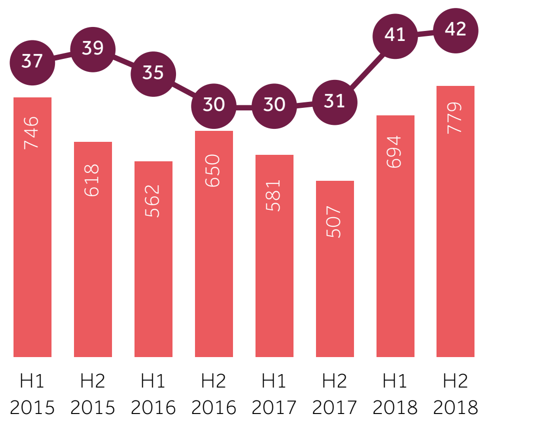
Consumer perspective: wrappers and products

The second half of 2018 saw a 54% increase in complaints to the Financial Ombudsman Service about non-cash ISAs, while the first half of 2018 showed a 220% increase in complaints about corporate bonds. Low interest rates continue to drive interest in alternative assets, while analysis shows a potential gender gap in stocks and shares ISAs.

Between H2 2017 and H2 2018, there was a 54% increase in open Financial Ombudsman Services complaints about non-cash ISAs[41]

In H2 2018 non-cash ISAs were the largest share of Financial Ombudsman Service complaints within the investments product group, at 35% compared to share dealings (21%) and portfolio management (19%). Meanwhile, between H1 2017 and H1 2018, corporate bonds saw a 220% increase in Financial Ombudsman Service complaints, although these have now fallen again.[42]

Figure 6.13: Percentage of Financial Ombudsman Service complaints upheld versus volume of Financial Ombudsman Service complaints (investment product group)[43]



There is some evidence of an investing gender gap

Across all age ranges, more women than men subscribed to a cash ISA in 2017-18. The precise opposite applies to stocks and shares ISAs.[44] Whatever the causes of these differences, they point to the possibility that there is a gender gap in the retail investments market, as has already been seen in pensions markets.

While much of the analysis in this sector view involves the possibility that consumers are over-exposed to risk, in this instance, failure to attract women's long-term savings to the retail investments market could point to an underexposure to risk. In the current environment, long-term savings held in cash are likely to fail to rise ahead of inflation and so their value in real terms is likely to decline.

'Fear of missing out' is a key incentive for cryptoasset consumers

In 2018 our research into cryptoassets found that 'getting rich quick', and 'fear of missing out' were the key incentives for consumers buying these products. Respondents also said they distrusted mainstream media and communications from institutions when considering these investments. They prefer to rely on friends, family and acquaintances, specialised online media and social media. Respondents were confident in their knowledge of the market and/or their 'instincts' when making decisions.[45]

Most crypto-asset investors have no divestment strategy

After their first purchase, most respondents did not appear to have any strategy to divest their assets or a sense of what would trigger them to do so. Instead they held and waited, thinking the technology they believed underpinned their assets would create a rise in their value. Most were aware of the risks in buying cryptoassets and several said this was part of the attraction. Several had strategies or expressed intentions around not spending more than they could afford to lose.[46]

Consumer cryptoasset selection is determined by platform selection and historic performance

The choice of platform available often influenced consumers in their choice of asset, because not all assets were available on all platforms. Some cryptoassets in particular were considered more reliable on the basis of having been around the longest and having generated profits in the past.[47]

Endnotes

1. Ipsos MORI, Financial Research Survey, 2019
2. FCA, Consultation Paper CP18/38, 2018
3. Action Fraud, 2019
4. FCA, Investment Platforms Market Study, 2018
5. ONS and Bank of England, Consumer price inflation: UK, 2019
6. London Stock Exchange and Bank of England, 2019
7. ONS, UK Economic Accounts time series, 2019
8. ONS, Average household income, UK: financial year ending 2018, 2019
9. FCA, DP19/2, 2019
10. Ibid
11. Financial Times, Investec shuts robo-advice service due to 'low appetite', 2019
12. Ignites Europe, Investec shuts robo-adviser after losses, 2019
13. FCA, Retail Mediation Activities Return, 2018
14. Ibid
15. Ibid
16. Ibid
17. Ibid
18. Compeer, Industry Update Report, Q4 2019
19. Ibid
20. Ibid
21. Platforum, UK D2C: Market update July 2019, Platforum, UK Adviser Platforms: Issue 38, May 2019
22. Ibid
23. HMRC, Individual Savings Account statistics, 2019
24. Ibid
25. Ibid
26. Ibid
27. Ibid
28. Ipsos MORI, Financial Research Survey, 2019
29. Ibid
30. Cambridge Judge Business School, The 5th UK Alternative Finance Industry Report, 2018
31. FCA, Investment Platforms Market Study, 2018
32. Ibid
33. Ibid
34. Ibid
35. Ibid
36. Ibid
37. Ibid
38. Ibid
39. Ibid
40. Ibid
41. Financial Ombudsman Service, 2019
42. Ibid
43. Ibid
44. HMRC, Individual Savings Account statistics, HMRC, 2019
45. Consumer attitudes and awareness of cryptoassets: research summary, FCA, 2018
46. Ibid
47. Ibid

Investment management

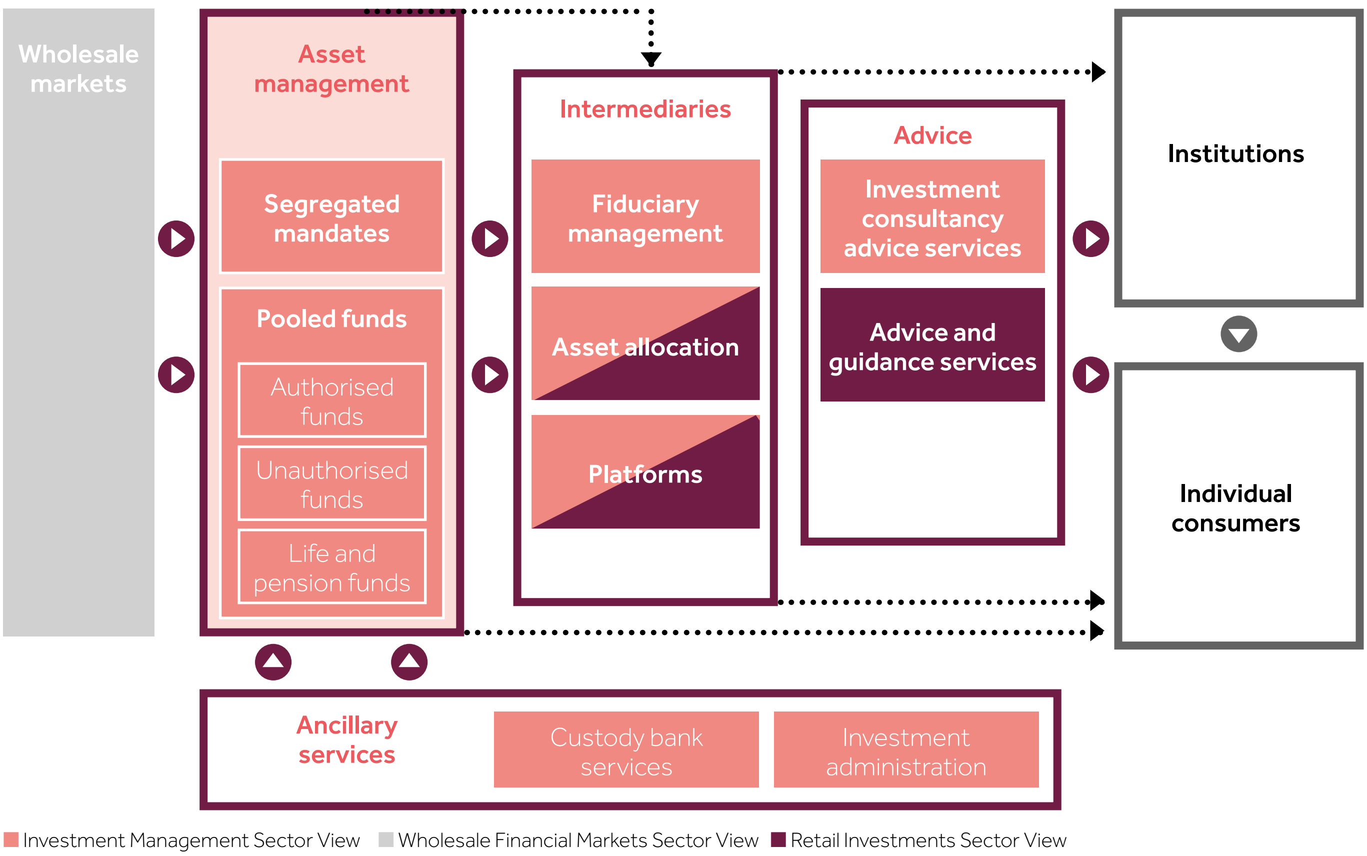
Introduction

The investment management sector covers asset management, institutional intermediary and advice services, and custody and administration services. The UK asset management industry, which services both institutional and retail investors, is Europe's largest for asset management. It had £9.1 trillion[1] in assets under management (AUM) at end-2018, and is a key contributor to the economy.

Persistent low interest rates, geo-political tensions and uncertainty continue to challenge and drive change in the sector. Climate change is also having an impact on financial services markets as investors seek green products and there is increasing global attention on what the industry's role should be in combatting it. Technological developments mean firms increasingly rely on new technology and third-party providers for outsourced technology solutions. These developments do, however, also offer opportunities, for example, to develop new products to meet new demands from customers and find more efficient ways of working.

Harm in the sector mainly comes from 6 areas. We are most concerned about the first 2: the pricing and quality of investment management products and operational resilience. The remaining 4 are: disorderly markets, market abuse and pricing and quality of firstly, institutional intermediary services and secondly, custody and investment administration services.

Figure 7.1: Overview of the investment management sector



What we found on harm

Pricing and quality of investment products remains a concern

There are many drivers that result in investors investing in poor value products, where they are either overpaying or holding investments that diverge from their stated objectives. Drivers of this harm range from consumers struggling to assess and compare fees and products to poor governance practices at asset managers.

Our Asset Management Market Study found weak price competition in several areas of the industry, no clear relationship between charges and performance and a lack of transparency and clarity on pricing and quality. These mean investors struggle to assess the most appropriate products and services. It can also mean investors do not switch funds when they no longer meet their needs. We also found poor standards of governance. Several regulations have come into force in the last 2 years to reduce this harm, including remedies developed as a result of our market study and others such as MiFID II and PRIIPS.

Asset managers manage the savings and pensions of millions of people:

45.5% of total AUM managed for pension funds[2]

18.8% of total AUM managed for retail investors[3]

Technological disruption from poor operational resilience or cybercrime can threaten market integrity and consumer confidence

A lack of operational resilience or cybercrime is a threat in this sector. This could be at firms within the sector or at third-party firms they have outsourced activities to. Harm includes financial or data loss for investors and potentially damage to market integrity. Confidence and participation could be affected if these incidences become more frequent and significant.

Poor operational resilience could lead to widespread market disruption, which prevents or hinders firms from investing, or limits investors' access to their capital. Specific issues include poor governance and oversight of outsourced functions, insufficiently resilient legacy IT systems with poor cyber security, and a lack of contingency plans for service disruptions caused by outsourced service providers. We have a comprehensive programme of work in place to reduce harm from a lack of operational resilience. The rapidity of technological development, however, means this is an area that will continue to be challenging for firms

Investment management sector*	2018	2019
Technology Incidents	8	26
Cyber Incidents	14	19
Non – Technology Incidents	4	5
Total[4]	26	50

*Number of Technology and Cyber incidents reported to the FCA by firms within the investment management sector, specifically the Asset Management, Alternatives, and Custody portfolios only (CDFs and Benchmarks excluded).

Investment in higher risk or less liquid assets can heighten the risk of disorderly markets

In the investment management sector, the potential for disorderly markets comes from a variety of sources. One potential source is the liquidity mismatch of daily dealt funds that invest in less liquid assets. In September 2019, we released details of policy changes for illiquid assets and open-ended funds. These will apply from September 2020 to non-UCITS retail investment schemes investing in 'immovables' such as commercial property. We are working with the Bank to consider whether open-ended funds in general should be subject to tighter rules on liquidity management. In September 2019, the European Securities and Markets Authority (ESMA) also published its final guidance on liquidity stress tests of investment funds. This applies to both Alternative Investment Funds (AIFs) and Undertakings for the Collective Investment in Transferable Securities (UCITS). The guidelines will apply from 30 September 2020.

Other factors that could cause disorderly markets include poor risk management of leveraged strategies, particularly at alternative fund managers, and the potential for a disorderly transition from LIBOR, which is expected to cease after end 2021, to alternative risk-free rates. We are actively working with industry on LIBOR transition to make sure transition is orderly and timely.

We carry out work to reduce the risks of disorderly markets. When necessary, we undertake additional activity in specific areas, such as the work done on illiquid assets and open-ended funds and our work on LIBOR transition.

40% of asset manager respondents[5] to Investment Association (IA) survey state that client LIBOR exposures increased in 2018 while 45% said they decreased*

*Survey responses included 20 IA members with ~65% of IA AUM (£7.7bn at end 2018[6])

Market abuse can cause losses to investors

Market abuses threaten market integrity and those committing it benefit unfairly at the expense of losses to other market participants and, in investment management, to investors. This can then threaten confidence and participation in financial services markets.

One issue in this sector is that a high proportion of asset management firms' income and individual employees' remuneration comes from performance fees. These fees can be significant and can create incentives to commit market abuse. Innovative technologies and investment strategies used by asset management funds could also increase the risk of market abuse. Systems and controls to manage the risk of market abuse at smaller asset management firms may also not always be as effective as at larger firms.

We actively monitor markets and take action to reduce the risk of, and prevent harm from, market abuse. Market Abuse Regulation and MIFID II have both increased the depth and scope of regulatory reporting by firms and our ability to detect and intervene to address market abuse.

CMA investigation prompts changes to address pricing and quality of institutional intermediary and advice services

Currently institutional intermediaries, mainly investment consultants, do not fall under our regulation. Our Asset Management Market Study revealed that competition in this market may not be effective. This is a relatively concentrated market where pricing and quality of products and services offered by investment consultants and fiduciary managers are often difficult to assess, both on purchase and subsequently, and switching rates are low. This was particularly common for investors using fiduciary management services.

We referred investment consultants and fiduciary managers to the Competition and Markets Authority. Their investigation led to requirements for firms and pension fund trustees to take specific actions to improve competition. We list these under drivers of change, but they include extending our remit to include investment consultants. The Government has yet to confirm whether investment consultants will be brought under our regulation.

Investment consultants and fiduciary managers provide investment advice and related services to UK pension schemes with assets of at least **£1.6 trillion**[7]

We continue to monitor pricing and quality of custody and investment administration services

Our main areas of concern in this area involve weak Client Money and Assets (CASS) controls and governance, weak depositary oversight of authorised fund managers and operational resilience.

There is also some concern that asset managers, particularly small ones, could be overpaying for bundled custody and investment administration services because of poor practices in some areas of service provision, such as FX transactions.

£10.9tn assets under custody at end 2018[8]

80% of total AUC held by top 5 firms[9]

14.5% of 1770 Investment Management Sector CASS Audit opinions were Qualified and Adverse in 2018[10]

What is driving change

Macro and socio-economic

Several macro and socio-economic factors are driving change in the asset management sector. The sustained low interest rate and low yield environment are influencing investor behaviour. Uncertainty over EU withdrawal led many firms to implement contingency plans for a no-deal Brexit and it remains a factor driving change in the sector. Focus on the role of asset managers as stewards, particularly on the threat of climate change, continues to grow.

Interest rates remain low and fund liquidity remains a focus

Many of the key trends in the macroeconomic environment from last year remain, including low interest rates and low household saving rates. The low interest rate/low yield environment suppresses returns in traditional asset classes. Together these heighten the attraction of high risk, often less liquid, investments and investment scams.

These challenges are also seen internationally and have led to concerns over the potential for a future liquidity crisis. In the asset management sector, the focus is on how sudden spikes in redemptions in funds with less liquid assets are managed, such as was seen with property funds after the EU referendum and more recently with the LF Woodford Equity Income Fund.

International focus on prudential matters is increasing

Global bodies such as the IMF and IOSCO have increased their focus on the sector, driven by the growing size of assets under management and the systemic risks posed by these concerns.

EU withdrawal remains a key driver

Uncertainty over Brexit and the possibility of a no-deal scenario led firms to implement contingency plans and regulatory authorities to set up temporary permissions regimes and agree Memoranda of Understanding (MoUs). Particular areas of concern that these dealt with were:

- inward and outward passporting
- delegating portfolio management
- the need for contracts held with UK banks for EU-domiciled derivatives to be rewritten
- cross-border information sharing if the UK is not recognised under the EU's GDPR adequacy regime
- our ability to supervise firms effectively being challenged by increasingly complex corporate structures

Attention on environmental, social and governance (ESG) and stewardship continues to grow

There is increasing public expectation that asset managers should act as responsible stewards, both in the UK and internationally. This not only involves asset managers having a longer-term view when they engage with investee companies, but also meeting the growing interest in responsible investment through ESG/green funds.

International interest in this area is moving the debate on, particularly around sustainable finance and the role finance can have in helping combat climate change. But there is, so far, little consensus on any standards and even whether standards are the right way to proceed.

The amounts held in ESG/green funds have grown in recent years, particularly driven by younger investors. However, as there are no recognised standards for these funds, there remains a high risk of greenwashing.

Technology and innovation

Technology developments continue to disrupt all areas of the financial services industry. In this sector technology is affecting a range of areas, from research and portfolio management, to investment advice, through the middle and back offices to client engagement and distribution. Technological advances bring innovation and efficiencies, but also increased spending, more complex oversight requirements and an increasing threat from cybercrime.

Use of artificial Intelligence and algorithmic decision-making in the sector continues to grow

Banks and asset managers have been using algorithmic trading and machine-based decision-making for over a decade. However, increasing amounts of processing power now allows them to expand its use across more of the business. Apart from trading, this includes identifying correlations, back testing investment strategies and new product development.

Technology substituting for human decision-making has inherent risks, including:

- accelerating trading speeds could lead to more widespread market failures and flash-crashes
- an increasing portion of liquidity is being provided by highly technology-reliant, non-bank proprietary trading firms which may increase risks if an algorithm goes 'wrong'
- different firms using the same system may contribute to herd behaviour, with the same data or trading algorithms leading to similar decisions in different firms

Increased outsourcing to third-parties presents increased oversight challenges

Outsourcing to third parties, which can present oversight challenges, is becoming more widespread. For example, for IT systems and to help with collecting and transferring data for MiFID II reporting requirements. Increased reliance on IT systems and greater collection of data may increase firms' vulnerability to systems failures and cybercrime, but use of specialist third-party providers may reduce this risk.

Advances in data use and changes to data sources bring advantages but also oversight challenges

Asset managers are increasingly seeking to generate excess returns above the market by harnessing the power of large and new data sets. Changing data sources are leading to changing roles and responsibilities in markets, eg custody banks becoming data providers. This is also creating new and non-traditional sources of inside information for firms, which brings increased oversight challenges.

Reg tech has advantages but increases the potential for online threats

Relying on artificial intelligence could reduce compliance costs not only through automation but also by alerting firms to regulatory hurdles. Technology could simplify risk management but generally firms need to do significantly more work to protect themselves from online threats to their business.

Distributed Ledger Technology (DLT) is not being adopted as quickly as expected

DLT could offer more transparent, secure and cheaper settlement and custodian services in the medium to long term. However, this technology is developing more slowly than industry observers expected.

Technology failures from cyber or other IT failures are challenging all areas of the UK's financial services sector

The extent of cyber and IT failures within the UK's financial services sector has been one of our priorities. Firms reported a 7% increase in technology outages over the year 2018 to 2019.[11] However, some of the rise in reported incidents could be down to better reporting and awareness, rather than solely an increase in events.

Regulation

The industry has undergone significant regulatory change, having implemented MiFID II, PRIIPs and Asset Management Market Study (AMMS) remedies in the past 2 years. Further regulation, such as the Shareholder Rights Directive II and the Senior Managers and Certification Regime (SM&CR), came in in 2019 while yet more is pending for 2021/22. Regulatory focus is mainly on promoting fair treatment of customers and good value by improving transparency, comparability, accountability and investor protection.

AMMS remedies covered a broad range of areas

Our Asset Management Market Study (AMMS) introduced a number of policy changes to the sector, including:

- **Box profits rules:** Banning risk-free box profits (introduced April 2019).
- **Governance rules:** New requirement to have independent directors on the boards of fund

management companies (25% or a minimum of 2). A new requirement to conduct an annual assessment of value and to report publicly on this (effective from September 2019).
- **Benchmark rules:** Improved disclosure about how asset managers should report the performance of funds to investors (effective from May 2019 for new funds and August 2019 for existing funds).
- **Objectives guidance:** Guidance on how firms should explain their investment objectives/ policies/strategies (effective from February 2019).
- **Institutional disclosure templates:** Developed by the Institutional Disclosure Working Group and the Cost Transparency Initiative following AMMS.

New rules to improve firms' approach to open-ended funds investing in illiquid assets

Following the referendum on EU withdrawal and the associated suspension of some property funds, we consulted on a package of measures to improve the rules on open-ended funds invested in illiquid assets. We published these in September 2019 to be implemented from September 2020.

Shareholder Rights Directive II to improve stewardship disclosure comes into force

From June 2019, the Shareholder Rights Directive II (SRD II) requires asset managers to make disclosures about how they undertake stewardship to help their clients, such as life insurers and pension funds, understand how they carry out these activities.

EU Sustainable Finance Action Plan to improve disclosure around ESG expected to come into effect in 2020

This regulation requires asset managers, financial advisers, insurance companies and pension funds to disclose how they integrate environmental, social and governance (ESG) factors into their investment decision-making and advisory processes. The rules will also require larger firms to disclose information about the principal negative impacts of their investments on the environment or society.

Cross-Border Distribution of Funds Regulations comes into force

There are 2 parts to these regulations, which aim to remove barriers to investment created by fragmented national approaches and

"

Technology failures from cyber or other IT failures are challenging all areas of the UK's financial services sector

"

measures. Some parts of the regulations are now in force. These include requirements for us to publish information and report to ESMA, as well as to extend the exemption in the PRIIPs Regulation for UCITS funds from the requirement to produce a Key Information Document (KID). Other parts of the regulations that affect firms will not come into effect until 2021.

Senior Managers and Certification Regime (SM&CR) has now been extended to asset managers

Asset managers are now within the scope of SM&CR which aims to raise standards of governance, increase individual accountability and help restore confidence in the financial services sector. It also covers accountability for firms' technology and cyber resilience.

Investment Firm Review expected to be implemented in 2021

The Investment Firm Review will introduce a new prudential regime for investment firms. Previously investment firms were subject to the same prudential requirements as more systemic financial services providers. The new regime is specifically aimed at investment firms and takes into account, in a more proportionate way, how far an investment firm can cause harm to clients and to the markets they operate in.

LIBOR transition cuts across several areas of the investment management sector

We cover LIBOR transition in detail in the wholesale sector view section. Transition from LIBOR, which is expected to cease from end 2021, to alternative risk-free rates (RFRs) should, in the long-run, increase market integrity. However, a disorderly transition could result in significant harm. Transition cuts across investment and hedging products, fund and manager benchmarks, critical risk management and many middle and back office processes. It also affects key oversight functions, such as authorised fund managers (AFMs) and depositaries.

CMA review of investment consultants and fiduciary managers broadens the regulatory remit of both the FCA and TPR, resulting in new rules

Following its investigation into the investment consultant and fiduciary management market, in December 2018, the CMA published a number of rules and recommendations, including:

- Pension trustees who wish to delegate investment decisions for more than 20% of their scheme assets to a fiduciary manager must run a competitive tender with at least 3 firms. Trustees who have appointed a fiduciary manager without a tender must put the service out to tender within 5 years.
- Fiduciary management firms must give potential clients clear information on their fees and use a standard approach to show how they have performed for other clients. This will give pension trustees the information they need to compare different providers.
- The CMA recommended that TPR produce new guidance to help trustees with these services. It also recommended that the Government broadens the regulatory remit of both the FCA and TPR, to ensure greater oversight of this sector in the future.

How the sector is changing:

Assets under management growing steadily

Growth of assets under management (AUM) in the UK stalled in 2018, ending the year at £9.1 trillion[12] In the previous 5 years AUM growth had averaged 11% per year.[13] The UK remains the leading European market for asset management, accounting for more than one third of European AUM, and is second only to the US globally.[14]

Figure 7.2: Assets under management in the UK (£tn)[15]

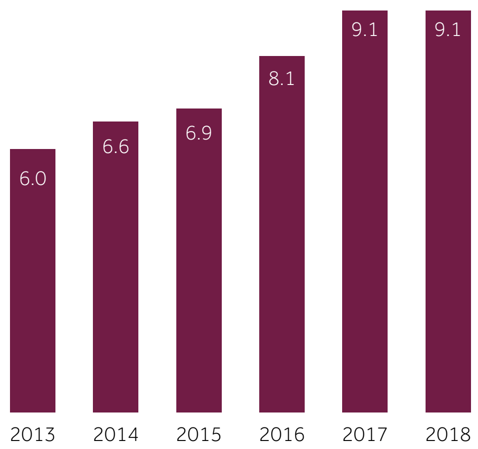
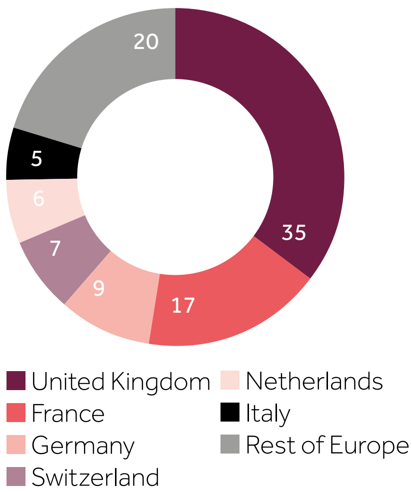


Figure 7.3: European assets under management (by country, %)[16]



Passive investments account for a quarter of AUM

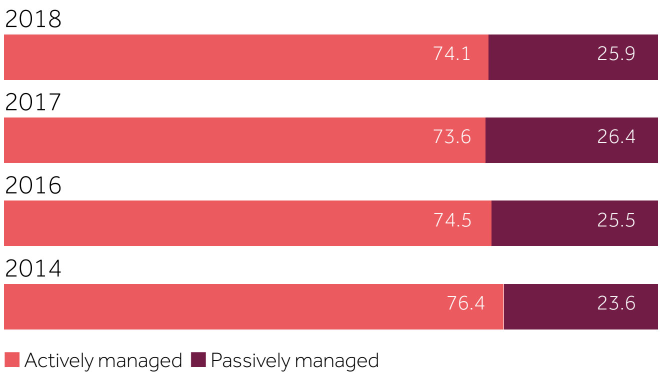
A desire for lower-cost solutions and continued strong stock market performance have contributed to a steady increase in passively-managed assets. Passively-managed assets now account for 26% of total AUM compared to only 17% in 2008.[17] Growth of passively-managed assets has been steady since 2013, though 2018 saw a very small decrease.

Institutional investors account for most of the passively-managed AUM, with 27.9% of total AUM managed for institutions being passively managed. On the retail side, only 16.0% of funds are passively managed.[18]

Value assessments to be published from early 2020

The value assessments that authorised fund managers (AFMs) have to publish for UK authorised funds as part of the Asset Management Market Study remedies are currently being worked on across the industry. Submissions will start in early 2020. Firms are considering 7 factors around costs, performance, quality of service and fairness. Challenges include how to present their findings and the potential need to move investors in share classes with higher charges to ones with lower charges. We expect to do some follow up work with firms once they have published their value assessments.

Figure 7.4: UK assets under management by active versus passive management (%)[19]



Endnotes

1. Investment Association, Investment Management in the UK 2018-2019, September 2019
2. Ibid
3. Ibid
4. FCA internal analysis
5. Oliver Wyman, LIBOR Transition Roadmap for Investment Managers, February 2019
6. Investment Association, Investment Management in the UK 2018-2019, September 2019
7. FCA, Asset Management Market Study Interim Report, November 2016
8. FCA internal analysis
9. Ibid
10. Ibid
11. Ibid
12. Investment Association, Investment Management in the UK 2018-2019, September 2019
13. Ibid
14. Ibid
15. Ibid
16. Ibid
17. Ibid
18. Ibid
19. Ibid

Wholesale financial markets

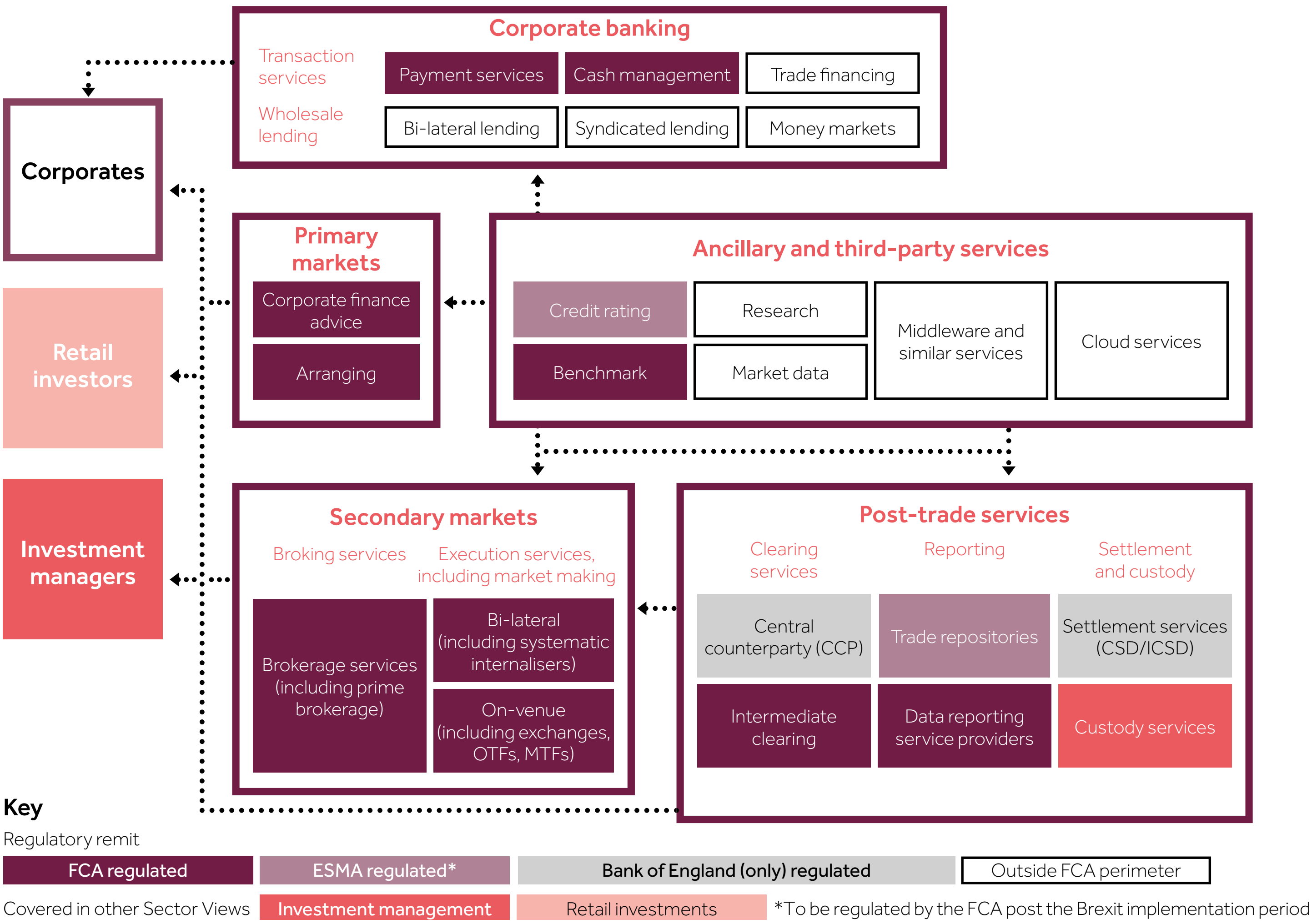
Introduction

The Wholesale Financial Markets sector, as shown in the diagram below, covers a wide range of wholesale activities. These include transaction services, wholesale lending, advising, arranging, broking, execution, clearing and settlement. This sector spans multiple asset classes including equity, debt, derivatives, foreign exchange and commodities.

These markets are currently undergoing substantial change. Brexit, and the uncertainty associated with it, remains a key driver due to the potential implications for cross-border activity. Firms are also using more technology across their activities and outsourcing certain functions to third-party technology providers. The sector is adapting to reflect regulatory developments, including significant changes brought about by MiFID II and the transition from LIBOR. Finally, the global economic and political environment continues to provide a challenging backdrop, with prolonged low interest rates, and ongoing geopolitical tensions and macroeconomic uncertainty.

Given the breadth of the sector, we group harm into 8 themes. There are 4 priority themes – LIBOR transition, operational resilience, market abuse, and financial crime. The 4 further themes are market power, disorderly markets, lack of market effectiveness, and conflicts of interest.

Figure 8.1: Overview of the wholesale financial markets sector



What we found on harm

In wholesale financial markets, we identified 8 harm themes. We are most concerned about harm from the first 4, which we detail below.

Transition from LIBOR progresses, but there is more to do

Transition from LIBOR to alternative risk-free rates should, in the long-run, increase market integrity. But we are still concerned that the potential for a disorderly transition could lead to harm. Firms will also need to manage any conduct risks arising from transition.

Large numbers of contracts and systems need updating before the end of 2021, after which LIBOR is expected to cease. Some markets have made good progress, but LIBOR is still used heavily, including in new contracts in some markets. We continue to work closely with market participants and other authorities to support the transition effort.

At the end of August 2019, there was over **£25 trillion** of outstanding notional in cleared Sterling LIBOR derivatives. About half matures beyond the end of 2021.[1]

Operational resilience remains a focus, with the risk of cyber-attack remaining high

Poor operational resilience increases the chance that firms suffer technological disruption or failure, potentially leading to unavailable services, loss of assets, or compromise of sensitive data.

This issue continues to concern us for several reasons. For example, the sophistication and availability of cyber-attack tools is increasing, and the number of cyber-attacks and other technology failures remains high. Many firms are also going through major operational change programmes for various reasons, including Brexit and LIBOR transition. This increases the risk of operational disruption.

Market concentration in the provision of some wholesale services, such as in certain infrastructure and third-party services, may also increase the potential for harm, especially where there are challenges in firms' and regulators' oversight of these services.

Wholesale Sector*	2018	2019
Technology Incidents	94	118
Cyber Incidents	7	10
Non – Technology Incidents	1	6
Total	**102**	**134**

*Number of incidents reported to the FCA by firms within the wholesale sector, specifically exchanges, multilateral trading facilities, organised trading facilities, wholesale banks, wholesale brokers, principal trading firms, benchmark administrators, primary information providers and data reporting services providers.[2]

Deterring, detecting and pursuing market abuse remain key to enhancing market integrity and protecting consumers

Market abuse can enable perpetrators to gain unfairly at the expense of other market participants, which can threaten confidence and participation in wholesale markets. Broadly speaking, it includes misuse of inside information, market manipulation, and creating false or misleading impressions in the market.

The openness, diversity and scale of UK financial markets requires us to oversee, detect and enforce to create an environment which deters market abuse. We continue to see instances of firms lacking controls, oversight, and understanding of market abuse requirements. This includes poor control of inside information and ineffective market surveillance systems. Technological developments continue to create new challenges for firms' systems and controls. Brexit also has the potential to affect firm and regulatory oversight as firms' structures and activities become more complex.

MiFID II and the Market Abuse Regulation help us to reduce harm in this area. Both have significantly increased the depth and scope of regulatory reporting which increases our ability to detect and intervene to address market abuse. The global nature of financial markets requires cooperation between international regulators, and as a major financial centre, London's responsibilities are considerable.

5,604 Suspicious Transaction and Order Reports and **578** other external notifications received and **484** preliminary market abuse reviews opened in the year to March 2019[3]

Financial crime remains a priority, with a high threat of cyber-enabled crime

Financial crime includes money laundering, terrorist financing, breaches of financial sanctions, bribery, corruption and fraud. These can lead to significant harm, including financial losses to victims. Effective deterrence is therefore key to market integrity.

As with market abuse, the openness, diversity and scale of UK markets drive potential harm in this area. As noted above, the threat of cyber-enabled financial crime also remains high, while increased outsourcing poses challenges for governance and oversight. Brexit may also affect oversight. As with market abuse, financial crime often occurs across borders. International regulatory cooperation is therefore important to combatting financial crime effectively.

> Money laundering facilitates serious organised crime, which costs the UK an estimated **£37 billion** every year.[4]

As well as the 4 priority themes above, we are also concerned about 4 further themes.

Market power

Market power can arise where a sector has relatively few participants offering services that others rely on. This can enable firms to charge higher prices, offer a lower quality of service, or to lack the incentive to innovate. This can have repercussions for consumers further down the chain and for the economy.

Disorderly markets

Disorderly markets can threaten confidence and participation in markets. We have seen, for example, instances of firms' systems and controls not adapting sufficiently to deal with the growing use of algorithms. Brexit may also lead to challenges from, for example, market fragmentation and lack of contract continuity.

Lack of market effectiveness

Well-functioning deep and liquid markets lead to more effective price formation, capital raising, and risk and resource allocation. By contrast, ineffective markets can damage confidence and participation, negatively affect pricing and quality, and lead to wider harmful side effects. We continue to consider where we can improve market effectiveness, such as through changes to our rules.

Conflicts of interest

We have intervened to address a number of conflicts of interest in recent years, including in investment research unbundling, Payment for Order Flow, and firm remuneration practices. The extension of the Senior Managers and Certification Regime at the end of 2019 should also improve outcomes in this area.

What is driving change

The low yield environment continues to influence behaviour. As uncertainty around the future UK and EU relationship continues, firms and authorities have been making progress on their preparations. Technological advances will continue to bring benefits, but also challenges, including to operational resilience and oversight.

Macro-economic and Brexit

Macro-economic conditions continue to present challenges.

The cross-border nature of wholesale markets exposes participants to geopolitical tensions and weakened prospects for global growth. Persistent low interest rates also continue to incentivise riskier behaviour, including investment in higher risk assets. We have seen, for example, continued global growth in leveraged loans and collateralised loan obligations. As well as risks from increased borrower leverage and diminished credit quality, an increased use of light loan covenants will likely weaken protections for investors if there is a downturn.

The resilience of wholesale financial markets will be a central issue in any economic downturn

Sharp falls in prices and increased volatility have an impact on firms' and consumers' financial positions, confidence, and ability to lend and borrow. Issues in wholesale financial markets can also feed back into retail markets and the real economy.

Negotiations between the UK and the EU will affect the sector

Brexit will impact wholesale financial markets because of the cross-border nature of the sector. The outcome of negotiations on the future relationship, and the approach taken by UK and European authorities may precipitate changes in UK and EU markets and business structures in the short, medium and longer term. Known risks may persist and new risks may arise for the sector depending on whether equivalence determinations and/or a trade deal are agreed for the end of the transition period. Brexit brings us new responsibilities, including supervision of credit rating agencies, trade repositories and securitisation repositories operating in the UK.

Firms and authorities are preparing for a range of possible outcomes. We give more detail on firms' activities in the trends and developments section below.

Technology and innovation

Firms' use of and reliance on technology continues to grow, including through outsourcing

Technology continues to change the way consumers and firms interact, the way in which decisions are made, and how and where activity takes place. Highly technology-reliant trading businesses now provide a significant amount of wholesale market liquidity, and we continue to see a trend towards data-driven, algorithmic trading strategies. Wholesale firms also continue to increase their use of third-party technology services, including middleware infrastructure and cloud services. This makes firms' resilience to the cyber, oversight and operational challenges that technology creates key to the market's continued orderly functioning.

Regulation

The sector is undergoing significant regulatory change. Regulatory developments should lead to markets that are cleaner, orderly, transparent, resilient and competitive. But it also creates challenges for firms and markets as they adapt to the changes.

The transition period will provide for some continuity

EU law will continue to apply in the UK throughout 2020, and passporting will continue as now during that time. This means firms operating cross-border through a passport can continue with those activities.

But negotiations on equivalence and the UK's future relationship with the EU are just beginning

The UK and the EU will begin discussions on the future relationship during the transition period. The Political Declaration also includes commitments to conduct mutual equivalence assessments by mid-2020. Throughout this period, we will continue to engage with firms and provide technical advice to the UK Government, in line with our objectives.

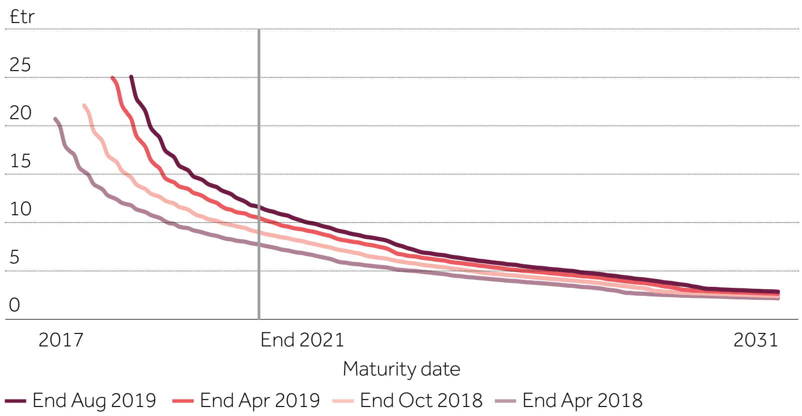
The negotiations provide an opportunity to resolve risks for the sector

Risks around market disruption and fragmentation arising from overlapping or conflicting UK and EU Share and Derivative Trading Obligations at the end of the transition period remain, but could be resolved through mutual equivalence determinations under the Markets in Financial Instruments Regulation (MiFIR) for trading venues. It will also be important to resolve uncertainty around adequacy under data protection legislation by the end of the transition period. Firms have previously undertaken considerable contingency planning for a scenario in which these, and other risks, crystallise. Firms need to ensure that they are prepared for a range of scenarios that may happen at the end of 2020 – and this includes the scenario in which the activities they conduct might not be covered by agreements reached between the UK and the EU.

Good progress has been made on LIBOR transition in some markets, but more progress needs to be made in others

LIBOR is expected to cease after end 2021, and firms must transition to alternative rates before this date. There has been good progress in some markets with contracts moving onto the Sterling Overnight Index Average (SONIA) or incorporating fall-back clauses. LIBOR is, however, still used heavily in wholesale markets, and new LIBOR-based contracts continue to be issued in some markets despite the risk of this. The following graph, for example, shows that the stock of cleared sterling LIBOR contracts continues to grow.

Figure 8.2: Roll-off outstanding notional for cleared LIBOR derivatives (£tr)



Note: This chart is an updated version of the chart shown in the Financial Policy Committee's Financial Stability Report from July 2019.

Source: Analysis based on LCH data provided to the FCA.
(a) includes gross notional outstanding of all interest rate derivatives with a GBP LIBOR-linked floating leg cleared at LCH Ltd excluding inflation swaps.
(b) End Apr 2018, End Oct 2018, End Apr 2019 and End Aug 2019 refer to observation dates for roll-off profile. The chart presumes no new trades are transacted after the observation dates

Firms will need to manage the risks from transition, including conduct risks. We expect firms to have a strategy in place and take necessary action during LIBOR transition, and to treat customers fairly.

MiFID II continues to drive significant change across the sector

MiFID II was implemented in January 2018, introducing a range of requirements to promote a more efficient, transparent and resilient financial system. We give more detail on the impact of some of these changes in the how the sector is changing section.

There are some signs that securitisation activity is picking up

The new EU Securitisation Regulation was implemented in January 2019. It aims to make it easier for investors to understand and assess the risks of a securitisation investment by introducing a framework for simple, transparent and standardised securitisations. Although activity remains low compared with previous years, the market has shown some signs of picking up.

Forthcoming changes under the Investment Firm Review should improve market effectiveness

We expect the Investment Firm Review to be implemented in 2021. It will introduce a new prudential regime for investment firms, who were previously subject to the same requirements as more systemic financial services providers. The new regime takes into account, in a more proportionate way, the degree to which an investment firm can cause harm to clients and to the markets they operate in. These changes should promote market effectiveness.

Other regulatory changes that should improve conduct in wholesale markets include:

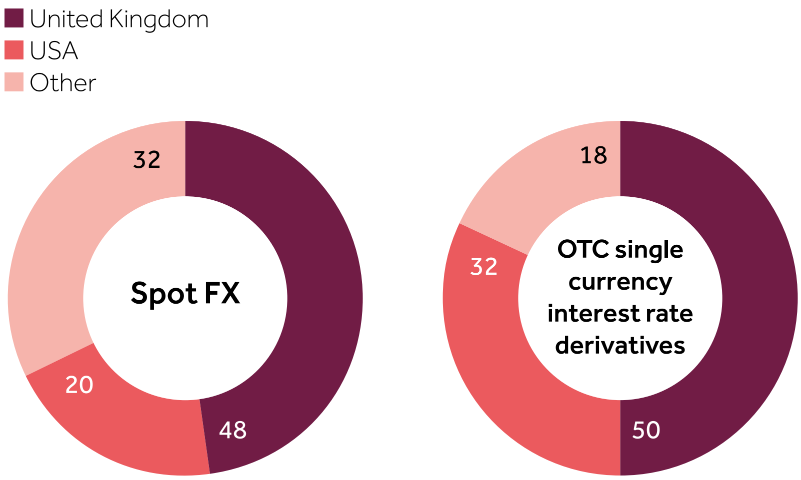
- Extending the Senior Managers and Certification Regime (SM&CR) to all solo regulated firms from 9 December 2019. The SM&CR aims to strengthen individual accountability in financial services.
- The new EU Prospectus Regulation came into effect in July 2019. It aims to simplify and improve the previous prospectus regime by enabling Small and Medium-sized Enterprises (SMEs) to benefit from a new, more proportionate, disclosure regime. It should also provide investors with better information to aid decision making.
- We confirmed recognition of the FX Global and UK Money Market codes in June 2019. These codes reflect the industry's views of best practice for unregulated activities within these financial markets.

How the sector is changing

The UK remains a key centre for wholesale market activity.

Recent data from the Bank for International Settlements, for example, shows that the UK accounts for 48% of global spot FX turnover and 50% of global turnover in OTC single currency interest rate derivatives.[5]

Figure 8.3: Regional turnover shares, April 2019 (%)[6]



Over the past year, UK firms have stepped up their Brexit preparations

In general, firms are seeking to keep their UK presence and operations as far as possible, while putting in place contingency arrangements so that they can adapt to the future UK-EU regime. These contingency arrangements aim to make sure firms can continue to serve European customers and ensure customers can meet EU requirements.

Some firms have already started to activate their contingency plans. This has led to some movement of activity to the EU27, and the relocation of some firms' offices. Overall, however, such movement remains limited in scale.

We have also seen technological developments and other innovations, including:

- The amount of capital raised in Initial Coin Offerings (ICO) has reduced significantly. There have been a number of reasons suggested for this reduction, including investor caution in response to fraudulent ICOs and the high failure rate of new firms that use the ICO process. We have issued public warnings about the risks of certain investments in this market.
- We estimate that, as of December 2019, fewer than 15 cryptoasset spot exchanges were headquartered in the UK, out of a global market of over 250. Our analysis suggests that these exchanges account for less than 5% of trading in this market. We have warned of the risks of purchasing unregulated cyrptoassets.[7]
- The launch of the Shanghai-London Stock Connect scheme in June 2019. This should encourage cross-border investment between the 2 countries and provide investors and companies in the UK and China with mutual access to each other's capital markets.
- The testing of blockchain-based systems in trading, settlement and payments services.
- RegTech developments, which may, for example, help firms' efforts to prevent financial crime.
- Industry and product developments on climate change and green finance.
- The growing sophistication of cyber-attack tools.

MiFID II has been driving change in the wholesale sector since its implementation in January 2018.

Some of the more significant changes include:

- Dark trading: restrictions have only had a limited impact on their intended goal of driving more trading to fully transparent trading venues. Instead, following MIFID II's implementation we have seen more use of systematic internalisers (SIs), periodic auctions and other trading functionalities. Although these alternative trading options are less transparent than central limit order books, they are more transparent than the methods they replaced. In addition, firms suggest they may support better execution by enabling them to trade with less market impact than on fully transparent venues.
- Closing auctions: we have seen continued growth of volumes executed on closing auctions. This is a trend that has been present for several years, driven by the rise of passive investments and associated demand to trade at the closing price. We are seeing new initiatives by trading venues in the UK and in Europe to meet this demand.
- Research unbundling: as a result of MiFID II rules on research unbundling, asset managers are now buying research themselves and not passing costs on to investors. Our research suggests brokers have not inflated their execution charges in response and that there has been a big drop in asset managers' spending on equity research. Research prices have fallen sharply but there does not appear to have been a material reduction in research coverage.

We have also been monitoring the impact of other MiFID II-related changes, including as part of EU-wide European Securities and Markets Authority (ESMA) reviews. These include the charging for data on a Reasonable Commercial Basis, commodity position limits regime, and disclosure of costs and charges.

Endnotes

1. Analysis based on LCH data provided to the FCA
2. FCA internal analysis
3. FCA internal analysis
4. HM Government and UK Finance, Economic Crime Plan 2019-22, July 2019
5. The Bank for International Settlements' Triennial Central Bank Survey, published September 2019. Data is for April 2019
6. Ibid
7. FCA internal analysis

FINANCIAL
CONDUCT
AUTHORITY

12 Endeavour Square London E20 1JN
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk