FINANCIAL CONDUCT AUTHORITY

Sector Views

Sector Views
Contents

	Introduction	6
1	Cross-sector themes	9
2	Retail banking and payments	15
3	Retail lending	23
4	General insurance and protection	31
5	Pensions savings and retirement income	39
6	Retail investments	47
7	Investment management	55
8	Wholesale financial markets	61

Sector Views
Introduction

Welcome to the Financial Conduct Authority's Sector Views. This publication provides our annual analysis of the changing financial landscape, the resulting impacts on consumers and market effectiveness. This analysis will feed into our Business Plan 2019/20.

The FCA needs a view of how the financial system is working as a whole to inform the decisions we make relating to consumers, market integrity, and competition. Once a year we bring our collective intelligence and analysis together into documents called Sector Views. These give us a picture – an FCA view – of how each financial sector is performing.

Sector Views describe financial sectors, the issues and developments we are seeing within them, the impact of change, and the actual or potential harm to consumers or markets. As well as analysing individual sectors, we look at macroeconomic developments and common drivers of change that are emerging across the financial sector as a whole.

Each Sector View helps us determine where to focus our efforts, our resourcing decisions, and our operational plans. Our business plan then sets out which areas we want to focus on for the coming year.

The Sector Views contained in this publication are based on the data available and our views at mid-2018.[1] Rather than wait to publish these alongside the Business Plan in April 2019, we have decided to share our Sector Views earlier so that stakeholders can get a more up-to-date insight into our view of how the financial system is working. We plan to continue to publish Sector Views in future years.

Although the Sector Views are not a consultation, we are interested in the views of our stakeholders on our findings. We would welcome comments on the cross-sector themes we have identified, the drivers of change in each sector, and your thoughts on what we have found on harm. While we will not be able to respond formally to the comments received we will use the intelligence received to improve future iterations of the Sector Views and inform our business planning.

Please send your comments to SectorViews@fca.org.uk

1. The Sector Views published 09/04/18 reflected our position at mid-2017 and fed into the Business Plan 2018/19.

Harm analysis

Our Sector Views give our analysis of how financial markets are working and evolving. They consider a wide range of factors that are driving change across the financial system, and we highlight some of the most significant of these in the cross-sector themes chapter. They include:

- how technology is driving change in financial services
- societal changes and their impact on the financial needs of different generations
- the potential impact of Brexit
- the macroeconomic environment

This informs our understanding of how these sectors may develop and helps us identify the areas of current or potential concern.

In our Mission 2017, we set out how 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 from occurring.

When we analyse harm, we look at its impact both at an overall market level and at the individual consumer level. 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.

Longstanding issues: These are problems that are always present in the financial system, such as conflicts of interest or information asymmetries. Our Sector Views identify how these issues are changing over time and where actual or potential harm may be increasing or decreasing. This helps us ensure our ongoing actions evolve to stay effective by, for example, adjusting the types and timings of disclosures in both retail and wholesale markets.

Developing issues: These can be the result of specific events, such as policy or legislative changes, or of ongoing trends, such as an ageing population or technological advances. Our role here is to consider the effects of these issues on sectors – some of which may be positive – and what harm they may cause. We continually aim to improve our understanding of societal change, such as through the information our Financial Lives Survey collects on consumers' needs and circumstances.

Our findings

Across all the Sector Views we find areas where both retail and wholesale financial sectors could produce better outcomes for users. We also find that it is increasingly important that firms' and markets' operational resilience is adequate to combat growing threats from cyber-attacks and prevent financial crime across all financial services sectors. We consider how Brexit affects all the sectors that we regulate and note that some sectors are particularly affected.

Retail financial sectors: Our analysis identifies areas where retail financial sectors do not work as well as they should for consumers. There are challenges for consumers in understanding and engaging with often complex financial services and products, especially where firms' incentives may not be aligned with meeting consumer needs. The result can be poor market outcomes with consumers buying unsuitable or poor value products or services, or firms not competing effectively on price and quality. The effects of this misalignment of firms' incentives and consumers' needs will often result in worse outcomes for consumers, particularly those with vulnerable characteristics.

Wholesale financial sector: In the wholesale sector, our focus has been on ensuring markets are clean, orderly, transparent, and resilient as well

as competitive. We have identified longstanding issues in the market, including conflicts of interest and asymmetries of information, and these will always require our attention. Other issues are more affected by macro-socio economic, regulatory, or technological developments, such as financial crime and market abuse.

Operational resilience: Across all sectors we find systemic issues that can affect the integrity of financial services markets and consumers' confidence in them. It is important that data and services are not compromised by threats, such as the increasing risk of cyber-attacks and technology outages. Barriers to financial crime may also be reduced by increased availability and advancement in cyber-attack tools.

Brexit: We continue to plan for a range of scenarios including a 'no deal' Brexit. All sectors are affected to some extent but the wholesale, investment management, and insurance sectors are potentially the most affected given the extent of cross-border trade in these sectors.

What we're doing

We are already tackling many of the issues identified in the Sector Views. Our Business Plan (2018/19) gives a more detailed explanation of our priorities and activities for the current year.

The Sector Views form part of the process that enables us to keep these priorities under review and focus our resources effectively.

How to read this document

In Chapter 1, cross-sector themes, we describe the emerging common themes driving change across sectors with a particular focus on technology as well as other developments in the wider environment that are impacting the sectors we regulate.

The remaining chapters cover all the markets we regulate. These are grouped into seven sectors:

- retail banking
- 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 overview:** The markets covered in the Sector View and some key statistics around the size of those markets.
- **How the sector is changing:** Notable trends and developments we have observed within those markets.
- **What is driving change:** How factors such as technological developments, regulation, the macroeconomic environment and societal developments, are driving change in the sector.
- **The consumer perspective (retail sectors only):** Insights into consumer experiences including those gained from the FCA's Financial Lives Survey data.
- **What we found on harm:** Issues we have identified where there may be a negative impact on consumers or the integrity of the financial system within the sector. We set out why these issues may be important and we consider what factors are driving this actual or potential harm. We also consider how the harm may develop over time.

Cross-sector themes

This chapter examines common drivers of change emerging across the sectors. This analysis help us understand how the sectors may develop and where we should focus our attention when identifying cross-sector priorities for the business plan. We focus on:

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

Technology themes

Technology is becoming increasingly important as a driver of change within financial services and is a key area of interest and focus for the FCA.

We have identified four broad and inter-related technology themes to help inform our understanding of future change. The scale and pace of change will depend upon the willingness of consumers and corporate users to trust new services and distribution channels. This, in turn, will be influenced by our regulatory approach and how this will foster trust and adoption within the sectors we regulate.

Digitalised automation, consumer engagement and firm accountability

Technology is changing the way consumers and firms interact, influencing how decisions are made, and helping improve communication through the use of technologies and services such as platforms and robo-advice.

The rise of digital platforms provides opportunities for engaging consumers and businesses with their financial planning. The adoption of Application Programming Interfaces (APIs), Open Banking and the Second Payments Services Directive (PSD2) seek to enable real time money management. These make it easier for consumers and businesses to manage payments, pay bills, and budget for their own financial needs by harnessing their actual payment patterns. Comparison platforms have been developed to help consumers choose insurance products, mortgages, investments and savings products. Robo-advice platforms are being developed so that they can offer, in addition to advice, investment and portfolio management services which can automatically trade to maintain the desired risk profiles, or realise investment losses for tax purposes.

The changing role of technology in the distribution and selection of financial services across sectors can bring significant benefits for consumers in the speed and ease of decision-making as well as savings from purchasing the most suitable product.

The increased use of technology to aid decision-making has implications for regulation. It is important we understand how firms use technology and what assumptions they use to build any automated services, to avoid consumers being sold products that do not meet their needs, or prevent widespread exclusion of vulnerable consumers. Firms will need to ensure they have strong compliance and control functions to mitigate financial, cyber crime, and misuse of data risks.

Disaggregation of the value chain and the regulatory perimeter

Technology is enabling firms to enter markets and compete by focusing on certain activities and targeting specific customer segments or needs through partnering or competing with incumbents.

Innovation can improve the design and delivery of many financial service products, reducing costs to firms and improving access for some consumers. Examples include the evolution of e-money propositions offering functionality akin to bank accounts, and the introduction of the Lifetime ISA, blurring the lines between cash savings, retail investments and pension products. In some cases, innovation leads to significant activity being undertaken outside the regulatory perimeter and without protections. For example, the growing use of Initial Coin Offerings (ICOs), which saw $5.8 billion of capital raised globally in Q1 2018 and the increasing global use of cryptoassets for transactions.[1] This can pose challenges for regulation as firms may act in ways not initially envisaged within our regulatory framework.

The growing participation from new entrants is likely to mean more complicated accountability and bring into question the adequacy of protections for consumers.

Sustainability of new business models and data analysis is facilitating personalised products and services

New entrants benefit from achieving scale at lower cost than firms using legacy IT systems. Over time some new entrants' business models will not be sustainable.

Technological progress increases the ability for more sophisticated analysis of data within financial services. This is leading to more tailored products and services that can better meet individual consumer needs, such as personalised insurance products, and opens up the possibility of more holistic financial planning tools.

The pros and cons of increasing personalisation need to be considered alongside broader issues including the potential for financial exclusion of certain groups.

In retail banking we found that the automation of certain decision-making processes by banks and payment firms may improve efficiency, but may also reduce firms' capability to identify and appropriately treat vulnerable consumers.

The increased use of technology to aid decision-making has implications for regulation. It is important we understand how firms use technology

1. Coindesk, monthly new ICO funding tracker.

Societal change

The UK population is changing, and so are its financial needs

In the UK, life expectancy has increased and, like many other countries, we have an ageing population. Slower economic growth is reflected in low interest rates and investment returns, and low real wage growth impacts on the ability to accumulate savings, and has led to increasing levels of debt. Intergenerational progress in terms of wealth accumulation, income growth and homeownership has slowed. This means that the financial circumstances and needs of each generation will differ from previous generations at equivalent ages.

Millennials (born 1981 to 2000) are finding it more difficult to get on the housing ladder and are experiencing less secure working practices and slower pay progression in their early careers compared to previous generations

As a result, their need for and ability to access certain financial products and services, including mortgages, is restricted. Younger consumers are unable to build up adequate savings in the short to medium-term, making retirement more challenging.

Generation X (born 1966 to 1980) are under pressure to plan for their own retirement while potentially supporting family across both sides of the generational divide

Pension freedoms have shifted responsibility for making a pension fund last through an entire retirement directly onto the consumer, and as a result we have seen a shift away from a retirement 'cliff edge' to a more phased transition over a number of years. The challenge of planning for a phased retirement is particularly significant for Generation X who are under pressure to plan for retirement while potentially supporting family across both sides of the generational divide.

While some Baby Boomers (born 1946 to 1965) have benefitted from generous pension entitlements and long-term property price appreciation, others will struggle to maintain living standards in retirement as life expectancy increases and rates of return on financial assets are low

Significant numbers of Baby Boomers have substantial property wealth but are cash poor, impacting their day to day spending. Increased longevity has resulted in challenges for the funding of long-term care in older age, especially for those not entitled, or unable, to rely on state provision. A subset of Baby Boomers who have had limited engagement with financial services in their lives to date may now need to engage at multiple points through their retirement.

Consumers of all ages are having to assume greater levels of responsibility for increasingly complex decisions in their interactions with financial services

The transfer of risk towards individuals is clear in pensions with an increasing reliance on defined contribution pensions, but is also significant in insurance with a decline in the use of advice and the purchase of certain products. Welfare reform leads to challenges for lower income groups' interactions with the retail lending sector. These could impact trust and confidence should some consumers be ill-equipped to manage with less support. In an era of low returns, consumers may be more open to attractive returns often offered by fraudsters.

As the UK population is changing, we continue work to deepen our understanding of societal change and use insights from our Financial Lives Survey to aid our understanding of consumer needs and circumstances

As we look ahead at the likely impact of these intergenerational changes and understand the risks to certain groups, together with the greater onus on consumers to manage their financial

futures, we may need to review some of our conduct requirements to ensure that they remain fit for purpose. We also need to ensure that we understand and regulate appropriately those products supporting wealth accumulation, decumulation and intergenerational transfers.

Brexit

The FCA continues to plan for a range of scenarios regarding Brexit

The FCA continues to plan for a range of scenarios regarding Brexit, including that a transition or implementation period will run from March 2019 until the end of December 2020. During the transition period, firms and investment funds would continue to benefit from passporting between the UK and the EEA as they do today. Obligations derived from EU law would continue to apply and firms must continue with implementation plans for EU legislation that is still to come into effect before the end of December 2020.

Our planning also includes being ready for the alternative possibility of a 'no deal' Brexit in March 2019 and includes consideration of how to address 'cliff edge' risks from the abrupt loss of passporting, such as contract continuity. The Government has passed legislation that will establish a temporary permissions regime for financial services if necessary. This will enable relevant firms and funds which passport into the UK to continue operating in the UK if the passporting regime falls away abruptly when the UK leaves the EU.

Brexit will impact all the sectors the FCA regulates

Wholesale and investment management are expected to be significantly impacted, given the extent of cross-border trade in these sectors. In the retail sectors, the insurance sector is expected to be particularly impacted. After the UK's withdrawal, the FCA may need to supervise firms whose structures have become more complex as a result of the changes, which might require greater regulatory oversight. The FCA intends to continue to cooperate closely with our international counterparts and will also continue to monitor for any wider effects and impacts Brexit might have on particular sectors of the market.

Macroeconomic developments

The macroeconomic environment can influence the behaviour of the firms we regulate and consumers

It is important for the FCA to understand how macroeconomic developments drive changes in the markets we regulate and how these may lead to harm.

The UK economy has faced a challenging external environment – in part reflecting the uncertainty surrounding Brexit

In its latest inflation report, the Bank of England (the Bank) expected global GDP to slow to 2% in 2021 from 2.75% this year. The predicted slowdown in growth reflects continued trade tensions between the USA and China but also tightening financial conditions, particularly in some emerging economies.[2]

UK GDP picked up in the second half of 2018 following a slowdown at the start of the year. It is projected to be modest, remaining below 2% through to 2021 according to the Bank's

2. Bank of England Inflation Report, November 2018.
3. ONS GDP data, 2018.

Figure 1: Real year-on-year GDP growth[3]

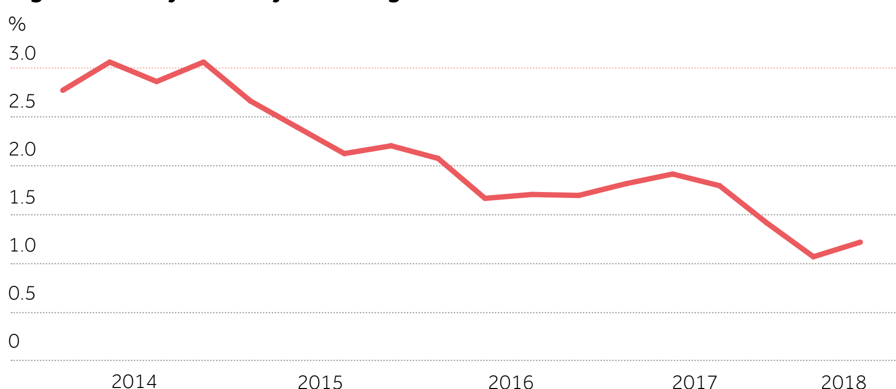


Figure 2: UK inflation – CPI year-on-year (%)[6]

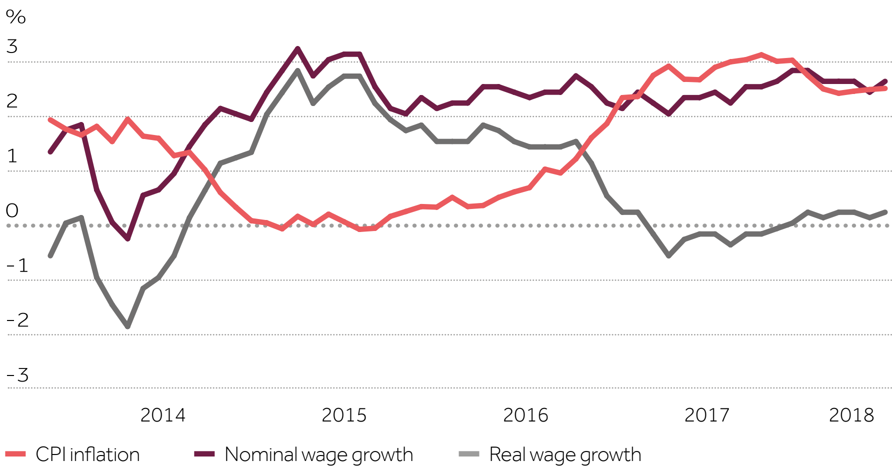
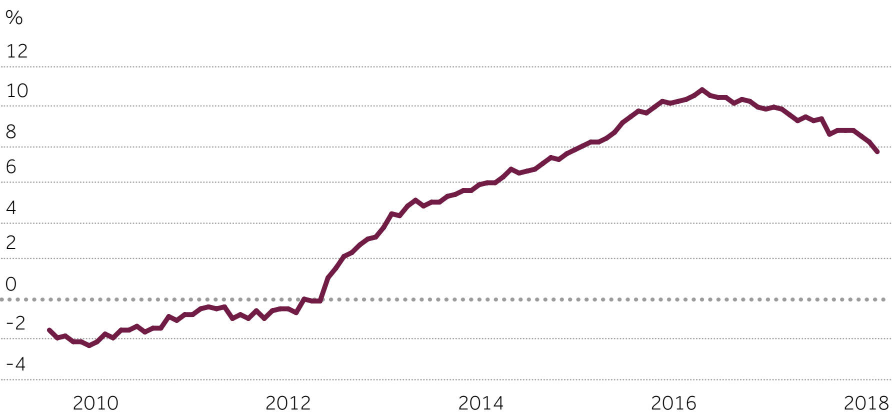


Figure 3: Annualised growth in consumer credit lending (%)[7]



forecasts.[4] The UK economic outlook, however, remains heavily dependent on the nature of the EU withdrawal deal.This, combined with low interest rates, reflects a challenging environment for the firms the FCA regulates and could impact their financial performance.

The low interest rate environment continues to have a significant impact on consumers and the firms we regulate

Over the past 12 months, the Bank has raised official base rates twice, from 0.25% at the beginning of 2017 to 0.75% today. The Bank does not anticipate, however, interest rates to return to 'normal levels' (which it estimates to be between 2%-3%) for several years.[5]

The prolonged low interest rate environment has contributed to consumers considering investing in riskier products, such as peer-to-peer lending. While these products may offer higher returns, consumers may often not be fully aware of the heightened risks associated with them.

In this environment, consumer demand for riskier savings and investment products could continue over the period up to 2021. Low interest rates have also meant that consumers have received historically low returns on their cash savings products.

Household finances have faced continued pressure over the past 12 months as inflation has grown faster than wages

This is likely to have contributed to the decline seen in the household savings ratio since the end of 2015 and could increase the incentives for some consumers to opt out of pensions saving.

At the same time, the pressure on household finances means some consumers are becoming more reliant on credit and borrowing

Consumer credit growth reached 7.7% in September 2018 having decreased relative to the 10.5% growth rate

4. Bank of England Inflation Report, November 2018.
5. Bank of England Inflation Report, August 2018.
6. ONS Consumer price inflation data, Labour market statistics data, and Earnings and working hours data, 2018.
7. Bank of England Consumer credit data, 2018.
8. Bank of England consumer credit data, 2018.

reached at the start of 2017.[8]

The combined effect of decreased savings and increased reliance on borrowing is of potential concern as it may mean that households may find it difficult to withstand financial shocks. With the inflation rate expected to fall over the next few years, however, this could reduce the pressure on household finances to some extent.

Employment has continued to grow over the past year. This growth has been driven by increases in full-time jobs. This can be seen as a positive development for the stability of households' financial resilience.

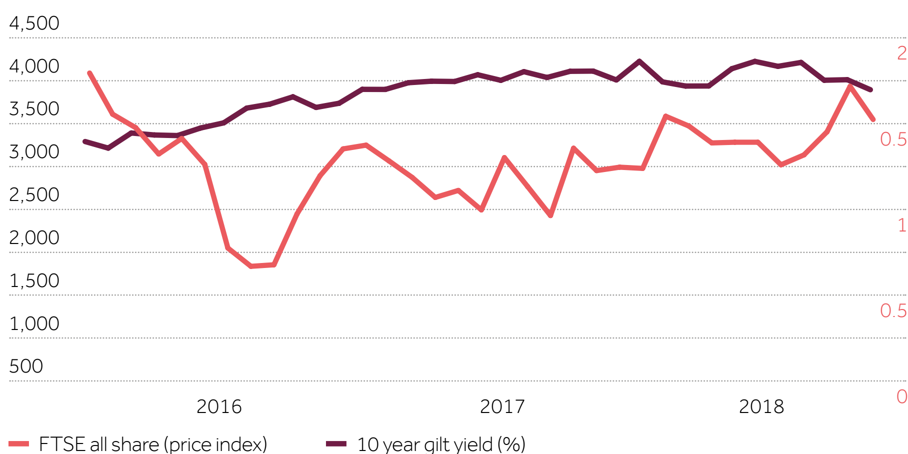
The FTSE 100 and All Share Indices have remained strong for most of the past year[9]

The FTSE All Share Index started 2018 above 4,200 and remained around that level before losing ground in September.[10] The rise in the value of equities has partly led to an increase in the total assets under management in the UK's investment management sector. In addition, investments denominated in currencies other than sterling have increased in value due to the lower value of the pound following the EU referendum. The Bank has also noted that spreads on corporate bonds have widened throughout 2018, raising the cost of finance for UK businesses.[11]

The continuing low interest rate environment has meant yields on UK Government bonds have remained at historically low levels

For those consumers approaching retirement this has impacted the amount of income they can expect to receive from guaranteed income products, such as annuities. This may lead to such consumers being more attracted to higher risk investments or misled by investment scams.

Figure 4: FTSE all share vs 10 year gilt year[12]



Summary

- The pace of technological progress and its implementation within financial services generates risks as well as opportunities for consumers. Firms must ensure their oversight and governance assesses the potential risks, including around the growing automation of product selection and decision-making.
- The disaggregation of value chains, with growing participation from new entrants and technology-focused firms, can increase complexity in relation to accountability and adequacy of consumer protections as market structures evolve.
- Preventing and tackling financial crime will continue to be a key way in which the FCA adds public value.
- As the UK population is changing, the FCA will continue its work to deepen its understanding of both societal change and macroeconomic factors to consider their impact across sectors and the potential for harm to be caused.
- Many of the factors driving change are international in nature and pose public policy questions – highlighting the importance of our continued engagement and dialogue with international counterparts and government on these issues.
- The FCA has initiated a wide range of Brexit workstreams and will need to continue to work with firms and government to resolve practical issues.

9. Bloomberg FTSE 100 index data.
10. Thomson Reuters.
12. Bloomberg. FTSE 100 and UK Government bond yields, Bloomberg.
11. Bank of England Inflation Report, August 2018.

Retail banking and payments
Sector View

The retail banking and payments sector is the gateway to financial services for most consumers and small businesses. 73,600 payments are made every minute in the UK[1] and 97% of adults have a personal current account[2] allowing salaries to be paid, rent and mortgage payments to be made and enabling businesses to trade daily.

Change in this sector is driven by advances in technology, a theme we see across sectors, and changing consumer preferences. Regulatory changes are helping to facilitate this development by encouraging innovation and competition.

Trust and reliability are central to the provision of retail banking services which consumers and businesses use every day. Consumers expect operational resilience and they want to be protected from financial crime. There are concerns that interrupted services or lost or corrupted data could have a widespread impact. There are also concerns that the shift to online distribution channels could create barriers for some vulnerable consumers. In addition, the FCA remains concerned about the way banks charge customers for overdrafts.

Sector overview

The retail banking sector is the gateway into financial services for most consumers and serves individual consumers and small and medium-sized enterprises (SMEs).[3]

The retail banking sector is closely linked to the retail lending sector. Overdrafts are inseparable from current accounts and are covered in the retail banking chapter.

The 6 largest personal current account providers have a significant presence in retail lending, especially mortgages, and other markets.[4]

The market map shows the sector divided into the current account market, the savings market, and payment services and e-money. Taken together, the cash savings and the current account markets form the market for retail deposits.

Current accounts and cash savings

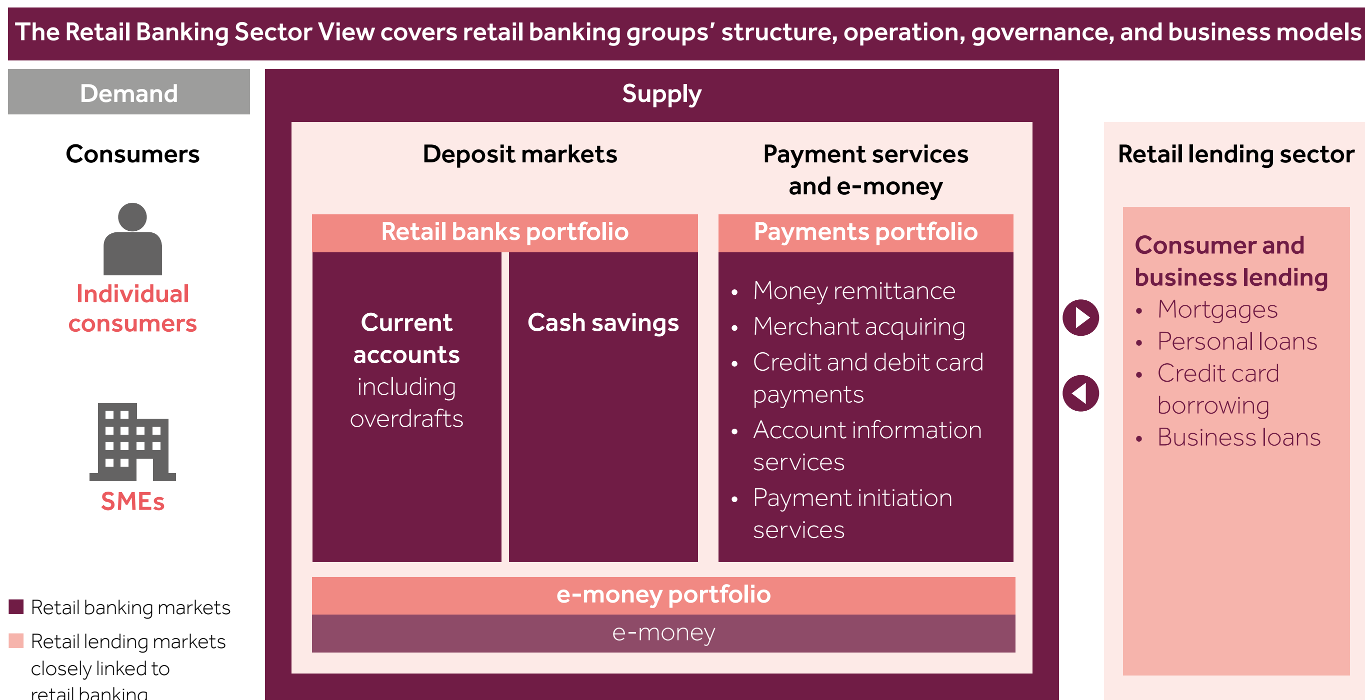
This market enables users to make fast and secure payments, hold funds securely, have a credit buffer to smooth cash flow, build savings for the short and the long term, and earn interest.

Payments services

The activities and firms operating in the payments market are extremely diverse. These activities range from direct debits and standing orders offered by retail banks, to services that underpin card-based payments such as merchant acquiring and payment processing. They also include e-money propositions including pre-paid cards and digital wallets, as well as money remittance firms enabling international transfers.

1. UK Payment Markets 2017, UK Finance.
2. GfK FRS, 12 months ending December 2017. All GfK FRS data sourced from © GfK Financial Research Survey (FRS) 12 months ending December 2017, 60,000 adults interviewed.
3. The Bank of England defines SMEs as those non-financial businesses with an annual turnover on the main business account of up to £25 million. The majority of lending to SMEs for business purposes is outside the FCA's regulatory perimeter, but most SMEs need access to credit and lending products.
4. The 6 largest providers of UK personal current accounts are: Barclays Group, HSBC Bank, Lloyds Banking Group, Nationwide Building Society, RBS Group, and Santander UK.

Figure 1: Overview of the retail banking sector



97%

of adults have a personal current account

The total value of household assets held in non-interest bearing accounts has increased by 8% since December 2016[5]

54%

of adults hold a cash savings product[6]

The total value of household assets held in interest-bearing accounts by households has increased by 1.8% since December 2016 to £1,124 billion, but cash ISAs remained flat[7]

66%

of the mortgage market and 62% of the credit card market is held by the big 6 retail banks[8]

Demand, 2017	Consumers	SMEs[11]
Current accounts	74m[9]	3.6m
Cash savings accounts	26m[10]	1.5m

Total value of household assets held, 2017[12]		
Non-interest bearing accounts	£189bn	▲ 8% vs Dec 2016
Interest bearing accounts and cash ISAs	£1,124bn	▲ 1.8% vs Dec 2016

73,600

payments made every minute by consumers and business in 2016

2%

increase in payment volumes and 4% in the total value[13]

5. Table A6.1, data to 29 December 2017, Bank of England.
6. GfK FRS, 12 months ending December 2017.
7. Table A6.1, data to 29 December 2017, Bank of England.
8. GfK FRS, 12 months ending December 2017.
9. GfK FRS, 12 months ending December 2017.
10. FCA calculation based on GfK FRS, data to December 2017 and ONS data.
11. SME Finance and Banking Report, Charterhouse Research 2017.
12. Table A6.1, data to 29 December 2017, Bank of England.
13. Excludes CHAPS. UK Payment Markets 2017, UK Finance.

How the sector is changing

The retail banking sector is in a period of transition. Significant change continues to be driven by advances in technology and regulatory changes such as the revised Payment Services Directive (PSD2) and Open Banking.

Retail banks and other providers are developing new services to take advantage of opportunities created by PSD2 and Open Banking

Some early offerings have reached the market. Examples include apps which aggregate data from users' accounts, calculating disposable income and nudging users to save. We expect choice to increase over time, giving consumers more control over their finances.

Technology firms are becoming increasingly important in the payments sector...

While existing providers in the sector range from global banks to more specialised firms, technology firms are becoming increasingly important. Google, Amazon, Apple and Facebook all now offer some form of payment functionality to UK consumers.

... and services are increasingly provided by intermediaries

Foreign exchange services, providers of consumer data analytics or fraud prevention software for corporate clients are entering the payments market.

Our High-Cost Credit Review (HCCR) has shown that overdrafts are poorly understood, with low levels of consumer engagement and weak competition

Our research has found that charges for overdrafts are highly concentrated, with a minority of consumers paying the majority of fees. For instance, over half the charges for unarranged overdrafts are concentrated on just 1.5% of customers.[14]

Since the monthly maximum charge (MMC) was introduced in August 2017 heavy users of unarranged overdrafts have benefited the most and are paying less in charges (£5.45 less per account per month on average). Total unarranged overdraft charges have also reduced by around £5.6 million per month.[15]

The MMC only applies to unarranged overdrafts and does not address all of our concerns about the pricing and use of all types of overdrafts.

Consumers are increasingly relying on electronic payments. Since the end of 2017, debit cards are the most widely used payment method

Many consumers use contactless cards for low value payments, although 50% of all spontaneous payments and 73% of consumer-to-consumer payments were still made with cash in 2016.[16]

As shown in Figure 2, cash is used for 40% of all payments but the number of cash payments fell from 17 billion in 2015 to 15 billion in 2016.

14. High-Cost Credit Review CP18/3, FCA.
15. High-Cost Credit Review CP18/3, FCA.
16. UK Payment Markets 2017, UK Finance.
17. UK Payment Markets 2017, UK Finance.
18. UK Payment Markets 2017, UK Finance.
19. UK Payment Markets 2017, UK Finance.

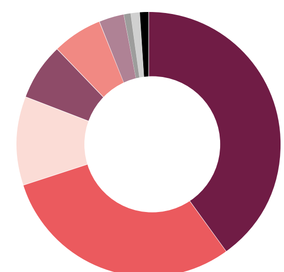
Payments*[17]	Consumers	(2016 vs 2015)
Volume	34.6 bn	▲ 0.3%
Value	£1,590bn	

Payments*[18]	Business	(2016 vs 2015)
Volume	4.1bn	▲ 7%
Value	£6,097bn	

*excludes CHAPS

Figure 2: Payment methods (volume) 2016[19]

Method	Share
Cash	40%
Debit card	30%
Direct debit	11%
Credit card	7%
Bacs direct credit	6%
Faster payments	3%
Standing order	1%
Cheque	1%
Other	1%



The migration from cash to cards is expected to continue but cash remains an important payment method especially for low income households.[20]

... while demand for cash savings is fairly static and the number of savings accounts which pay interest over the base rate has fallen[21]

54% of adults hold a cash savings product[22] with the total value of household deposits held in interest bearing accounts increasing by 1.8% compared to last year.[23] This year 71% of products paid over the base rate compared with 74% of products 12 months ago (Figure 3).[24]

Lifetime ISAs (LISAs) became available in April 2017, but only three firms offers cash LISAs.

What is driving change

Recent regulatory developments have been aimed at facilitating innovation, technological development and competition in retail banking and payments to meet consumers' changing preferences. As a result the sector is in transition as new entrants and incumbent firms look to develop new propositions to meet consumers' changing preferences.

Regulation and technology are changing the payments sector...

The regulatory environment for payments is complex – with multiple regulators and significant new regulations introduced over the past decade.

E-money regulations and the Payment Services Directives (PSD1 and PSD2), have encouraged many technology firms to enter the market.

Advances in technology and changing consumer preferences are now becoming an even more significant driver of change, both in the UK and internationally.

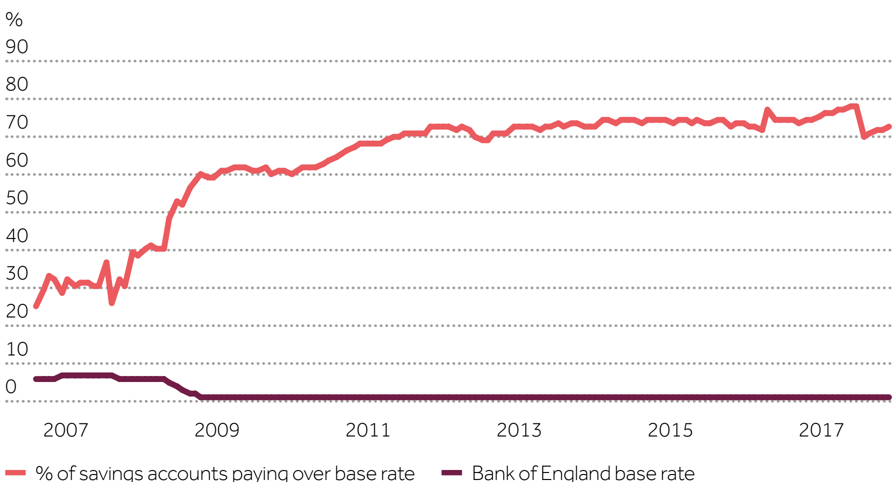
As a result, consumers stand to benefit from cheaper, faster payments (eg across borders), reduced friction and improved ease of making payments.

Moreover, regulatory interventions like PSD2 seek to encourage competition and foster an environment that helps facilitate innovation. This is likely to improve consumer awareness, reduce information asymmetries by using real time payments data to allow more tailored comparison of financial products, and improve access to financial services.

The way in which payments are made is evolving, yet resilience and security of systems remain a key issue for the sector.

> **"Technology firms have entered the payments market and the sector is undergoing rapid change. UK Finance found that over a third of consumers who use mobile payments make at least one such payment per week"**

Figure 3: Percentage of savings accounts paying over the base rate



20. UK Payment Markets 2017, UK Finance.
21. UK Savings Trends, March 2017, Moneyfacts.
22. GfK FRS, 12 months ending December 2017.
23. Table A6.1, data to 29 December 2017, Bank of England.
24. UK Savings Trends, March 2017, Moneyfacts.

Consumer perspective

Only 3 in 10 consumers have ever switched current account but 44% of adults have more than one active current account

Financial Lives Survey data show 70% of account holders who have held their account for over 3 years have never switched provider. 60% of the non-switchers say they are happy with their existing provider and for 35% nothing would encourage them to switch.

44%
of adults have more than one active current account

Our Financial Lives Survey data also show that couples and mortgage holders are more likely to have more than one current account, often to separate joint and individual accounts, for budgeting and to separate bill payments.

Consumers often hold several products with their main bank, most commonly a savings account. 56% of current account holders also have a savings product with their main bank but only 15% have a mortgage with their main bank.[25]

56%
of current account holders also have a savings account with their main bank

Some surveys also suggest that consumers are reluctant to share data, which could slow down the adoption of Open Banking

Open Banking will allow consumers to give providers access to their financial information. It is intended to improve competition but surveys suggest most consumers are reluctant to share data with providers other than their main bank.

Data from Mintel show 58% of current account holders are willing to share financial data from other providers with their main bank, compared with 12% who would be willing to share financial data with new banks (Figure 4). 44% of consumers say nothing would encourage them to share their financial data, whereas 29% of potential data sharers are motivated by personalised offers.[26]

Branches remain an important channel to open and manage accounts, including for younger consumers…

Despite the growth of digital banking, self-reported consumer data show the number of branch interactions has been stable.[27] Our Financial Lives data show 18-24 year olds use face-to-face services at branches more regularly than 25-44 year olds.

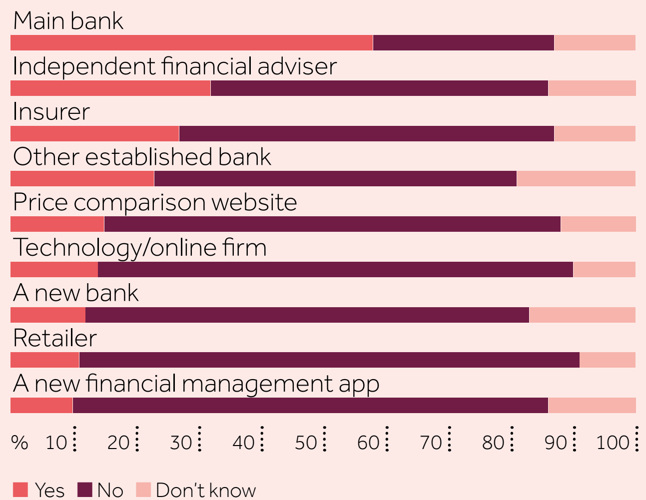
In 2017, 46% of new current accounts were arranged at a branch, and 63% of current accounts were at least partially managed in branch. 11.9 million adults used only the branch to manage their current account in 2017, a decrease of 21% since 2011.[28] There has, however, been a shift to in-branch self-service.

… but the branch network continues to decline

As technology is changing the way consumers and firms interact, the number of bank and building society branches fell to 8,981 in 2016, down from 12,048 in 2006.[29]

Our Strategic Review of Retail Banking Business Models sought a better understanding of the role of branches.

Figure 4: Willingness to share data with different types of providers (%)



44%
of consumers say nothing would encourage them to share their financial data[30]

25. Consumers and Data Sharing in Financial Services, Mintel.
26. Consumers and Data Sharing in Financial Services, Mintel.
27. GfK FRS, 12 months ending December 2017.
28. GfK FRS, 12 months ending December 2017.
29. UK Payment Statistics 2017, UK Finance.
30. Consumers and Data Sharing in Financial Services, Mintel.

... consequently the retail banking and payments sectors are in transition with the development of new business models

We anticipate that UK payments will evolve over the coming years, shaped by the type and number of new entrants and business models adopted by these firms.

In a fragmenting market, banking and payment services are increasingly offered in partnership with and between technology firms. We expect that incumbent firms will increasingly outsource the delivery of major and critical services to unregulated providers.

Our Strategic Review of Retail Banking Business Models considered alternative scenarios that could arise in the future depending on the extent to which consumers embrace new technology and move payments, deposits, and borrowing to alternative providers. The way in which technology is driving change is a cross-sector theme.

Traditionally UK consumers' preferences and behaviour have evolved slowly in response to new payment options

Convenience, security and acceptance are key determinants of the adoption of new payments methods, with older consumers less likely to take up new tech-enabled payment methods.

Macroeconomic factors are contributing to consumers saving less

The combination of lower interest rates on savings accounts, higher levels of household indebtedness, higher inflation, and low real wage growth has led to an overall declining savings ratio (excluding pensions) while real interest rates (the interest rate after taking account of inflation) remain negative.

Lower levels of savings could affect business models and funding costs of firms if they have lower overall deposit levels. We have not, however, seen evidence of this.

In the payments sector uncertainty regarding Brexit adds complexity to a number of issues in the sector

The future arrangements and uncertainty regarding Brexit add complexity in relation to a number of issues in the sector such as access to European payment schemes, the loss of passporting, and what consumer protections will apply for UK consumers making EU payments. Issues around access to payment systems could potentially result in increased costs and/or slower transfers.

What we found on harm

Trust and reliability are central to the provision of retail banking services which consumers and businesses use every day, and competition in the sector has been the focus of several initiatives by the Competition and Markets Authority (CMA) and the FCA. As the market evolves in response to these developments we need to consider the potential impacts on segments of consumers that may not be able to access the benefits of technological innovation. We also remain concerned with how banks charge for overdrafts.

The interconnectivity of retail banking in the financial system means that interrupted services or lost or corrupted data could cause widespread harm for affected individuals and affect wider market confidence

Cyber-attacks in the financial services sector are becoming more frequent and widespread. This is potentially made worse by the use of complex and ageing IT systems, outsourcing of operations and the growing transfer of data between firms.

Interrupted services or lost or corrupted data can cause inconvenience or financial loss for consumers. They can also lead to reputational damage for firms and markets. This remains a focus for us as lost or corrupted data raise concerns about market integrity,

43,875
reported cases of authorised push payment fraud in 2017

£236m
total value of push payment fraud in 2017

and facilitate financial crime and identity theft. Incidents can quickly spread to firms which rely on and are connected to each other.

Our work continues to focus on ensuring that firms are more resilient to cyber-attacks and technology outages, so reducing the risk and frequency of disruption and also ensuring new and replacement technologies are resilient.

We work closely with global bodies such as the International Organisation of Securities Commissions (IOSCO), Group of Seven (G7), Financial Stability Board (FSB) and others who prioritise data security, resilience and outsourcing. One particular area we are focusing on is outsourcing arrangements where the service provider supports many firms, which could mean the impact of any disruption with that provider has a wider impact.

Financial crime harms society and the wider economy

Financial crime causes financial loss to victims and enables criminal activity. It includes money laundering, terrorist financing and financial fraud. The universal nature of retail banking transactions, as well as the frequency and speed with which they are conducted, make the sector especially vulnerable to financial crime.

The safeguards we put in place to prevent financial crime are designed to make the UK and the financial services sector a hostile place for criminals and a safe place for consumers, while ensuring we meet latest international standards.

We want safeguards to be proportionate, operate efficiently and minimise any unintended consequences of regulation. Evidence suggests that banks are continuously improving their processes but money launderers are becoming more sophisticated too.

We also want to reduce and prevent the harm caused by scams and increase consumer awareness of the dangers of fraud. In 2017, firms' fraud losses fell by 5% to £731 million. £2 in every £3 of attempted unauthorised fraud across payment cards, remote banking and cheques was prevented.[31]

While some types of fraud such as payment card fraud have declined in response to industry efforts, others have increased, notably authorised push payment fraud.

While firms protect consumers from most types of banking fraud, victims struggle to prevent or recover losses from some authorised push payment fraud. During 2017, there were 43,875 reported cases of authorised push payment fraud with a total value of £236 million. In 2017, victims lost £2,784 on average. For businesses, the average fraud loss was much higher, at £24,355. Only 26% of authorised push payment fraud losses were returned to consumers.[32]

Recent initiatives on authorised push payment fraud, driven by the Payment Systems Regulator (PSR) and UK Finance, seek to spread best practice, improve market confidence, and reduce consumer loss. One of the initiatives is the development of a contingent reimbursement model, which will set out when firms are responsible for reimbursing the losses of scam victims.

Technology and innovation enable products and services that can better meet many consumers' financial needs, but these can also create barriers for the most vulnerable

Banking apps give consumers more flexibility and they have led to an increase in the number of interactions between banks and consumers. Although these changes improve access for many, they can affect those who rely on a shrinking branch network.

The shift to digital channels also raises concerns that certain segments of the population will be excluded or receive poor service. Low digital and financial capability increase concerns around vulnerability and access.

Commercial incentives might be insufficient for incumbent banks to effectively compete on quality and price to retain business

31. 2017 Annual Fraud Update, UK Finance.
32. 2017 Annual Fraud Update, UK Finance.

Charges for overdrafts are higher and interest rates for back book savings accounts are lower than would be expected in an efficient market. Many consumers view the current account as a homogeneous free product. They are reluctant to shop around, and the quality of firms' service or the pricing of ancillary services such as foreign exchange are difficult to compare.

Competition in the sector has been the focus of regulatory attention across the current account, savings and payment markets.

Our Strategic Review of Retail Banking Business Models analysed current account profitability and the FCA and CMA competition remedies seek to improve competition in the current account market. This work is closely linked to the High Cost Credit Review (HCCR) .

The HCCR found that charges for overdrafts are highly concentrated, with a minority of consumers paying most fees

The current distribution of charges across the current account market appears potentially harmful – particularly for unarranged overdraft users. There is a significant difference between arranged and unarranged overdraft prices, with firms making around ten times the yield on unarranged lending than on arranged lending.

Furthermore, vulnerable consumers are more likely to use unarranged overdrafts and pay more in charges. For some consumers, an overdraft may not be the most suitable credit product.

We consulted on interventions to increase consumers' awareness of how they are using their overdrafts and how the overdraft facility works. Following consultation, we published rules including mobile phone alerts linked to overdrafts, improvements in the visibility and content of key information and online tools to allow consumers to get an indication quickly of their eligibility for an overdraft.

We are consulting on interventions that relate to pricing and a reduction in the repeat use of overdrafts.

There have been instances where firms failed to treat SMEs fairly

Based on some well-publicised cases of historic harm, there are concerns that firms' governance, systems and controls may fail to ensure consistently that SMEs are treated fairly. Information and resource asymmetry between banks and SMEs puts SMEs at a disadvantage in understanding complex issues relating to products and charges.

Only some lending to SMEs is within our regulatory remit: specifically, where a borrower is a sole trader, small partnership or unincorporated body, and the amount of credit or hire does not exceed £25,000.

Consumers misunderstand the protections and benefits associated with new and different types of payment services

This includes the loss of protection under Section 75 of the Consumer Credit Act for credit card purchases due to the presence of third-party payment processors and misunderstanding how Continuous Payment Authorities work.

We want to increase awareness of relevant regulations

Innovation is supporting competition, but some technology-led businesses lack experience complying effectively with financial services regulations.

Some e-money firms may not do enough to ensure products are suitable for their customers, for example, where these are sold with other products.

With increasing data-sharing, consumers may not fully understand what consent they have granted, and data lost through security breaches could be misused in the future.

Retail lending
Sector View

Retail lending allows consumers to borrow to meet their financial needs, from buying a house or car to supporting everyday expenditure. Around 39 million people in the UK have outstanding credit borrowing[1] and there are 13.5 million mortgage accounts outstanding.[2] The total amount of lending across the sector is estimated to exceed £1.5 trillion.[3]

Change in the sector is being driven by the developing needs of different generations of the UK population over time. Longevity, earnings growth, changing working patterns and housing costs impact different generations of the population in different ways. Technological developments offer potential benefits for firms and consumers both through helping consumers navigate complex markets and by reducing costs.

Borrowing is a necessity for many consumers, which means they are more susceptible to being sold unsuitable or poor value products and services. This can lead to some consumers facing financial difficulties, and we remain concerned that some of these consumers are poorly treated.

Sector overview

The market map shows the sector split into two main sub-sectors: mortgage lending, and consumer credit. The sector also includes providers of distribution and ancillary services.

Distribution

Many consumers access lenders directly. Some consumers may need advice or guidance to understand which products or services might best meet their needs. These consumers may access credit through intermediaries, such as mortgage or credit brokers. Some consumers obtain credit via peer-to-peer platforms, which intermediate between those looking to lend and those looking to borrow.

Mortgage lending

Mortgage lenders provide loans secured against a property. These are mainly used to fund or refinance the purchase of a property over a number of years. They may also be used for investment purposes, or to release equity from a property.

Consumer credit

Consumer credit lenders provide shorter term finance. The sector provides loans to consumers across the financial spectrum for a range of needs, from day-to-day expenses to buying a car.

We have made a distinction between mainstream and high-cost credit markets, as the product features and the demographics serviced by these markets are significantly different.

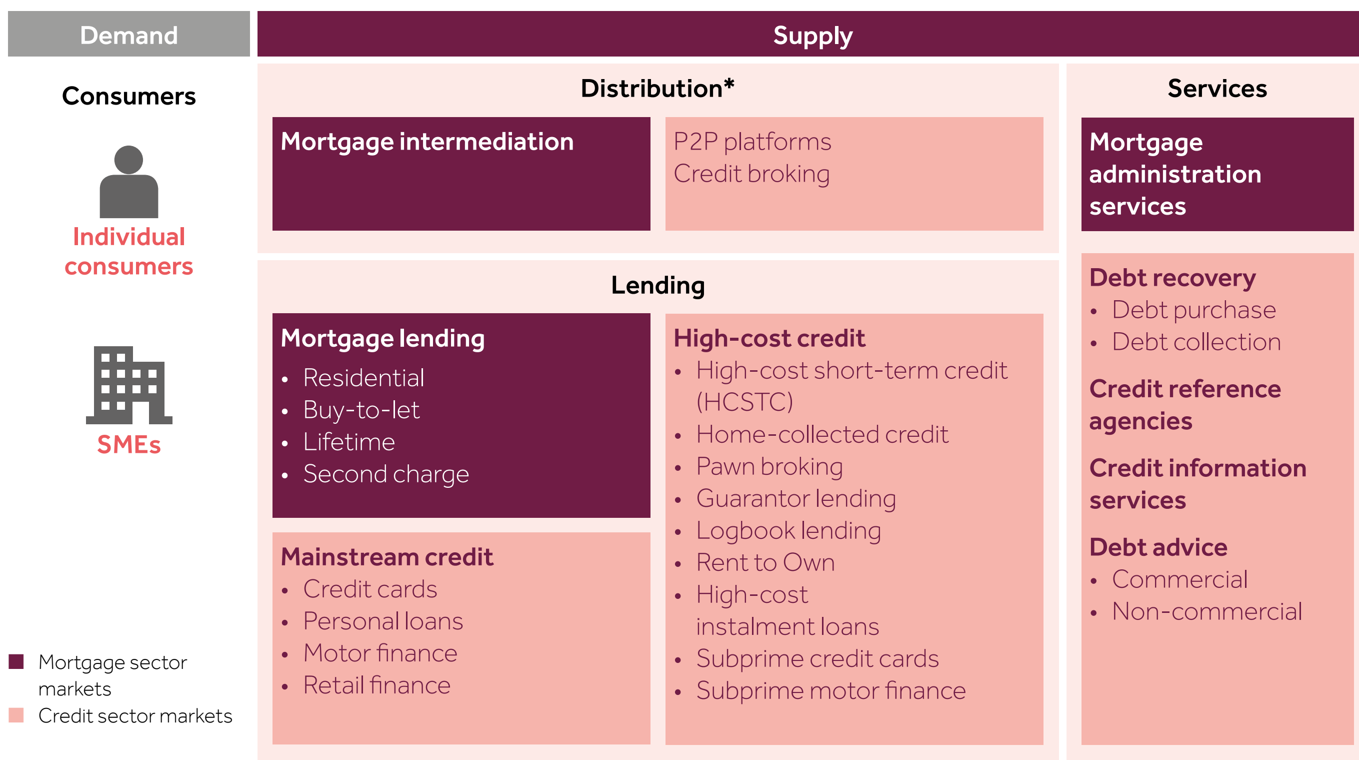
Service providers

These firms provide ancillary services to both lenders and consumers. These services include providing information about credit standings, debt advice and administering mortgages on behalf of lenders.

At the bottom of the next page we summarise some core market statistics to highlight the size and scope of the sector.

1. FCA, Getting affordability right in consumer credit, speech by J Davidson, Director of Supervision, at Credit Summit, March 2018.
2. Bank of England/FCA MLAR, 2017.
3. Bank of England, Money and Credit, March 2018.

Figure 1: Overview of the retail lending sector



£1,375bn
mortgage loans outstanding
▲ 3% vs 2016[4]

13.5m
mortgage accounts outstanding
▲ 1.8% vs 2016[5]

4,536
residential mortgage products
▲ 4.7% vs April 2017[6]

15%
of mortgage holders would struggle to make repayments if their mortgage increased by £99 per month[7]

£70,841m
outstanding credit card lending
▲ 4.1% vs April 2017[8]

c7m
personal loans outstanding[9]

£3.3bn
outstanding high-cost debt[10]

3.1m
consumers with outstanding high-cost debts[11]

c4m
motor finance products outstanding
▲ 1.7% vs 2016[12]

4. Bank of England/ FCA MLAR, 2017.
5. Bank of England, Money and Credit, March 2018.
6. Moneyfacts, UK Mortgage Trends Treasury Report, April 2018.
7. FCA Financial Lives Survey 2017.
8. Bank of England, Money and Credit, March 2018.
9. FCA CRA data, November 2016.
10. FCA CRA data, November 2016.
11. FCA Financial Lives Survey 2017.
12. FCA High-Cost Credit Review Technical Annex 1: CRA Data Analysis of UK Personal Debt, July 2017.

*Distribution is also provided by other sectors, including general insurance, retail shops, motor.

How the sector is changing

The rate of growth of consumer credit has slowed, with signs it may slow further, while mortgage growth continues to be muted, particularly as demand for buy-to-let products decreases. Mortgage rates are likely to follow base rate increases, and the end of the Term Funding Scheme could increase the cost of funding for some firms. Mortgage terms and loan-to-income ratios (LTIs) continue to grow.

The rate of growth of consumer credit lending remains high but has started to slow...

The rate of growth of consumer credit slowed to 8.6% in March 2018, down from 10.3% in April 2017 (Figure 2).

This was driven by a reduction in the overall volume of new car finance lending, which reduced by 4% year-on-year. While average new car finance agreements increased in value, the overall number of agreements reduced in 2017, leading to an overall reduction in lending.[13]

... and there are signs that mainstream credit firms are starting to restrict lending

The Bank of England (the Bank) has raised concerns about the recent high rate of growth of consumer credit which, together with changes to interchange fees[14] and regulatory interventions, have led to mainstream credit firms starting to slow lending.[15] This can be seen by reductions in both the number of 0% balance transfer deals and the average balance transfer period.

Steady growth in mortgage lending was driven by first-time buyers and remortgagers...

In the 12 months to February 2018, the total value of outstanding residential lending increased by 4.2%.[16] Growth continues to be driven by first-time buyers and remortgagers, which grew by 5% and 12% respectively in 2017.[17]

... with the share of buy-to-let (BTL) mortgages decreasing

Changes to the Prudential Regulation Authority's (PRA) requirements on underwriting standards and tax treatment of BTL mortgages led to the share of BTL lending decreasing to 12.7% in Q4 2017, the lowest percentage since Q3 2013.[18]

The average mortgage term is increasing...

Terms are increasing with 34% of all mortgages now longer than 30 years, compared to 20% in 2007 (Figure 3). 40% of borrowers who took out a mortgage in 2017 will be aged over 65 when their mortgage matures. This reflects wider societal changes, as highlighted in the cross-sector themes chapter, and may impact on pension savings for these borrowers.

Figure 2: Annualised growth in consumer credit[19]

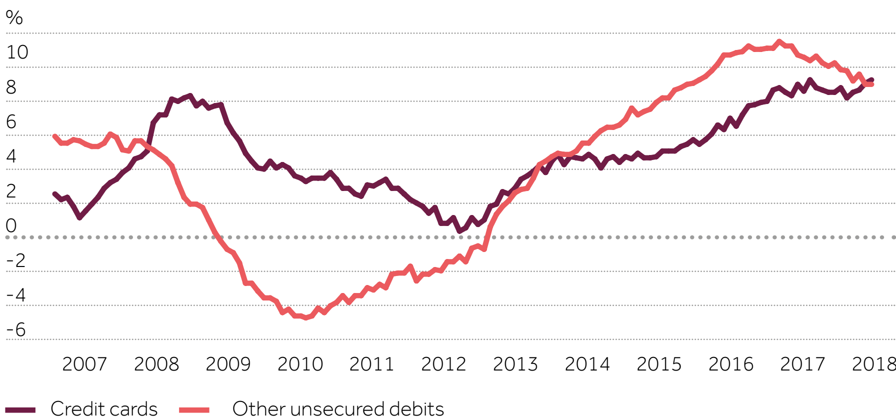
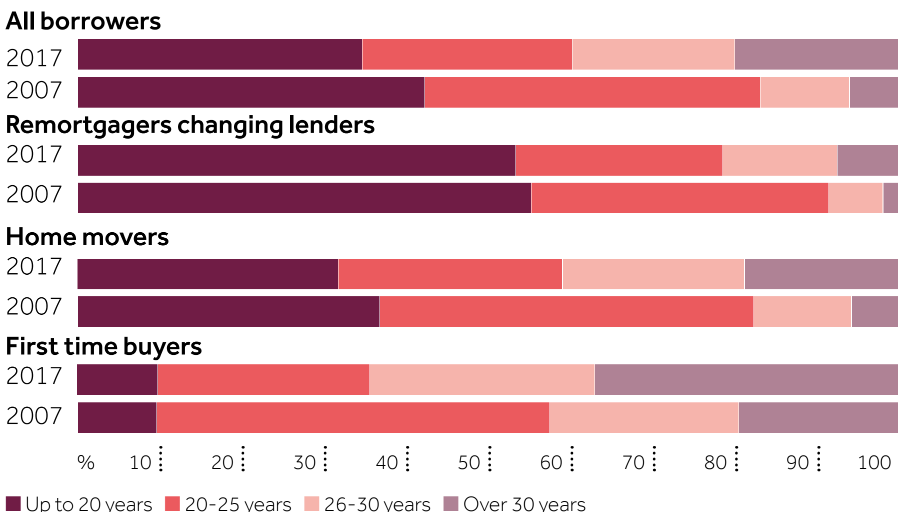


Figure 3: Mortgage term bands by borrower type (%)[20]



13. The Financing & Leasing Association, March 2018.
14. The interchange fee is a transaction fee paid by the merchant's bank to the card issuer when a customer makes a card payment.
15. Bank of England, Credit Conditions Survey, 2018 Q1.
16. Bank of England, Money and Credit, March 2018.
17. FCA PSD, 2017 Q4.
18. FCA PSD, 2017 Q4.
19. Bank of England, Money and Credit, March 2018.
20. FCA PSD, 2017 Q4.

… and loan-to-income ratios (LTIs) continue to increase

For loans made in 2016, LTI ratios for new mortgages continued to increase (Figure 4). Over 25% of mortgages now have an LTI of greater than 4 times income, with an increasing number of loans near the Bank's 4.5 times LTI flow limit.

The end of the Term Funding Scheme will lead to increased costs for firms, and potentially for consumers

The Term Funding Scheme was implemented by the Bank. Its aim was to encourage the transmission of Bank rate cuts to households and businesses by providing term funding to banks at close to the Bank rate.

It ended in February 2018 after a total of £127 billion had been lent to firms.

What is driving change

Pressures on household finances suggest many households may find it difficult to withstand financial shocks. More homeowners are looking to access equity in their property. Technology changes will provide benefits for many consumers, but could reduce access for those with non-standard circumstances.

Consumers may be less able to withstand financial shocks…

A range of factors, including subdued earnings growth, changing working patterns (Figure 5) increasing household debt (Figure 6), and lower saving rates suggest many households may lack financial resilience to withstand financial shocks. These factors are considered in more detail in the cross-sector themes chapter.

Figure 4: LTI ratios on new mortgage advances (%)[21]

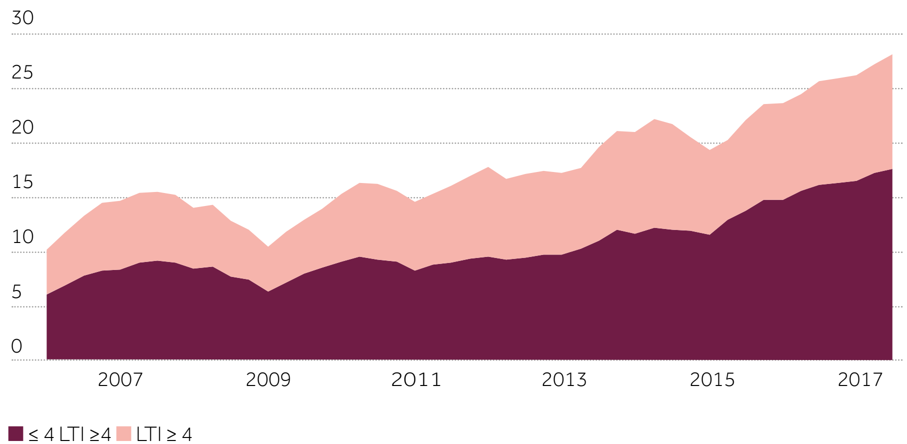


Figure 5: UK employment and types of employment (index 100=31.05.2008)[22]

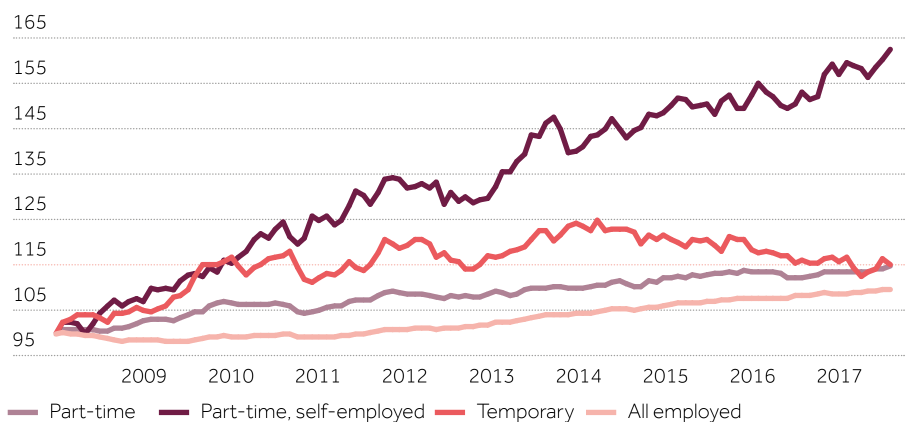
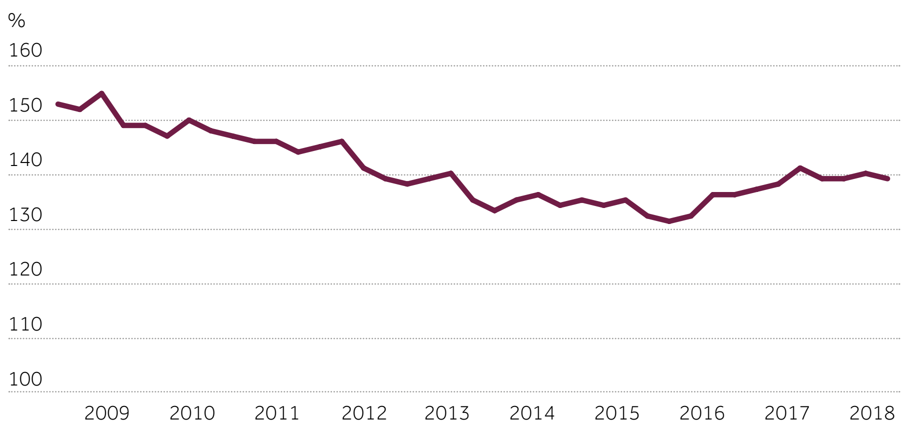


Figure 6: UK household debt (% of disposable income)[23]



21. Bank of England,Financial Stability Report, November 2017.
March 2018.

22. ONS, Labour Force Survey, March 2018.

23. ONS, Debt to disposable income, March 2018.

Consumer perspective

Around 39 million people in the UK have at least one retail lending product...

Financial Lives Survey data show that 75% of all UK adults used a form of regulated credit in the last 12 months, and that 31% hold a residential mortgage.

75%
of all UK adults used a form of credit in the last 12 months

... many of whom are credit card transactors who repay their liabilities on a monthly basis

Of the 39 million with credit products, a large number are credit card transactors, who repay their debts in full every month or most months. If transactors are excluded, those aged 25-34 are most likely to hold these products.

Debt repayments as a percentage of pre-tax income are highest for those aged 25-34...

Those aged between 25-34 have the highest average borrowings, and pay an average of 19% of their pre-tax income, towards average total debts of £50,900 per person.[24]

... and are lower for those over-65s

The lowest average overall debt is held by those aged over 65, whose average debt repayments equate to 4% of pre-tax income.[25]

19%
of pre-tax income of those aged 25-34 is used to repay debt, on average

Many households have limited financial resilience and would struggle if their mortgage or rent increased...

An increase in monthly mortgage or rent payments by £99 or less would mean that 17% of mortgage holders and 55% of renters would struggle to make repayments.

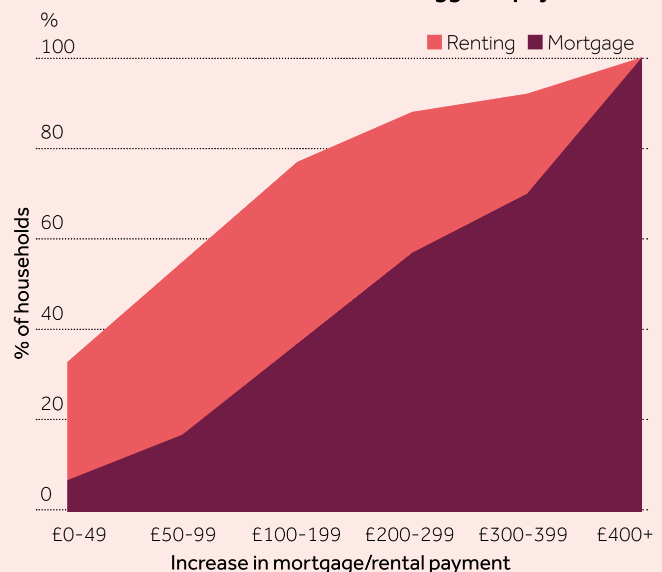
Financial Lives Survey data show that many households would struggle financially if their payments increased or they lost their main source of income.

... but many households with a mortgage would be able to withstand significant increases

Financial Lives Survey data show that 43% of households with mortgages could withstand a monthly increase in their mortgage repayments of up to £299 (see Figure 7).

Homeowners are more resilient than renters. The number of renters who could withstand an increase of up to £299 is significantly lower, with only 12% of households able to withstand such an increase.

Figure 7: Amount mortgage and rental payments could increase before households would struggle to pay them (%)



Over-indebted adults have less financial knowledge...

Financial Lives Survey data show that compared to all other adults, over-indebted adults are less knowledgeable about financial matters, with 67% of over-indebted adults saying they have low knowledge, compared with 42% of all other adults.

...and are less confident about managing their finances

52%
of over-indebted consumers have low confidence in managing money, compared with 19% of all other adults

24. Resolution Foundation, 'An unhealthy interest? Debt distress and the consequences of raising rates', February 2018.
25. Resolution Foundation, 'An unhealthy interest? Debt distress and the consequences of raising rates', February 2018.

... which may lead some consumers to become increasingly reliant on credit as a safety net

These factors could lead to some consumers using credit as a safety net and to smooth income fluctuations. Consumers may also look to hire products instead of purchasing them.

Higher housing costs are causing consumers to rent for longer and borrow until later in life...

High house prices, particularly in London and the South East, mean that many consumers struggle to get on the housing ladder and are renting for longer. The percentage of 16-44 year olds owning property has reduced notably since 1981 (Figure 8). This trend increases the likelihood of consumers borrowing into later life, particularly as the length and size of loans continue to increase.

... and an increasing number of ageing homeowners will seek to access equity...

We expect more older homeowners to access equity from their properties for various reasons including retirement income, to pay off existing liabilities such as interest-only mortgages, long-term care, or to support younger family members.

... but may find the range of options limited

A smaller range of options, and a limited supply of suitable housing stock, means that some consumers face limited choices.

In an effort to increase choice for older borrowers the FCA recently introduced new rules for retirement interest-only mortgages, excluding the product from the definition of a lifetime mortgage.[26]

Digital tools should provide benefits for many consumers...

Technology is changing the way consumers and firms interact, influencing how decisions are made and helping improve communication through the use of technologies and services such as platforms and robo-advice. These changes should allow consumers to better navigate complex markets and reduce costs, particularly in the mortgage market.

... but may restrict access for some credit consumers

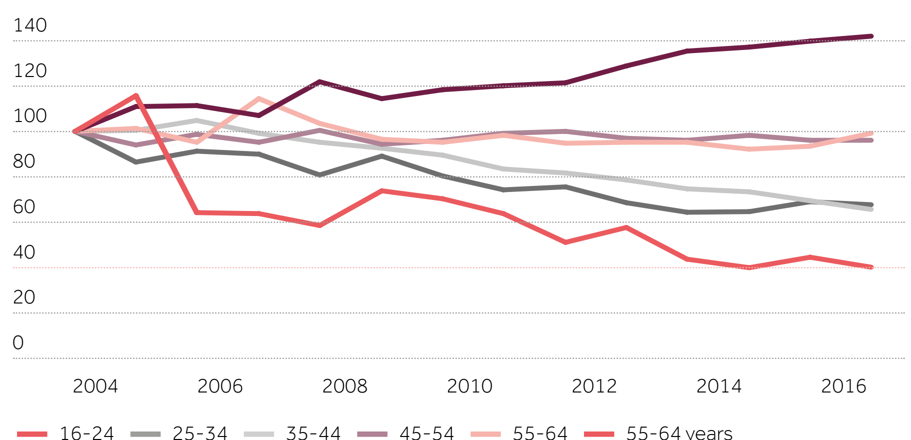
Tools that allow for more differentiated pricing have the potential to improve access for many consumers. They could also reduce costs and speed up decisions. But these tools may be inflexible and unable to assess non-standard circumstances. This could reduce access to credit for these consumers.

Firms are increasingly outsourcing for efficiency gains and to lower costs

More firms are using third-party providers for operational elements of their businesses, such as IT and data storage. This could provide better data security for some firms, but concentration of consumer data increases the potential impact on consumers of service interruptions and cyber-crime.

26. FCA Retirement Interest-Only Mortgages Instrument 2018, FCA 2018/16.
27. English Housing Survey, 2016 to 2017.

Figure 8: Homeownership by age group (index 100=2003-04)[27]



What we found on harm

Borrowing tends to be a means to an end, with many consumers not considering their longer-term ability to repay. Those borrowing may fail to deal with debts before they become unmanageable. This can be exacerbated by firms utilising consumer bias, misaligned incentives between lenders and borrowers, and firms' misinterpretation of regulation.

Harm in the sector is also affected by declining consumer resilience due to external factors such as squeezed household income and declining homeownership. The ageing population and big data are trends that could also drive harm in the future.

The FCA's intervention will deliver benefits for many consumers, particularly those who are vulnerable, and will reduce harm across the sector. These interventions include rules regarding long-term indebted credit card borrowers, revisions to our creditworthiness rules as well as proposed remedies in both the Mortgages Market Study (MMS)[28] and the High-Cost Credit Review (HCCR).[29]

Consumers may receive poor value or unsuitable credit products due to product design

Across a number of consumer credit markets, we have found that products may be framed in a way that makes it difficult for consumers to make informed choices. Firms may use consumer bias to make profits on hidden features or fees and charges. This happens both at the point of sale and during the lifetime of an agreement.

A number of FCA interventions will reduce this harm in credit markets.

Our Credit Card Market Study (CCMS)[30] and HCCR found that customers are not given sufficient choice and control over credit card and catalogue credit limit increases. We agreed voluntary remedies on credit card limit increases with industry, which should benefit 1.4 million accounts per year. As part of the HCCR we consulted on new rules to give consumers more choice about whether catalogue credit limits are increased.

Poor lending and borrowing decisions can lead to persistent debt, financial distress and over-indebtedness

We remain concerned that misaligned incentives and non-compliance with regulatory standards are leading consumers to enter into unaffordable agreements. This concern is heightened by consumers being driven by behavioural biases. For example, consumers are overly optimistic about their ability to repay or may delay dealing with debts until they become unaffordable.

The HCCR highlighted that some pre-contractual creditworthiness and affordability assessments for high-cost credit products are poor or inadequate.

In our policy statement 'Assessing creditworthiness in consumer credit',[31] we clarify our expectations of firms when assessing creditworthiness. Firms will be expected to demonstrate how their policies and procedures comply with our rules and deliver good outcomes for consumers.

Some consumers seeking debt advice are sold unsuitable debt solutions and/or given unsuitable advice

Debt advice is typically a 'distress' purchase, so consumers tend not to shop around for the best advice or provider. When they do seek advice, we have found that some advisers have misaligned incentives or frame products to exploit behavioural bias, which can lead to consumers ending up with unsuitable products.

Since the FCA started to regulate consumer credit, engagement by the FCA with this market has had a

28. FCA Mortgages Market Study Interim Report (MS16/2.2), May 2018.
29. FCA High-Cost Credit Review (CP18/22), May 2018.
30. FCA Credit Card Market Study (MS14/6.3), July 2016.
31. FCA Assessing creditworthiness in consumer credit (PS18/19), July 2017.

positive benefit for consumers. This harm should be further reduced by the Government's proposal to implement a breathing space for those in problem debt, as well as our thematic review of debt advice.

Some firms are not treating consumers in financial difficulty appropriately, particularly in consumer credit markets…

In consumer credit markets this harm is caused by firms failing to identify financial distress at a sufficiently early stage, and some failing to deal appropriately with difficulties once they have been identified. Some consumers face increased challenges in relation to unregulated liabilities. This can lead to consumers, who are typically distressed and under creditor pressure, making inappropriate decisions about which debts to prioritise.

Both the HCCR and the CCMS identified the need for firms to develop appropriate steps to identify consumers in financial difficulties at an earlier stage.

… and the second charge mortgage market

Since second charge lenders are second in line to be paid in the case of repossession, they have a lower level of security than first charge lenders. This dynamic can incentivise second charge lenders to not take earlier and more direct recovery action. This can lead to financial and non-financial distress for consumers.

As set out in our 2017-18 Business Plan,[32] this issue was considered as part of our work on long-term mortgage arrears.

Some mortgage borrowers are not able to switch mortgages and may be overpaying

The MMS found that some residential mortgage consumers, that took out mortgages before the financial crisis, are unable to switch products despite being up to date with payments. The MMS found that these customers are unable to switch to cheaper mortgages due to changes in lending practices since the financial crisis.

For some customers this harm is likely to be reduced as a result of the proposed MMS remedies and industry response. A large proportion of active lenders have signed up to a voluntary agreement aimed at helping these borrowers.

For others, including those consumers who have mortgages with firms that are not active lenders, the solution is more difficult. Work is ongoing to explore options for these consumers.

Consumers may be purchasing poor value mortgage products

Over 7,000 mortgage products are available to consumers, so it is difficult for them to establish which ones they qualify for and determine which offer good value for money. The MMS estimates that around 30% of consumers (in 2015-2016) could have found a cheaper mortgage with the same key features as the product they chose. On average, these consumers paid around £550 per year more over the introductory period compared to the cheaper product.

Through the MMS, we found evidence that the tools available to consumers (and their intermediaries) to help them establish which products they qualify for are not working well. For example, the MMS found that brokers are not always incentivised to place consumers with the lenders that will provide the best value, but rather the lender that is most likely to approve the application. The MMS proposed remedies aimed at reducing this harm. These include making it easier for consumers and intermediaries to find the right mortgage, and providing consumers with a wider range of tools that give them more choice about the support they need.

32. FCA Business Plan 2017/18, April 2017.

General insurance and protection
Sector View

General insurance is a mature sector, providing vital protection against financial loss for consumers (personal lines insurance and protection) and corporates (commercial and wholesale insurance and reinsurance).

Technological development is gradually but profoundly transforming the sector by enabling innovation and more flexible products. The landscape around data is changing very fast. Use and ownership of data are key drivers of commercial advantage but can also carry risks of loss or misuse. Business models are emerging to exploit the potential of data analytics and these developments are helping firms respond to demand from younger consumers for more flexible cover and products.

Low understanding, inertia and behavioural bias can leave consumers vulnerable to harm from products that are poor value or which do not otherwise meet their needs when they need to claim. In view of this, firms need to ensure effective governance and oversight, including over their pricing, sales and product design functions, and over the distribution of their products.

Brexit is impacting the sector, with firms restructuring their operations and customer portfolios ahead of withdrawal.

Sector overview

The sector provides general insurance products to consumers (personal lines) and corporates (commercial lines and wholesale). Protection policies meet the longer term need 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).

Commercial and wholesale insurance forms the largest part of the sector in premium terms. Premiums from UK and international business are roughly double those from personal lines insurance.

Distribution

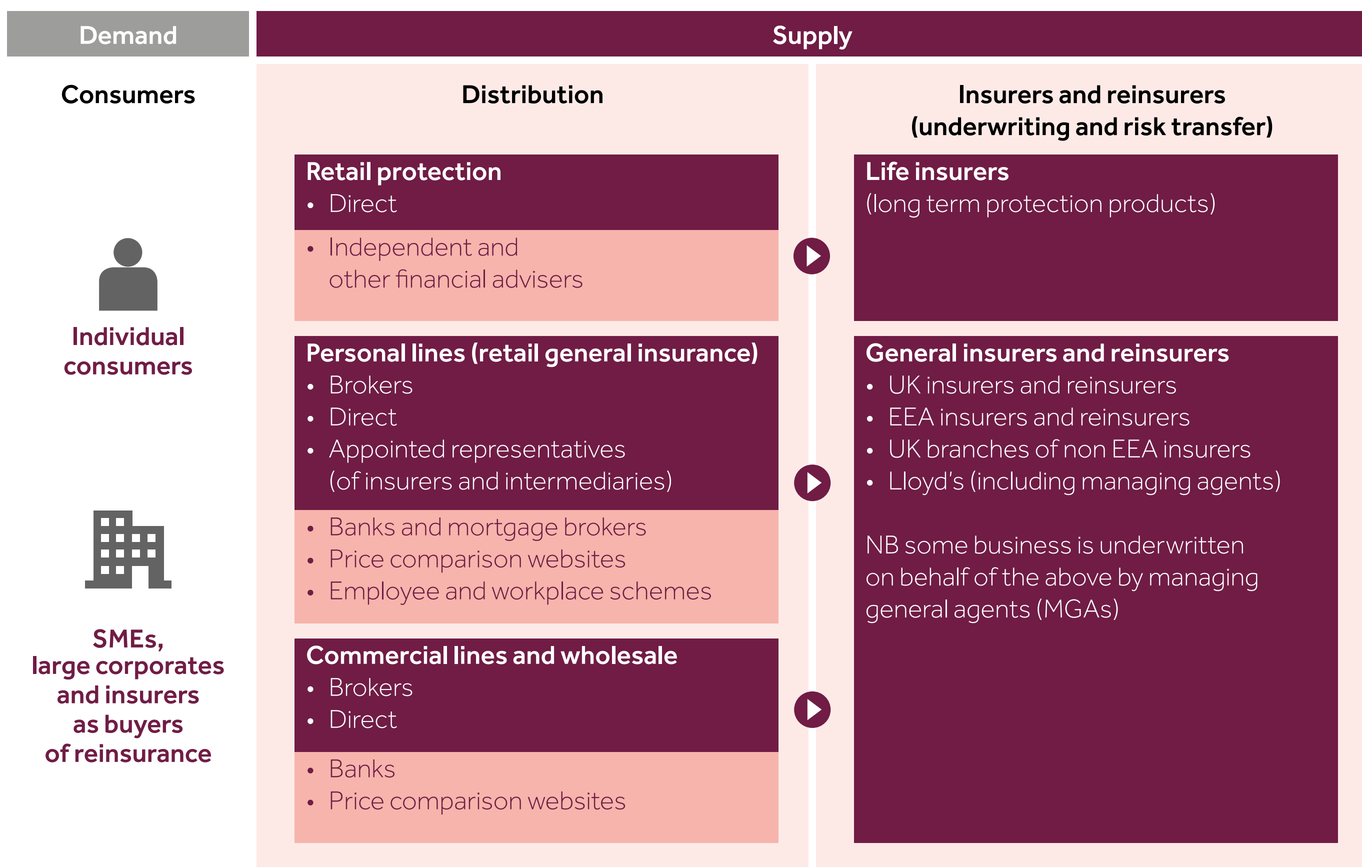
The market map shows the sector's distribution channels. Many niche distributors cater for specialist needs that may not be fully catered for by distribution channels that cater for more standard consumer needs.

The sector has many distributors. Despite the growth in use of price comparison websites for comparing and arranging insurance, face-to-face channels remain important in personal lines. Banks are a significant retailer of home insurance for example. Affinity channels, and sales alongside goods and services other than insurance (add ons), are important channels for some personal lines products. Brokers are the principal distributors of wholesale and commercial insurance.

Protection

Protection business is mostly written by life insurers. Otherwise, the majority of general insurance business is written by providers (including Lloyd's of London) operating in several classes and market segments. In a few classes, such as private medical insurance, specialist firms predominate.

Figure 1: Overview of the general insurance and protection sector



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

£32bn
total value of personal lines GWP, 2016[1]

19.7m
home content policies

16.6m
buildings policies[2]

27.3m
motor policies[3]

£66bn
total value of commercial and wholesale lines GWP, 2016

17.8m
phone and gadget policies[4]

10.4m
multi-trip travel policies[5]

5.2m
private medical policies[6]

£2.9bn
total value of protection GWP, 2016

1.8m
individual protection policies[7]

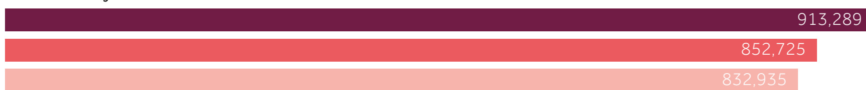
12.5m
people covered by group protection policies[8]

Gross written premium (GWP), personal lines (2016)	
Household	£8.5bn
Motor	£11.0bn
Accident and health	£7.6bn
Pecuniary loss	£5.3bn

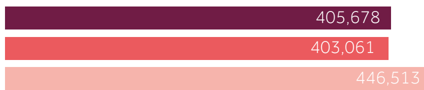
1. All GWP values: FCA analysis using PRA Returns and Lloyd's Annual Report (all EEA Branch estimated at 10%).
2. Home content and buildings policies: ABI UK Insurance and Long-term Savings Key Facts 2017.
3. ABI Motor Premium Tracker January 2018.
4. ABI Detailed Analysis of General Insurance 2017.
5. ABI Travel Insurance Data (May 2017).
6. FCA calculation based on LaingBuisson Health. Cover UK Market Report 14th edition.
7. Swiss Re, Term and Health watch, 2017.
8. Swiss Re, Group Watch, 2018.

Figure 2: Individual protection: number of policies, 2016[11]

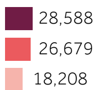
Term only ▲ **7%** vs 2015



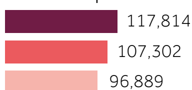
Term (including critical illness) ▲ **1%** vs 2015



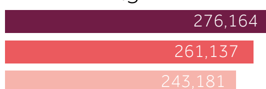
Critical illness ▲ **7%** vs 2015



Income protection ▲ **10%** vs 2015



Whole life (guaranteed acceptance) ▲ **6%** vs 2015



Whole life (fully underwritten) ▼ **22%** vs 2015

Figure 3: Average premium (£) for private car comprehensive motor insurance policy, Q4 2014-2017[12]

£493
▲ **9%** vs Q1 2017

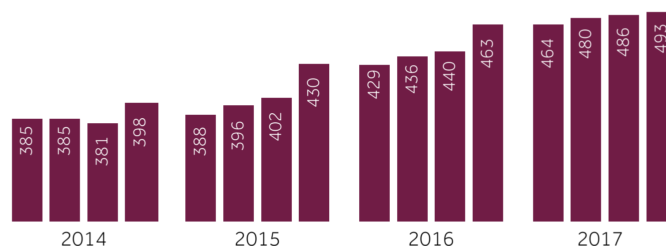


Figure 4: Average savings by switching car insurance provider at renewal[13]

Length of time with provider before switching	Average saving after April 2017	Average saving before April 2017
1 year	**£64.49**	£63.62
2 years	**£65.47**	£67.15
3 years	**£77.92**	£75.57
4 years	**£77.91**	£81.78
5 years	**£96.53**	£81.16
6 years	**£88.93**	£104.77
7 years	**£63.54**	£96.78
8 years	**£130.83**	£82.56
9 years +	**£119.80**	£116.71

How the sector is changing

Demand and supply evolves slowly in the general insurance and protection sector...

The need for corporates and consumers to cover their key financial exposures and livelihoods results in stable demand for core insurance products.

Changing needs and preferences are creating additional demand in parts of the sector. Demand for cyber insurance is growing, for instance, as businesses are increasingly exposed to attacks. Overall levels of insurance of home contents are falling slightly, as more households are renting their homes. Those renting are less likely to purchase contents insurance than home owners. According to one estimate, nearly 16 million adults in rented or owner-occupied accommodation do not currently purchase home contents insurance.[9] Sales of individual protection policies are starting to increase, after several years of decline, Figure 2 provides a breakdown of numbers of protection policies by type.

...with stable premiums in most personal lines classes

Cost pressures are impacting claims across the sector. There are both upward pressures from rising repair costs, and savings from expense reduction in firms and claims handling. Premiums have remained stable in most classes, though motor premiums rose by 9% in 2017. Figure 3 shows changes in motor premiums since 2014.

Consumers now have greater transparency at renewal

Since April 2017, our rules require renewal notices to show the previous year's premium. 0.3 million more motor and 1.1 million home insurance customers shopped around in 2017 compared to 2016, Consumers who shopped around saved an average of £64 and £34 in premiums respectively.[10] Longstanding customers generally make the greatest savings if they shop around (Figure 4).

9. Financial Inclusion Commission – Improving the Financial Health of the Nation, November 2017.
10. Moneywise, quoting Consumer Intelligence research.
11. Swiss Re Term and Health Watch 2017.
12. ABI Motor Premium Tracker January 2018.
13. Consumer Intelligence (moneywise.co.uk).

Consumers are interested in greater product flexibility

New product trends include pay as you go motor and travel cover, and protection cover for those with flexible incomes. Some providers are also responding to consumer demand for simpler proposal forms.

Surplus insurance capacity has been eroded by recent natural disasters...

The cost to the global insurance industry of the 301 recorded catastrophes in 2017 exceeded £100 billion,[14] against £39 billion for 329 in 2016. Since the start of the 1990s, the gap between insured and uninsured losses has been growing. The scale of these losses has reduced surplus capacity in the sector. Premium rates had been falling for several years across most classes, but this trend has now halted.

... creating opportunities for new capital sources

The size of some natural catastrophe exposures presents opportunities for the securitisation of these exposures. £3 billion of Insurance Linked Securities (ILS) were issued globally in the first quarter of 2018.[15] They have been enabled as regulated activities since the beginning of 2018, with the first ILS securitising a £50 million portfolio for a Lloyd's syndicate.[16]

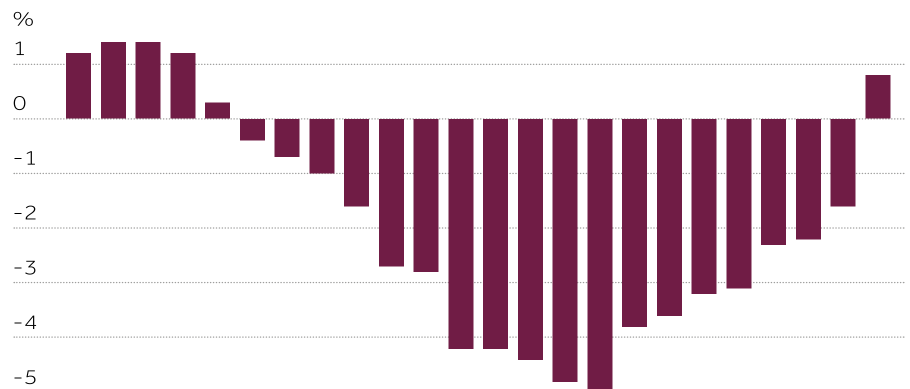
Firms are restructuring as consolidation picks up in parts of the sector...

Several regional commercial business and managing general agents (MGAs) have recently been acquired by larger intermediaries. Recent mergers have also resulted in two of the largest global insurers expanding their UK market share.

... and ahead of Brexit

Several firms have created separate EU and UK subsidiaries. Others are also separating past business in this way, to enable continued servicing under a range of Brexit scenarios.

Figure 5: Average commercial insurance pricing change, Q1 2012 to Q4 2017 (%)[18]



The general insurance and protection sector faces particular challenges, including continuity of contracts and rights of redress under existing policies, and cross-border portfolio transfers.

What is driving change

Technological developments, combined with economic pressures, are gradually but significantly driving change, including innovation, cost reduction and transformation of the design and delivery of products and services

For consumers, there are small but significant differences in consumer needs and preferences across generations, with younger generations opting for more flexible products.

Weak economic growth is having a mixed effect on the sector...

Figure 5 shows changes in average commercial insurance premiums since 2012. Demand for insurance and protection in the UK, while not increasing overall, has not been materially affected by lower GDP growth (1.8% in 2017).[17] Global demand for insurance is strong with increases in Europe by 2% and Asia by 6%, representing an opportunity for the London Market (wholesale and commercial).

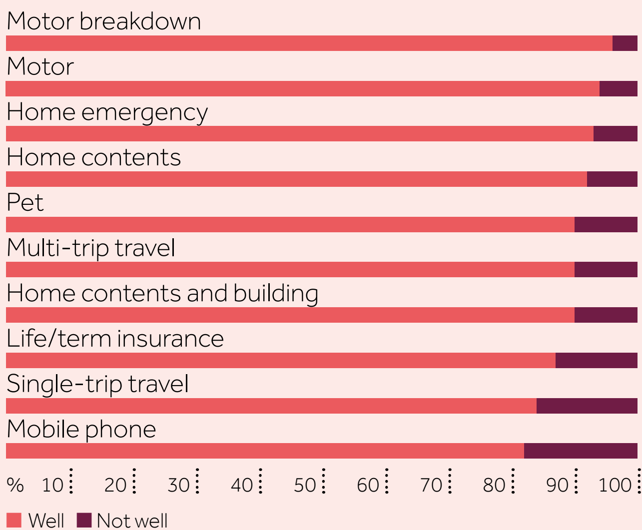
14. Swiss Re Institute – sigma No. 1, 2018.
15. Artemis Q1 2018 Catastrophe Bond and ILS Market Report.
16. 'Insurer Neon has broken new ground launching the UK's first catastrophe bond vehicle' (cityam.com).
17. ONS GDP data, 2018.
18. Marsh Global Insurance Market Index Q4 2017.

Consumer perspective

Consumers claim a high level of understanding...

Figure 6 compares levels of understanding by product. Financial Lives Survey data show over 90% of motor policy-holders claim a good understanding of the cover provided.

Figure 6: How well do you understand what your insurance covers? (%)



... but many do not feel the literature provided helps them choose the right product, provider or cover best able to meet their needs

A significant number of policyholders claim not to have the information needed to make a decision on cover, or that the information provided is not 'user friendly'. 15% say they have difficulty finding information on products and 19% find the information difficult to understand.[19] Equally, our Financial Lives Survey data show only a minority of policyholders spend time understanding what they buy. The majority of consumers do not read policy details carefully when taking out cover (roughly four-fifths of motor policyholders) or feel they do not have enough information to make decisions on the quality of different insurance products (29%).

These findings point to the need both for clearer information about products, but also clearer signposting on obtaining cover for those with specialist needs.

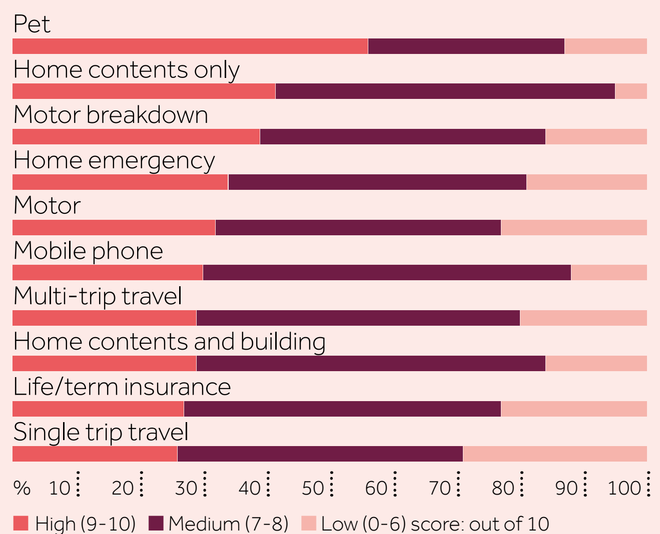
Insurers command consumer trust, but not loyalty

Levels of trust vary by product (Figure 7). Roughly three-quarters of adults have a high level of trust their product provider (insurer). Levels of trust in price comparison websites (PCWs) to find the best deal are lower. Only around half of consumers trust PCWs to find the best deal.

Insurers have higher levels of trust from their own customers than from the wider public. Roughly half of the general public consider that insurers do not treat those making claims fairly.[20] By contrast, the Financial Lives Survey data show over 90% of recent claimants have had their claims paid (completely or partially), with only 6% experiencing a problem.

Levels of loyalty to firms are much lower. Only 13% of adults feel that firms treat loyal customers well. This is consistent with consumers' experience of obtaining better renewal terms when they shop around. Research suggests that consumers would respond positively to loyalty rewards such as renewing at existing rates or matching competitors' quotations.[21]

Figure 7: How much trust do you have in the provider of this product? (%)



Consumer understanding of price comparison websites (PCWs) vary by age

57% of 25-34 year olds said they trusted PCWs to provide them with the best deal, whereas the corresponding figure for the over 65s was 23%. PCWs can help consumers select from a range of options. They obtain quotes from several insurers, but not necessarily all of them. In its 2017 findings from its market study, the Competition and Markets Authority noted that some consumers could obtain better outcomes from using more than one PCW when shopping for cover.

There are many reasons why some consumers choose not to buy insurance

Many renters – up to 10.5 million according to one survey – do not insure the contents of their homes. A high proportion of these are individuals who lack the savings to replace household contents in the event of loss. Research found the reasons include inertia and affordability (real or imagined) as well as a lack of experience in buying insurance in general.[22]

19. Mintel, Consumers and General Insurance UK, December 2017.
20. Financial Inclusion Commission, Improving the Financial Health of the Nation, November 2017.
21. Mintel, Consumers and General Insurance UK, December 2017.
22. Financial Inclusion Commission, Improving the Financial Health of the Nation, November 2017.

... including cost reductions and job losses

Several firms across the sector announced or made significant job losses in 2017-18. The stated reasons for these job losses include changing distribution patterns and the need for expense reduction, to which adverse economic conditions (see cross-sector themes chapter) have contributed.

Global insurance premiums have been stable or falling for several years (Figure 5). Rising expense levels, and recent natural catastrophe claims contributed to Lloyd's £2 billion loss in 2017.[23] The need to reduce transaction costs is behind Lloyd's London Market Target Operating Model initiative to modernise operations. This includes increasing the volume of business transacted electronically and streamlining claims settlements under £250,000.

Continuous developments in data and technology create new opportunities and risks...

Technology is an enabler of many developments within the sector.

Data can give insurers (and also distributors) the means to commercial advantage through pricing, underwriting and marketing. How firms use data is now subject to tighter regulation under the General Data Protection Regulation (GDPR), which increases the penalties and means of redress for misuse.

Blockchain technology is enabling innovative products and platforms. These include a platform for marine cargo transactions and a flight delay policy to pay claims without the need for notification by customers.

Insurance products are coming onto the market that link with connected home technology to incentivise behaviour that lowers the likelihood or severity of claims. These include leak detectors in homes and wearable fitness monitors with health insurance.

We expect artificial intelligence (AI) to have significant future application in the sector, including possibly in claims functions. AI has the potential to reduce costs and increase productivity, but also the potential for negative outcomes, for instance if algorithms are used that exploit behavioural biases.

... and regulation is driving increased accountability

New regulations in 2018 have increased the accountability of firms and individuals for product governance and oversight (Insurance Distribution Directive) and data (General Data Protection Regulation). Accountability in the sector will also be further extended by the inclusion of insurers within the scope of the Senior Managers and Certification Regime from December 2018.

What we found on harm

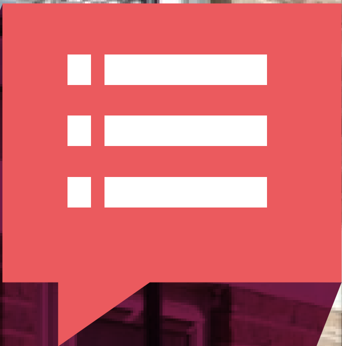
The harm that we are currently seeing in this sector affects or is related to specific products, suppliers or customer groups. Current consumer harm mainly relates to overpriced or poor value cover, which may come to light when making a claim.

Differential pricing can cause harm

It is common practice for existing home and motor insurance customers to be offered renewal quotations at higher rates than those offered to new customers.

Last year, we introduced rules requiring firms to include a comparison with last year's premium in their renewal notices. There are signs that this has led to more consumers comparing prices at renewal. As a result of our initial supervisory work on insurance pricing practices, included in our Business Plan, we have decided to launch a market study with a focus on consumer outcomes, fairness of outcomes and the impact of pricing practices on competition.

23. Lloyd's Annual Report 2017.



Insurance is sometimes bought in situations where it is impractical to compare prices

We have observed that the sales environment, and the ease with which consumers can compare products and prices, can affect consumers' ability to choose products that meet their needs. Barriers to choosing suitable products include pressure at the point of sale, or consumers not being given time to consider whether the product meets their needs.

Customers should expect value from the insurance they buy

Since our general insurance add-ons market study, which identified some areas of poor value in add-ons and standalone products, we have been piloting value measures data to make it easier to compare value in products. The data make it possible for the first time to compare claims frequencies and payouts in the classes included within the pilot.

Consumers suffer harm if claims are not paid fairly and promptly

The results of our Financial Lives Survey indicated that a sizeable minority of consumers either were not successful when making claims or complained about the outcome. We expect firms to monitor levels of satisfaction and identify the root causes of dissatisfaction.

Claims fraud and excessive repair costs lead to higher premiums for everyone

False or exaggerated claims impose additional costs on all consumers. Insurers detected over half a million insurance fraudulent claims in 2017, though the number of detected fraudulent claims fell by 8% to 113,000. Activities of some claims management companies may have encouraged some claimants to make fraudulent or exaggerated claims. From April 2019, we will be regulating claims management companies.

Access to insurance can be challenging for those with specialist needs

Our Travel Insurance Call for Inputs found that some individuals with pre-existing medical conditions experience difficulty in finding suitable cover. Suitable products may be available from specialist distributors and we are proposing actions to improve signposting for consumers.

Consumers without insurance are at risk of financial hardship

Millions of consumers have no insurance at all, either through choice or because they cannot afford it. Many of them do not have sufficient savings to withstand financial loss or misfortune. Many of the several million renters who do not insure their home contents do not have sufficient savings to cover the cost of replacing essential goods. In addition, they are uninsured for third party liability, which is normally included in contents policies.

Wholesale insurance market practices lack transparency

Services and facilities developed by brokers in the London Market would be detrimental to competition if they reduce access or exclude firms that do not sign up to them. Our broker market study is looking at how competition works, and whether market practices inhibit competition.

Firms' poor compliance can also lead to consumer harm

Failure to comply with rules that protect consumers can increase the risk of consumer harm. For instance, a minority of firms did not implement renewal transparency rules fully or promptly. We have required these firms to make follow-up communications with customers and may take further action in cases where the issues persist.

Pensions savings and retirement income
Sector view

The pensions savings and retirement income sector covers the provision of products and services designed to help consumers save for, and support themselves in, retirement. These include workplace and non-workplace pension savings, retirement income products such as annuities and drawdown, and the advice and administration services used by consumers and providers of pension products.

Key drivers of change in the sector include a number of the themes identified in our cross-sector themes chapter, such as the ageing population, increasing individual financial responsibilities, the low yield environment, and the emergence of new technologies such as robo-advice. Pension freedoms also continue to reshape consumers' retirement income choices.

The prospect that consumers may lack an income in retirement that is adequate or, at least, in line with their expectations remains the central challenge for the sector. Our analysis shows that areas such as pension scams, or poor value, or unsuitable products can all contribute to this central concern. In addition, the potential for poor pension services to lead to poor outcomes for consumers is an area of increasing concern.

Sector overview

The market map shows how we continue to split the pensions sector into two main sub-sectors (accumulation and decumulation) supported by two service sub-sectors (pension advice and services) used in the delivery of pension products to pension consumers and scheme members.

We also provide a summary of the core data for the main accumulation and decumulation sub-sectors.

Consumers

Our market map splits the consumers in the market into two main types. Workplace consumers covers employers setting up pension schemes for the benefit of their employees (often driven by the need to comply with auto-enrolment), as well as de-risking defined benefit schemes using bulk annuities. Individual consumers covers those consumers looking for pensions savings and retirement income products to support them throughout their retirement journey.

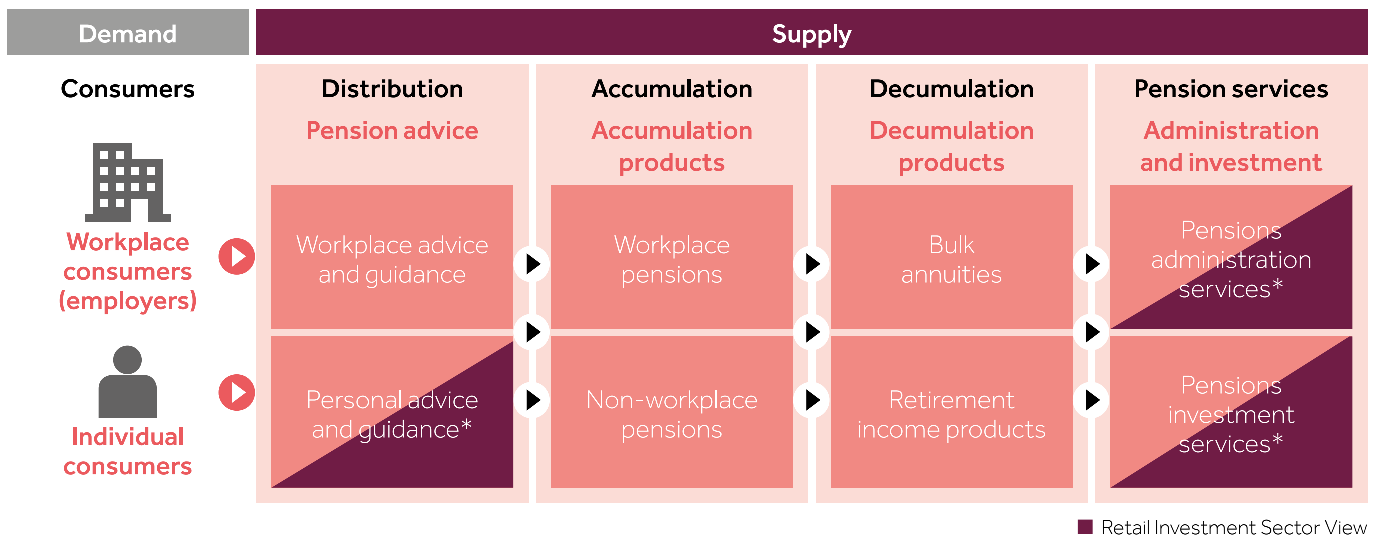
Distribution

Distribution of pension products is often facilitated by advice or guidance services. The workplace pension advice and guidance market covers those services that provide employers with advice/guidance on the set-up, design and on-going monitoring/governance of their workplace scheme. Personal pension advice and guidance involves providing individuals with advice on the set-up, design and ongoing monitoring/governance of their personal pension products (including pension savings and retirement income advice).

Accumulation

The accumulation product market is divided between workplace pensions, where pension savings products are provided to consumers through their employer in the form of group pension plans and commercial master trusts, and non-workplace pensions, where pension savings products such as personal pension plans and lifetime ISAs are provided directly to individuals.

Figure 1: Overview of the pensions savings and retirement income sector



Decumulation

In decumulation we divide the market up between retirement income products, which provide individual retirees with products and services to convert pension savings into a retirement income and/or a continued investment solution during decumulation, and bulk annuities, which are offered to defined benefit pension schemes and are designed to pay the retirement income of some or all of a scheme's retirees.

Pension services

The final piece of the market map focuses on the underlying 'services' which are used to support the delivery of pension products to employers and individuals.

This includes pension administration services, which support employers and product providers with technology and other services to help them manage their pension plan (such as communications, payroll, retirement income services, investment fund administration). It also covers pensions investment services, which support employers, individuals and product providers with investment services designed to help them with the investment design/portfolio allocation of their pension product.

Accumulation, 2017

£179bn
assets held or invested in contract-based defined contribution workplace pensions
▲ 7% 2017 vs 2016[1]

£1,733bn
other assets held or invested in workplace pensions[2]

20m
workplace pension consumers[3]

£420bn
non-workplace pensions savings market
▲ 4% 2017 vs 2016[4]

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

Decumulation, 2017

£299bn
assets backing annuities
▶ 0% 2017 vs 2016[6]

£95bn
assets held or invested in drawdown
▲ 9% 2017 vs 2016[7]

9m
retirement income consumers[8]

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

How the sector is changing

Workplace pensions recorded another year of strong membership growth in 2017. Total non-workplace pension sales also grew while the number of defined benefit to defined contribution (DB-DC) transfers rose sharply. Despite some growth in retirement income product sales the proportion of consumers selecting each option was largely stable.

Workplace pension growth continues to be driven by master trusts…

Master trusts recorded almost 2.8 million new memberships in 2017 (Figure 2), with growth driven by both small employers auto-enrolling their employees and larger employers switching from single employer pensions. Although contract-based workplace pensions attracted fewer new members, the data show the number of new contract-based pensions actually rose slightly in 2017, compared to a slight decline in the number of new master trust memberships.

… but overall contribution rates remain low

Overall contribution rates in the market continued to be low (at less than 6%), although data suggest average group personal pension (GPP) contribution rates are higher than in trust-based schemes (Figure 3) and that larger employer-led schemes have higher total average contribution rates than smaller ones.

Product designs have continued to be updated…

2017 saw the three biggest firms, with over half of the 9.3 million consumers with lifestyled pensions, all announcing design updates to align legacy products more closely with the retirement choices consumers now have, as a result of pension freedoms.[9] Meanwhile the debate around the potential for greater use of factor-based and environmental, social and governance (ESG)-based investing in defined contribution products intensified. Evidence, however, for the use of these or other 'alternative' investments in defined contribution pensions remains limited.

… as pension providers continue to transition to more capital-light business models

The most prominent example of this shift in the past year occurred in February 2018, when Standard Life Aberdeen chose to reduce its capital costs by exiting the life insurance market and selling this part ofits business to Phoenix.

The size of non-workplace pension sales has risen sharply…

Average single premium sales values for non-workplace pensions grew sharply in 2017 to £74,000 (Figure 4). This compares to average sales values of £40,000 in 2014 (just before pension freedoms).

… possibly reflecting the sharp increase in the transfer of large pots from defined benefit schemes

9. FCA, Supervisory work, 2017.
10. TPR, DC Trust: presentation of scheme data 2017 and FCA, Product Sales data, 2017.
11. PPI, The Future Book 2017.
12. FCA, Product Sales Data, 2017.

Figure 2: Annual GPP sales vs annual change in master trust membership[10]

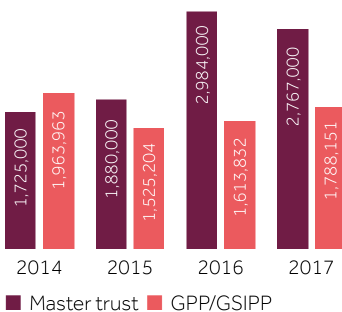


Figure 3: Total average contribution rate (employer and employee) defined contribution (%)[11]

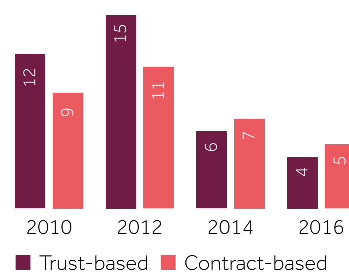
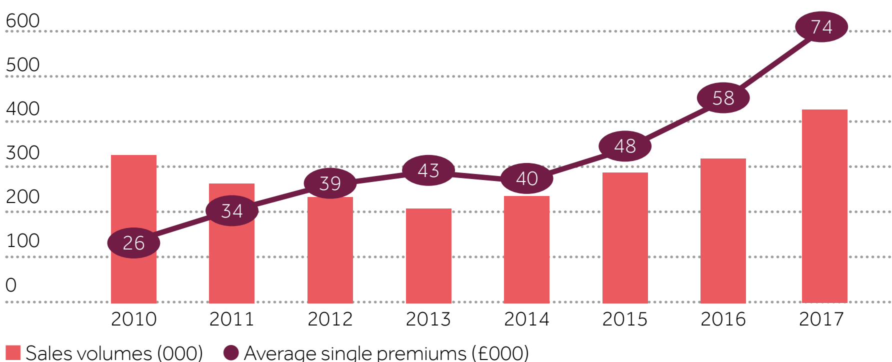


Figure 4: Average single premium values (£000) and total sales volumes (000) for non-workplace pensions[12]



DB-DC transfers continued to rise in 2017. FCA data show that the rate of transfers grew exponentially in the period from April 2016 to September 2017, almost doubling in each 6 month period (Figure 5).

The impact of pension freedoms on the retirement income market has begun to stabilise...

The number of drawdown and full cash withdrawals rose slightly in 2017 (by 11% and 6% respectively), while the proportion of consumers selecting each option was broadly stable, with around 55% taking full cash withdrawals, 30% taking drawdown, and 10-15% selecting annuities in both 2016 and 2017 (Figure 6).

... although a large proportion of those withdrawing cash from pension pots are choosing to re-invest it in non-pensions vehicles

Of the 55% who are taking full withdrawals, data from the FCA's Retirement Outcomes Review (ROR) suggest 52% are placing these assets in cash or investments within ISAs, savings or bank accounts.[13]

What is driving change

While FCA and other policy actions continue to shape the sector, long-term challenges remain, driven by some of the macroeconomic developments and societal changes outlined in our cross-sector themes chapter. Meanwhile, technology trends point to a future of lower cost, more holistic approaches to long-term financial planning, but legacy IT and data security challenges remain

The ageing population presents a considerable challenge for pension savings...

Over the next 25 years the over-65 population is expected to increase by 51% while over-85s will more than double (Figure 7). With projections showing high government costs for supporting over-85s (Figure 8), and long-term care costs in England averaging £28,000-£38,700 pa,[14] any shortfall is likely to fall on individuals.

▲ **229%** DB-DC transfers

▼ **14%** annuity sales volumes

▲ **11%** drawdown sales volumes

13. FCA, Retirement Outcomes Review - Interim Report, 2017.
14. FCA, Ageing Population Occasional Paper, 2017.
15. FCA, Retirement Income Data, 2017.
16. FCA, Retirement Income Data, 2017.
17. ONS, population estimates, 2017.
18. OBR, Government spending estimates, 2017.

Figure 5: DB-DC transfers[15]

Figure 7: Past and future population growth by additional number of people (000)[17]

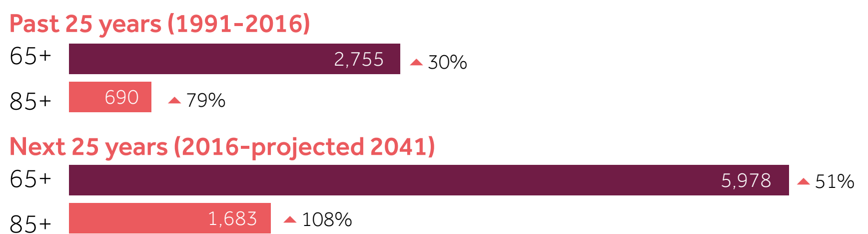


Figure 6: Retirement income products sales volumes[16]

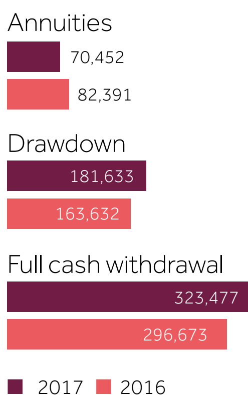
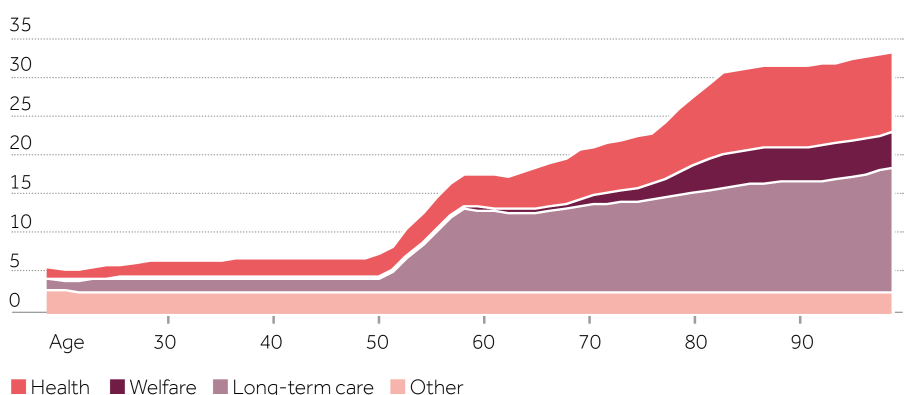


Figure 8: Annual cost of health, long-term care and welfare, per person by age (£000)[18]

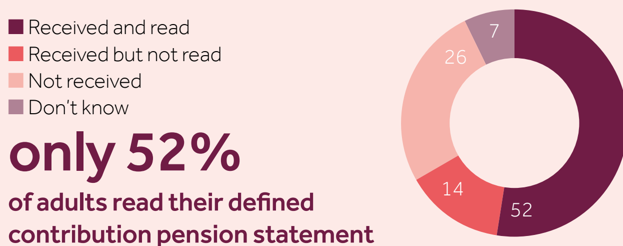


Consumer perspective

Consumers continue to struggle to engage with their pensions…

Data from the FCA's Financial Lives Survey show just 52% of UK adults with a defined contribution pension have read their annual pension statements (Figure 9). When it comes to reviewing pensions, the figures are even lower, with only 29% of UK adults with a defined contribution pensions reporting any awareness of the charges they pay, and only 18% of UK adults having reviewed where their pension is invested since joining.

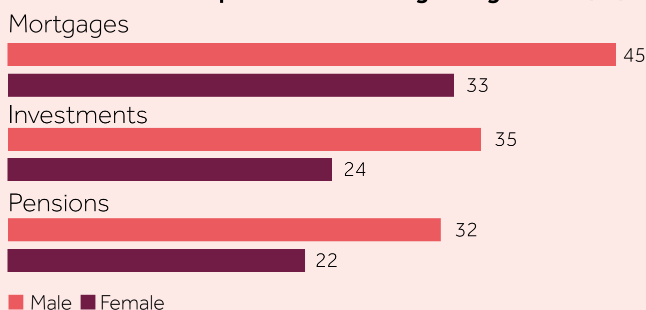
Figure 9: Recall receiving an annual defined contribution statement from pension provider in last 12 months (%)



… and levels of understanding within the sector are low when compared to other financial services markets

Financial Lives Survey data show just 32% of UK men and 22% of UK women said they knew enough to choose a pension product without getting advice (compared to 45% and 33% for mortgages) (Figure 10). In addition, 26% of those who have accessed a pension in the last two years are unsure what type of pension it was (defined benefit or defined contribution).

Figure 10: Adults agreeing that they know enough to choose a financial product without getting advice (%)



Education levels have limited impact on consumers' level of understanding…

Despite the debates surrounding the need for financial education in pensions, Financial Lives Survey data suggest understanding in pensions is largely independent of education level, with understanding of annual statements fairly uniform across most education levels.

… and evidence of a gender gap in the sector continues to emerge

Financial Lives Survey data also highlight a gender gap in pensions, with women scoring worse than men in their level of trust in pension providers. Women also rated pension products and providers lower in terms of satisfaction. This may be driving women to participate less with the sector, and evidence from the industry suggests that the pensions savings gap for women may have widened over the past 10 years.

Although many consumers are withdrawing from the sector at retirement…

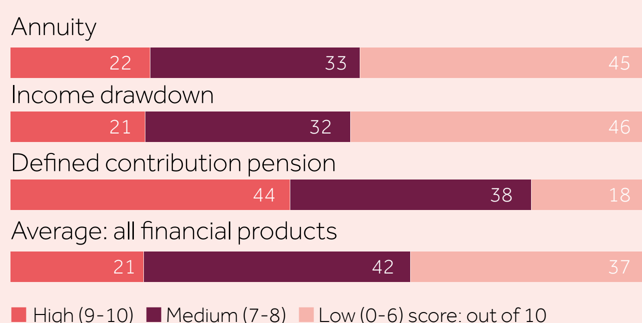
The FCA's Retirement Income data show 55% of pots are fully withdrawn in cash at retirement. Further work published in the ROR showed 52% of these pots end up back in savings/investment products, strongly suggesting consumers want to continue to save/invest but not in pensions.[19] Financial Lives Survey data suggest those who take out retirement income products shop around less for these products than for other financial services (Figure 11).

Figure 11: Shopped around when purchasing the following products in last 1-3 years (%)

… there is evidence that trust in the sector improves once consumers start to decumulate

More positively, however, the Financial Lives Survey suggests that consumers with decumulation products display high levels of confidence and trust in pension providers. Annuity and drawdown providers receive higher trust scores than providers of accumulation products. They also score higher than the average for all financial services and products assessed by the survey (Figure 12).

Figure 12: Trust in product provider, by type (%)



19. FCA, Retirement Outcomes Review – Interim Report, 2017.
*Average of products the Financial Lives Survey measured shopping around for, across varying time periods.

... as consumers are assuming greater levels of financial responsibility...

As defined contribution pensions become the norm (Figure 13), individuals are facing a future of greater responsibility for managing their own financial risks. Meanwhile despite the success of auto-enrolment (AE) the low paid and self-employed continue to fall outside its remit

... and household finances remain challenged

Falling savings rates and very low long-term real interest rates have lowered household resilience and increased incentives to opt out of pension saving. Meanwhile, retirees face a future of potentially increasing indebtedness (Figure 14) which may encourage them to transfer more money out of pensions.

The charge cap continues to ensure low costs in workplace pensions...

Department for Work and Pensions' (DWP) analysis shows 98% of charges for current contract-based members are below the 0.75% charge cap.[20]

... but low real interest rates continue to pose challenges to product demand and supply

Real interest rates remain very low, limiting the supply of guaranteed income products and heightening the attraction of high-risk investments and scams.

Pension freedoms and other policy actions continue to have a significant impact on the sector...

Aside from FCA actions (discussed below), significant policy actions in 2017 included enhanced master trust regulation by the Pensions Regulator (TPR); improvements in cost disclosures to members and trustees; and the DWP's AE review.

... and, as the FCA plans for a range of scenarios regarding Brexit, we continue to monitor the sector for potential issues that could arise

In the pensions sector a key focus is contract continuity for customers of UK firms currently living in the EU.

Although the sector is struggling with legacy system issues...

As an example of this, six platforms reported average delays upgrading legacy platform technology of 15 months in 2017.[21]

... new technologies hold out the prospect of lower costs and more holistic retirement planning...

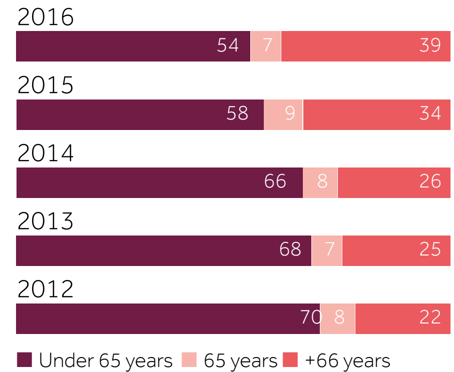
New technology developments are emerging to increase consumer engagement and, combined with 'open data' initiatives such as those contained within the Payment Services Directive 2 (PSD2), support the creation of more holistic financial planning tools.

Robo-services offer the prospect of low cost pension advice; however, the difficulties of meeting complex consumer needs with fully-automated advice systems make it likely these services will be integrated into broader 'multi-channel' approaches.

... while GDPR should improve consumer protections

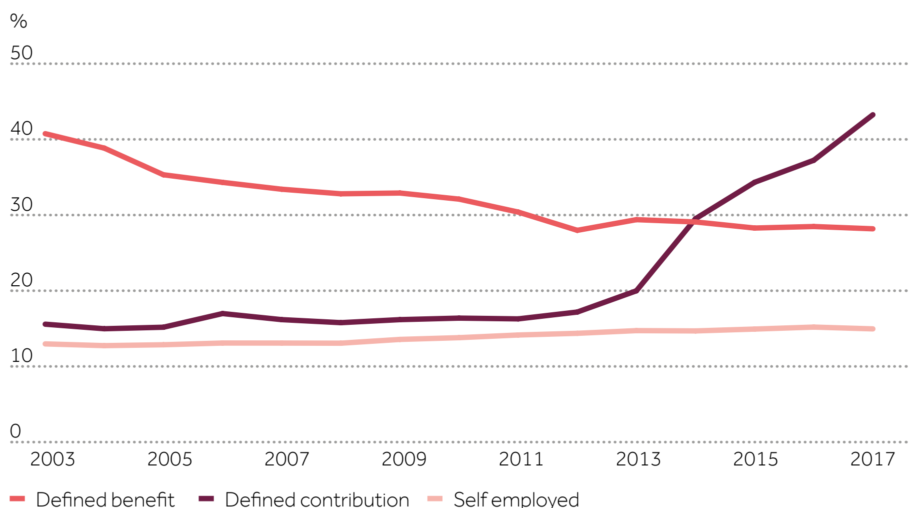
Although posing implementation challenges, GDPR is seeing firms, advisers and schemes offering consumers enhanced data security, management and transparency.

Figure 14: Borrower age at maturity (% of mortgage advances)[23]



20. DWP, Pensions Charges Survey, 2017.
21. Professional Adviser, "Re:Platforming' – Average daily delays hit 15 months... and counting", 2017.
22. ONS, Annual Survey of Hours and Earnings (ASHE) and Labour Force Survey (LFS), 2017.
23. FCA, Product Sales Data, 2017.

Figure 13: Workforce with defined benefit or defined contribution pension and self-employed (%)[22]



What we found on harm

The prospect of individuals not having adequate income, or, at least the level of income they expected, in retirement is the central challenge for this sector.

The joint pensions regulatory strategy we recently published with TPR outlined four key areas containing the secondary harms and drivers of harm that lead to this overarching harm:

- consumers may struggle to maximise their pension savings
- consumers not being enabled to make good decisions
- pension savings not being managed in line with savers' long-term needs
- pensions savings not being well looked after

Despite auto-enrolment's positive impact on pension saving levels, consumers may still be struggling to maximise the amount they save into their pension

Fuelling this is the concern that consumers may ultimately fail to save enough for their retirement. This is driven by macroeconomic factors, such as those outlined in our cross-sector themes chapter, which can affect both consumers' ability to save and the overall value of their pensions. It is also affected by socio-demographic shifts such as increasing longevity and increasing demand for long-term care which can cause consumers to under-estimate the amount of pension savings they may need in retirement.

In addition, while auto-enrolment has significantly driven up pension participation, groups such as the self-employed and those on low pay remain largely excluded from the workplace pension market. There are also concerns that consumers may assume that making the current minimum contribution will yield sufficient savings to support them through retirement when current evidence suggests this is unlikely to be true.

Although addressing the issues that contribute to consumers under-saving continue to remain largely outside the FCA's remit, we aim to offer consumers as much support as we are able to. This is a key driver behind our efforts to coordinate more closely with TPR.

Low levels of confidence in the sector also increase the challenge of engaging consumers to maximise their pension savings

Data from both the FCA's Financial Lives Survey and ROR highlight the continued challenge of ensuring consumers engage with their pensions. Drivers of low confidence in pensions cited by consumers include reports of high profile pension failures as well as ongoing uncertainty as to the future direction that public policy might take. Looking forward there is also the possibility that confidence in the sector could be lowered by high profile cyber-attacks or data management issues.

Consumers who are not being enabled to make good decisions can be more vulnerable to issues such as pension scams

Harm suffered by consumers as a result of pension scams is one of the most significant issues affecting the sector. As well as their impact on individuals, we also have concerns regarding the significant role they can play in lowering consumer confidence in the sector. The FCA's ScamSmart campaign is designed to help consumers' awareness in this area.

Ensuring consumers are supported in making good decisions and avoiding the potential negative impacts arising from unsuitable pension transfers remains a key concern

This issue is currently most likely to affect those consumers with a defined benefit pension who are transferred into a defined contribution pension. Those who transfer out of their scheme when it is unsuitable for them to do so run the risk of significant losses in the future.

As a result, this is an area of potential consumer harm that attracted significant FCA attention in 2017. Responding to suitability concerns the FCA reviewed a sample of defined benefit transfer recommendations from those firms most active in areas where our previous work had identified the greatest potential for harm and found only 47% suitable.[24] As a result of this review, four firms chose to stop advising on defined benefit transfers. In total, since the start of 2016, 32 firms have chosen to stop providing advice or have decided to limit their pension transfer activity.

One key concern is that consumers often lack experience dealing with the large amounts of money on offer from these transfers, making them particularly vulnerable to mistakes in assessing whether what they are being offered is truly well matched to their long-term needs. We are also concerned with how some consumers' assets are being invested and with the level of fees being charged following a transfer. With this issue in mind, the broader issue of the availability and suitability of advice relating to non-standard investments is a key area of focus for ongoing FCA work into self-invested personal pensions.

Retirement outcomes may be damaged by pension savings that are not being managed in line with savers long-term needs

Although we are currently investigating the possibility of this harm occurring for consumers in non-workplace pensions, the retirement income market continues to be the FCA's main focus when it comes to this harm.

Our ROR research suggests a third of non-advised consumers in drawdown are wholly holding cash, over half of whom are at risk of losing out on income in retirement. For example, consumers in cash could increase the income from their pot by up to 37% over 20 years by moving to a mix of assets.[25]

Our evidence suggests that if firms helped consumers navigate these decisions, for example through offering a more structured set of options, investment outcomes could be improved.

Updates to legacy lifestyled pension products, however, are reducing the risk that these products target unsuitable retirement outcomes

Although our last Sector View raised the prospect of poorly designed lifestyle and legacy products as a potential source of harm, the past year has seen a number of the largest firms take action to reduce the potential for this harm to emerge.

FCA actions in 2017 supported the largest firms in taking action to update lifestyle designs for their new, existing and legacy business in light of pension freedoms.

Although we have expressed some concerns about firms' plans to review legacy business written pre-2001, our research to date suggests the majority of firms have reviewed or are reviewing lifestyle designs and have migrated, or have plans to migrate, customers to new funds with lifestyle investment strategies that target more suitable outcomes.

Pension savings that are not well looked after can result in poor value products that may be eroding consumers' savings and retirement income

The FCA's ROR highlighted that weak competitive pressures and low levels of switching in the non-advised drawdown market could lead to consumers paying too much in charges. By switching from a higher cost provider to a lower cost provider ROR estimated that consumers could increase their annual income by 13%.[26]

Meanwhile, as mentioned in the investment management chapter, our Asset Management Market Study has shown the role that even small percentage differences in fees can make in determining long-term pot values.

The prospect of poor value non-workplace pensions is an emerging area of concern

Our analysis has highlighted concerns that consumers of non-workplace pension products may be encountering similar issues with poor value products as has previously been identified in other markets within the pension sector.

This concern is based on the existence of similar drivers of potential harm in non-workplace products as those previously identified as driving poor value and sub-optimal outcomes in other pension markets, such as workplace pensions. These drivers include weak demand side pressures, in part driven by low levels of ongoing engagement with the product, and complex products/charging structures that make it difficult for consumers to engage and compare product options.

Given these parallels, the FCA is currently undertaking work aimed at collecting more evidence as to whether the current market dynamics in non-workplace pensions ensure fair outcomes for consumers.

The issue of poorly looked after pensions also includes the prospect that consumers suffer negative effects from poor or discontinued pension services

This issue has become a more prominent part of our assessment in 2018. Our concerns in this area include the issues that can arise from poor governance of outsourced suppliers, the threat posed by potential cyber-attacks on the pension system and the ongoing impact of legacy IT systems issues. In addition, the outsourced pension administration market is highly concentrated, increasing the potential that any future issues in this market could pose a systemic risk to the ongoing stability of the sector.

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24. FCA, DB transfer advice suitability review, 2017.
25. FCA, Retirement Outcomes Review, Final Report, 2018.
26. FCA, Retirement Outcomes Review, Final Report, 2018.

Retail investments
Sector view

The retail investment sector covers the distribution of investment products to consumers through a variety of different channels: financial advisers, wealth managers, and platforms. It also covers some specific retail investment products. The sector serves several million consumers and has seen steady growth in consumer numbers and assets invested across all distribution channels in recent years.

Change in the sector continues to be driven largely by the low interest rate environment, regulatory scrutiny, policy changes, and technological developments. The growing disparity in inter-generational wealth, a cross-sector theme, is expected to play a part in how this sector develops in the long term.

The main concerns in this sector continue to be unsuitable products and services, high charges, and low quality products and services. These, as well as consumer harm caused by financial or data loss from financial and cyber crime, could have knock-on effects for confidence and participation.

Sector overview

In this sector we focus on the distribution of retail investment products through financial advisers, wealth managers and platforms, and on some of the more complex retail products.

The market map shows how different areas of the sector fit together and how they interact with the investment management, wholesale, and the pensions savings and retirement income sectors.

Consumers who hold retail investment products tend to be older, better educated and wealthier than the UK population as a whole.

Wealth managers provide highly tailored services and advice to high net worth individuals, while the more general **financial advice and guidance** market caters for the mass market. An execution-only market exists to give consumers direct access to various investments.

There is a **broad range of product markets** in this sector. These range from stocks and shares ISAs to investment-based crowdfunding to structured products, as shown in the market map.

Investment funds, another type of retail investment product, are covered in the investment management chapter. Pensions savings and retirement income products are covered in the previous chapter.

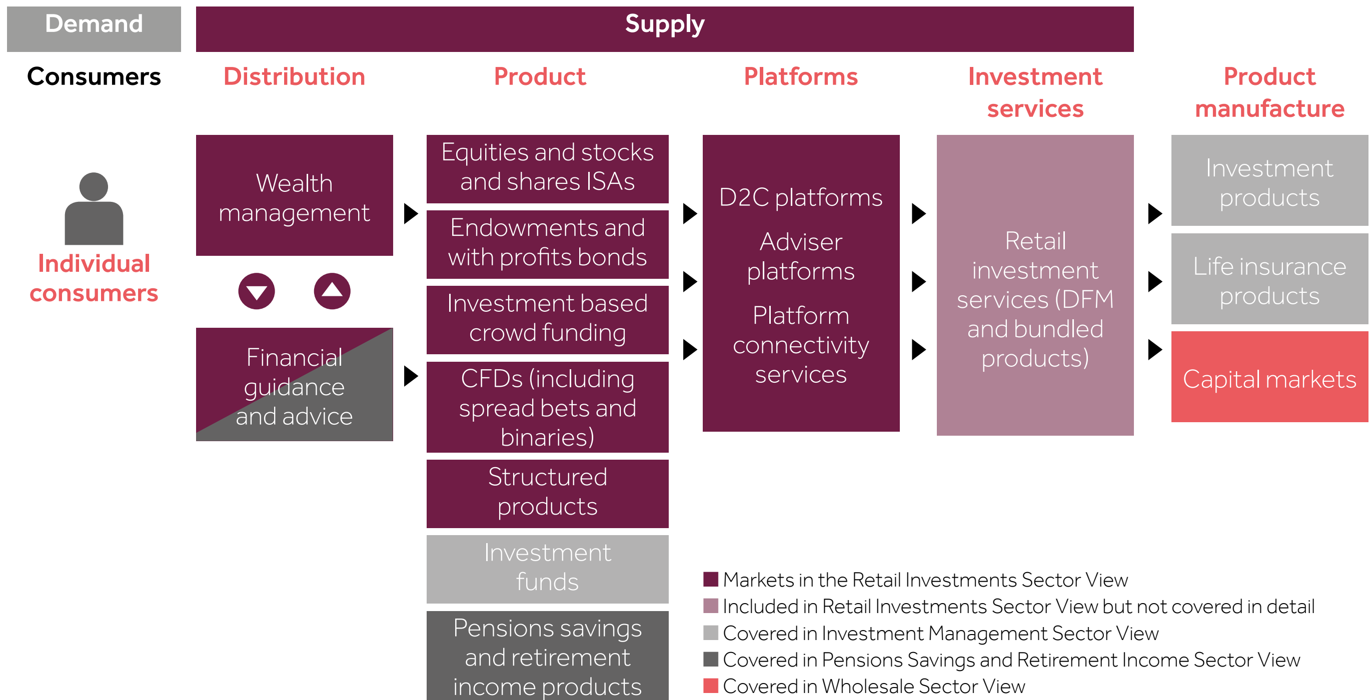
Platforms enable retail consumers and financial advisers to purchase retail investment products. There are direct-to-client (D2C), share dealing and business-to-business (B2B) adviser platforms.

Investment services markets supply product providers and individuals with **investment services or portfolio allocation** designs on a third-party basis.

This sector interacts with both the **investment management and wholesale sectors**. Many investment products are manufactured by asset managers while brokers purchasing shares or other securities for retail investors interact with wholesale markets to buy them.

Following is an overview of some of the core data for these different areas, such as the assets invested or under administration. It also shows the number of consumers and the rate of any increase or decrease in assets held.

Figure 1: Overview of the retail investments sector



£926bn
total assets held or invested in wealth management, 2017[1]

£736bn
by wealth managers
▲ 11% vs 2016[2]

£190bn
execution only
▲ 18% vs 2016[3]

£497bn
assets held or invested on platforms, 2017[4]

£185bn
D2C platforms
▲ 10% vs 2016[5]

£312bn
adviser platforms
▲ 12% vs 2016[6]

£507bn
assets held or invested by financial advice and guidance[7]

Assets invested via platforms have doubled in the last 4 years[8]

Wealth management: number of consumers[9]	
Wealth managers	**1.1m**
Execution only brokers	**2.1m**

Platforms: number of consumers[10]	
D2C platforms	**4.1m**
Adviser platforms	**3.1m**

1. Compeer, UK Wealth Management Quarterly Update Q4 2017.
2. Ibid.
3. Ibid.
4. FCA Investment Platforms Market Study, Interim Report, MS17/1.2. Numbers updated following publication of the Interim Report.
5. Ibid.
6. Ibid.
7. FCA Investment Platforms Market Study, MS17/1.2.
8. Ibid.
9. Compeer estimates.
10. FCA Investment Platforms Market Study, MS17/1.2.

How the sector is changing

Retail investments grew across all distribution channels and in most product offerings in 2017.

The advice and wealth management markets are undergoing significant transformation...

New regulations, changing fee structures and shifting and increasingly complex client needs are adding to financial pressures on firms. Both wealth management and financial advice markets have seen some consolidation as a result. In addition, the advent of robo-advice and easy access to cheap passive funds have opened up alternative routes to investment.

... as investment platforms increase easy access to investment products...

The number of consumers and assets invested via platforms has grown rapidly in the last four years (Figure 2).

Direct-to-consumer platforms are opening up retail investing to consumers. Financial advisers use adviser platforms to help them administer client accounts and access a wide range of investments.

In 2017 we launched an Investment Platforms Market Study to assess whether competition between platforms is working in the interest of consumers. An interim report was published in July 2018 with the final report due to be published in early 2019. Details of the findings so far are given in the last section of this chapter.

... but, despite this, retail investments are not widely held among UK adults

The FCA's Financial Lives Survey showed that, excluding pensions, only a third (33%)[11] of the UK population hold any form of investment product, regulated or unregulated. Stocks and shares ISAs are the most popular retail investment product and continue to grow, albeit slowly (Figure 3). Investments in endowments and with profits bonds continue to decrease. Investment funds, which saw high net inflows in 2017, are covered by the next chapter.

Retail investors are increasingly accessing a range of assets and risk via model portfolios...

Model portfolios are designed to help make investing simpler. Investors and advisers choose a portfolio which may have a general risk label (such as 'cautious', 'balanced', 'adventurous'), with the expectation that the portfolio will expose them to a degree of risk associated with the description of that portfolio.

... while some consumers who hold retail investments are looking to higher risk products for returns

In 2017 we saw an increase in investment by consumers in some more complex products.

11. FCA, Financial Lives 2017.
12. FCA, Investment Platforms Market Study Interim Report, MS17/1.2.
13. HMRC, Individual Savings Accounts (ISA) statistics, August 2017.

Figure 2: Platforms market, number of consumers (m)[12]

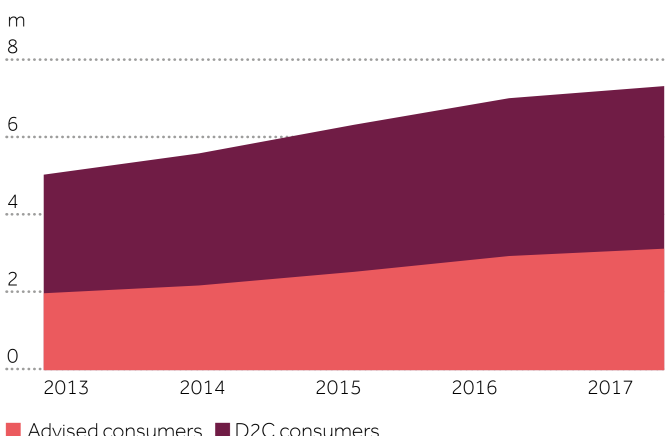


Figure 3: ISA subscriptions [13]

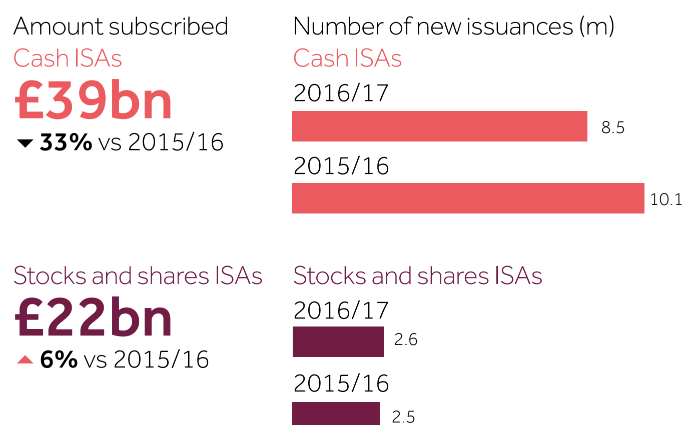


Figure 4: Investment-based crowdfunding (£m) [14]

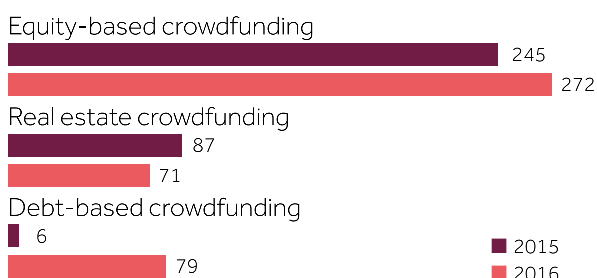
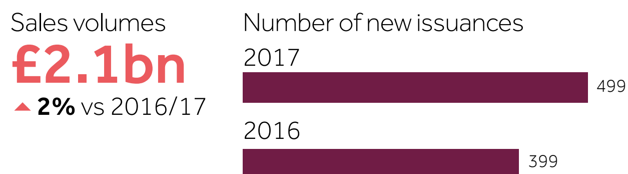


Figure 5: Structured products 2016/17 [15]

Sales volumes

£2.1bn

▲ **2%** vs 2016/17



14. University of Cambridge, Entrenching Innovation: The 4th UK Alternative Finance Industry Report, December 2017.
15. StructuredRetailProducts.com

These products include Contracts For Difference (CFDs), investment-based crowdfunding (Figure 4), spreadbetting, and structured products (Figure 5). The complexity of these products means they may not always be well understood by consumers. In general, the total amount invested in these products is relatively small.

High risk cryptoassets, which are outside the FCA's remit, attracted considerable attention in 2017

The FCA's remit covers the sale of cryptocurrency derivatives, such as futures, CFDs or within an authorised fund, but not cryptoassets themselves. Consumers do not always understand what falls under our regulatory remit. As a result they may not realise that they may not be covered by any financial compensation scheme if they suffer loss.

What is driving change

Change in the retail investments sector continues to be driven largely by three factors:

- the low interest rate environment and its effect on investment returns
- regulatory scrutiny and policy changes
- technological developments resulting in changes and innovation in investment product design and the channels by which consumers access investments

A fourth factor expected to drive change in the sector in the longer term is the growing disparity in inter-generational wealth. As detailed in the cross-sector themes chapter, this is a result of increasing longevity, the move from defined benefit to defined contribution pensions, changes to employment patterns and falling home ownership.

Younger consumers will not be able to look forward to the same pension benefits as older consumers. It will put them under pressure to build up meaningful levels of long-term savings to see them through retirement. Ensuring the retail investments sector is working effectively remains important.

Investments, particularly long-term savings like pensions, need to work harder

As discussed in the cross-sector themes chapter, the UK economy has faced a challenging external environment and economic growth has slowed in recent months. Household finances have faced continued pressure over the past 12 months as inflation has grown faster than wages, resulting in consumers having less to invest. This, along with a growing reliance on credit and borrowing by some consumers, adds a layer of complexity to consumers' financial needs. In turn, this increases the difficulties they already face when assessing their own needs, either with or without advice or guidance. This could lead to an increase in investments in unsuitable products.

The low yield environment may lead to an increase in consumer interest in more complex products, such as investment-based crowdfunding and structured products. These offer the potential for higher returns but also have a higher propensity for financial loss.

Multiple regulations have been implemented recently with more coming in 2019

These include MiFID II, PRIIPs, GDPR, SM&CR, IDD, the Shareholder Rights Directive and the FCA's own Asset Management Market Study remedies.

Other developments include: ESMA, in March 2018, banning sales of binary options (which came in to the FCA's remit in January 2018) to retail consumers and placing restrictions on the marketing, distribution and sales of CFDs; and the FCA, in H2 2017, launching the Investment Platforms Market Study, from which policy changes are likely to follow.

The main aim of the regulations is to improve transparency, accountability, data protection and value for money for investors, particularly retail consumers.

The complexity and volume of regulation does raise some concerns over execution risk, potential operational risks and potential fee increases. Technological developments, particularly in automation and targeting, could, however, improve efficiencies for firms and consumers in this sector and improve access to and affordability of savings products.

Online services that aid consumer understanding could help consumers make more suitable investments

Such services can aid consumer understanding by showing a range of potential outcomes, including financial losses, and could assist in product comparability.

Consumer perspective

Retail investments are not widely held among UK adults

The FCA's Financial Lives Survey showed that, excluding pensions, retail investments are not widely held among UK adults. Only 3 in 10 (29%) of UK adults own an FCA-regulated retail investment product. Ownership of unregulated retail investment products, which include buy-to-let, commercial properties and commodities, such as wine, art and jewellery, is much lower at less than one in ten (9%) of UK adults.

Stocks and shares ISAs are the most widely owned retail investment product, with almost 2 in 10 (17%) of UK adults having one

Mintel's ISAs UK 2017 report shows that stocks and shares ISA usage is growing slightly (2.6 million accounts in 2016/17) but it has yet to recover to its peak of 3 million accounts in 2013/14.

Investment knowledge is low with nearly half (52%) of UK adults saying they do not know enough about investments to buy one without advice

This compares to nearly 3 in 10 (29%) who say they do (Figure 6).

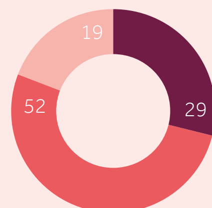
Trust in financial advisers is mixed with only a third of UK adults trusting them to work in the best interests of their clients

Given that half of the population do not think they know enough to take out investment without advice, it is important that consumers trust financial advisers.

According to the Financial Lives Survey, trust in financial advisers is mixed: 39% of all UK adults trust financial advisers to act in the best interests of their clients, 31% do not, and a final 30% are undecided.

Figure 6: Know enough to take out an investment without seeing a financial adviser

- I know enough
- Do not know enough
- Neither



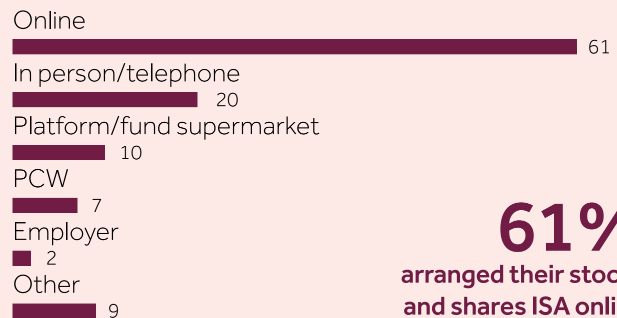
52%
of UK adults do not know enough about investments to buy one without advice

Consumers investing without advice are most likely to use online channels to purchase investment products

According to the Financial Lives Survey, the most common method of arrangement for consumers acting without advice is online, with 61% of respondents having purchased a stocks and shares ISA, the most popular retail investment product, online at the provider's website in the last 2 years.

Only 20% of respondents took out a stocks and shares ISA in person or over the phone, while 10% of respondents used a platform or fund supermarket (Figure 7).

Figure 7: Method of arranging stocks and shares ISAs[16]



61%
arranged their stocks and shares ISA online

Fee transparency is considered one of the most important factors when choosing an investment product

Mintel's ISAs UK 2017 report shows that the most important factor for retail investors when choosing the most popular retail investment, a stocks and shares ISA, is clarity on charges (45%). The next two equally important factors are the provider's reputation and the ability to manage the investment online, both 34% (Figure 8).

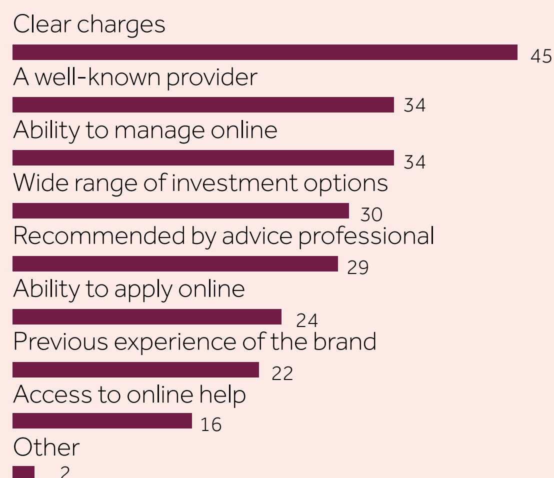
Consumers find the range of products on offer overwhelming

Mintel's Equity Investing UK 2017 report suggests that the range of investment products available to consumers is overwhelming. It also suggests a flat fee structure would be preferable to the percentage of assets fee structure that is prevalent. 61% of internet users surveyed felt the range was overwhelming while 59% would prefer a flat fee structure.

The simplicity of tracker funds is appealing to 49% of respondents although 37% are willing to pay higher fees for active management.

Ethical investing is important to 54% of respondents, up from 39% the previous year.

Figure 8: Important factors when choosing a stocks and shares ISA (%)[17]



16. Multiple responses were allowed.
17. Mintel, ISAs, UK, November 2017.

Automated advice, although still small in reach, is likely to grow with most of the big retail banks planning to launch offerings in 2019. This could increase the access and affordability of financial advice. Automated advice is relatively untested, particularly in relation to offering suitable advice for consumers with complex financial needs.

Brexit is another factor that could drive change in this sector

Brexit may affect how EU funds and UK asset managers structure themselves. UK investors should, however, be able to continue to invest in and redeem EU-domiciled funds. EU-domiciled funds may also make use of the TPR to continue to market to retail consumers into the UK, but this may be time limited. Beyond, TPR, funds will need to seek recognition from the FCA to continue marketing.

Structural changes to the investment management sector from reallocation and restructuring of firm resources could, however, have a more long-term impact. See the investment management chapter for further detail on how the investment management industry could be affected by Brexit.

What we found on harm

The biggest concerns for consumers in the retail investments sector relate to unsuitable products and services and high charges and low quality products and services.

These have the potential to occur across the different distribution channels and within the various investment products covered in this sector, especially the more complex products.

They are driven by some consumers' limited financial knowledge and engagement and firm-specific behaviours. These result in conflicts of interest, poor treatment of clients, a lack of comparability across products and sometimes misleading or confusing communications. A lack of robust and up-to-date processes to protect against cyber and financial crime and technological disruption is another driver.

Unsuitable advice on workplace pension transfers is one of the areas of greatest potential concern with respect to advised sales

The potential impact of unsuitable pension transfers on consumers' retirement income is a key concern and is detailed further in the pension savings and retirement income chapter. In 2017 questions over the suitability of the advice offered to consumers looking to make a transfer came more into the spotlight. In particular, our supervisory work highlighted poor practices in the advice offered to consumers looking to make defined benefit to defined contribution pension (DB-DC) transfers. Many consumers were advised to transfer when remaining in the defined benefit pension scheme would have been more suitable.

We are carrying out work to mitigate the risks of unsuitable DB-DC transfers. We have completed a market-wide data request on DB transfers as part of a thematic review and are assessing the responses.

Identifying appropriate retirement income products is another significant area of concern with respect to advised sales

A lack of innovation in retirement income products, product complexity and fee structure opacity, together with the complex nature of the financial needs these products aim to meet make this a challenging area for both consumers and financial advisers.

Some consumers' limited financial knowledge means they may struggle to select the right retirement income solution for their needs. They may be unable to assess the quality of the advice being given or decide whether a product is suitable for their needs. In addition, the market is failing to provide consumers with

the tools to understand their retirement needs when it comes to product selection.

Some adviser firms have not yet updated their investment strategies for decumulation clients. In addition, they may not have adequately considered decumulation risks.

From the product provider perspective, the FCA's ROR highlighted there has been little in the way of product innovation in retirement income products since pension freedoms came into force. The presence of a few large providers that control the majority of assets held in pensions savings products limits the incentive for competition in this space.

Regular data provided by firms to the FCA on retirement outcomes will be used to monitor developments in this market. We will also continue to monitor the suitability of advice for both non-workplace pensions and non-pension or non-retirement investment products.

Poor and expensive services from financial advisers also have the potential to have a detrimental effect on consumers

Consumers can struggle to assess the cost of advice and can overpay for services which they may not need. High charges at any point in the value chain can reduce consumer returns.

Availability of suitable value-for-money advice for consumers with small pots to invest remains an area of some concern

The number of financial advisers that are willing to offer advice on small investment pots is understood to be limited. Some consumers with small pots may, therefore, overpay for advice services they do not need. Others may make investments without advice, which could result in investment in unsuitable products.

Confidence and participation in financial markets could be threatened by financial crime, cyber crime and technological disruption

Cyber crime attacks and financial crime against wealth managers could threaten market integrity and result in consumers suffering financial or data loss or service interruption. Our analysis shows that wealth management firms hold sensitive financial data on high-net worth individuals (HNWIs) and politically exposed persons (PEPs) making them a target for cyber criminals.

Technological advances in the speed and sophistication of computing power available to cyber-criminals, coupled with systems that may not be sufficiently resilient against cyber-attacks at some wealth managers, make this the area of most concern in the wealth management sector.

Other threats to confidence and participation can also stem from high risk unsuitable products (see below) and poor client assets and money (CASS) controls at wealth managers, both of which could result in financial loss for consumers.

We also have concerns that in wealth management, consumers may be overpaying for services and potentially investing in unsuitable products through automated advice discretionary fund management services. In addition, in some cases consumers may not be switching away from high cost or low quality wealth managers as a result of lengthy switching times.

Unsuitable investments in complex and risky products are an area of focus

These products include Contracts for Difference, spreadbetting, structured products and investment-based crowdfunding. Loan-based ('peer-to-peer') crowdfunding is covered in the retail lending chapter.

The complexity of these products means that consumers may find it difficult to assess the risks involved in investing in them. This means they frequently overestimate potential returns and underestimate the potential for capital loss.

Inappropriate sales tactics, such as the use of headline grabbing return figures or mis-categorisation of retail investors as professional investors, can result in consumers investing in unsuitable products.

More consumers are searching for yield from higher-risk products

The current economic environment and low yields, discussed in greater detail in the cross-sector themes chapter, have heightened interest in higher-risk products and increased the chance that consumers might invest inappropriately.

The FCA continues to monitor these products. In July 2018, the FCA launched a consultation paper on both investment-based and loan-based crowdfunding.

The FCA monitors many other retail products

Products which have been given some additional attention in the past year include model portfolios (see below), Exchange Traded Funds (ETFs) and cryptoassets.

The main concern with ETFs is that consumers do not always understand that the price of the ETF and net asset value (NAV) of the underlying fund can diverge significantly which could result in lower than expected returns.

A concern with cryptoassets is that some consumers might not understand the risks associated with investing in them. For example, they may believe they are investing in tangible assets. Moreover, consumers may not understand that cryptoassets do not fall within the FCA's remit, and and are not covered by the Financial Services Compensation Scheme.

Investment platforms market is working well in many respects

Our Investment Platforms Market Study interim report was published in July 2018. So far the study has found a mixed picture. The market appears to be working well in many respects, for both advised and non-advised consumers, and customer satisfaction is currently high. Consumers who pay more for their platform tend to get greater functionality on average. There is, however, concern that competition between platforms is not working well for some consumers.

- Switching between platforms can be difficult – consumers who would benefit from switching can find it difficult to do so.
- Shopping around can be difficult – consumers who are price sensitive can find it difficult to shop around and choose a lower-cost platform.
- The risks and expected returns of model portfolios with similar risk labels are unclear – consumers using these model portfolios may have the wrong idea about the risk-return levels they face.
- Consumers may be missing out by holding too much cash – consumers with large cash balances on D2C platforms may not know they are missing out on investment returns, the interest they lose or the charges they pay by holding cash in this way.
- Some clients may be subjecvt to poor value services: one such group are called 'orphan clients' who were previously advised but no longer have any relationship with a financial adviser, face higher charges and lower service.

In addition, the positive impact of platforms on competition between asset managers may be reduced because:

- platforms employ commercial practices which may restrict fund managers' incentives or ability to offer fund discounts to competitor platforms, and this may reduce competition on fund discounts
- platforms could improve how they present fund charges at different stages of the consumer's decision making

The final report from the market study with any proposed remedies will be published in Q1 2019.

Model portfolio risk labels are unclear and often inconsistent

Model portfolios have become an increasingly popular way for consumers to invest, particularly through platforms. They are designed to make investing simpler by enabling investors, through advisers, wealth managers and platforms, to choose a portfolio which meets a pre-determined risk category, such as cautious, balanced, or adventurous.

The lack of consistency in how these risk categories are interpreted by providers may mean that consumers could, by being exposed to more risk than expected, be invested in unsuitable products.

As noted above, model portfolios sold through platforms are the subject of research as part of the FCA's Investment Platforms Market Study. Findings relating to model portfolios available via platforms are likely to be relevant to other distribution channels.

Any remedies relating to model portfolios proposed as result of the market study may be applicable more widely.

Increase in scams through high risk unsuitable products at wealth managers

The FCA is investigating a number of wealth managers for losses suffered by investors relating to a variety of scams around high risk unsuitable products. These scams could cause consumer detriment and damage financial market integrity.

Investment management
Sector view

The investment management sector covers asset management, institutional intermediary and advice services, and custody and investment administration services. It remains a key contributor to the UK economy.

In recent years the biggest drivers of change in the sector have been the low interest rate environment, regulatory scrutiny, policy changes and technological developments. In the past two years Brexit and what shape it will take, particularly for passporting and delegation, has been an increasingly important factor.

Key concerns in this sector are the pricing and quality of services from providers in the three main areas: asset management, institutional intermediaries and advice, and custody and investment administration.

Further areas of concern are problems that could arise from the increasing use of automation in the financial services industry and greater outsourcing. While these bring benefits to the industry they, and the oversight problems they can cause, also have the potential to threaten stability and resilience across the sector.

Sector overview

The key area of focus in the investment management sector is asset management services.

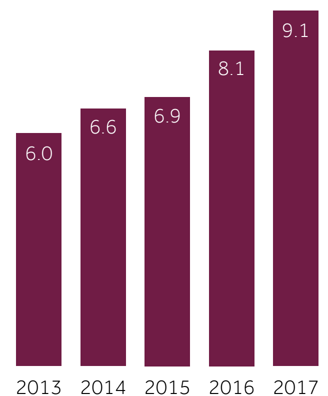
The sector also includes intermediary and advice services, and ancillary services.

The market map shows how the different areas of the investment management sector fit together, and where it overlaps with other sectors.

As is shown in the market map, intermediary services include fiduciary management, asset allocation and platforms, which are offered alongside advice services. Ancillary services include custody and investment administration.

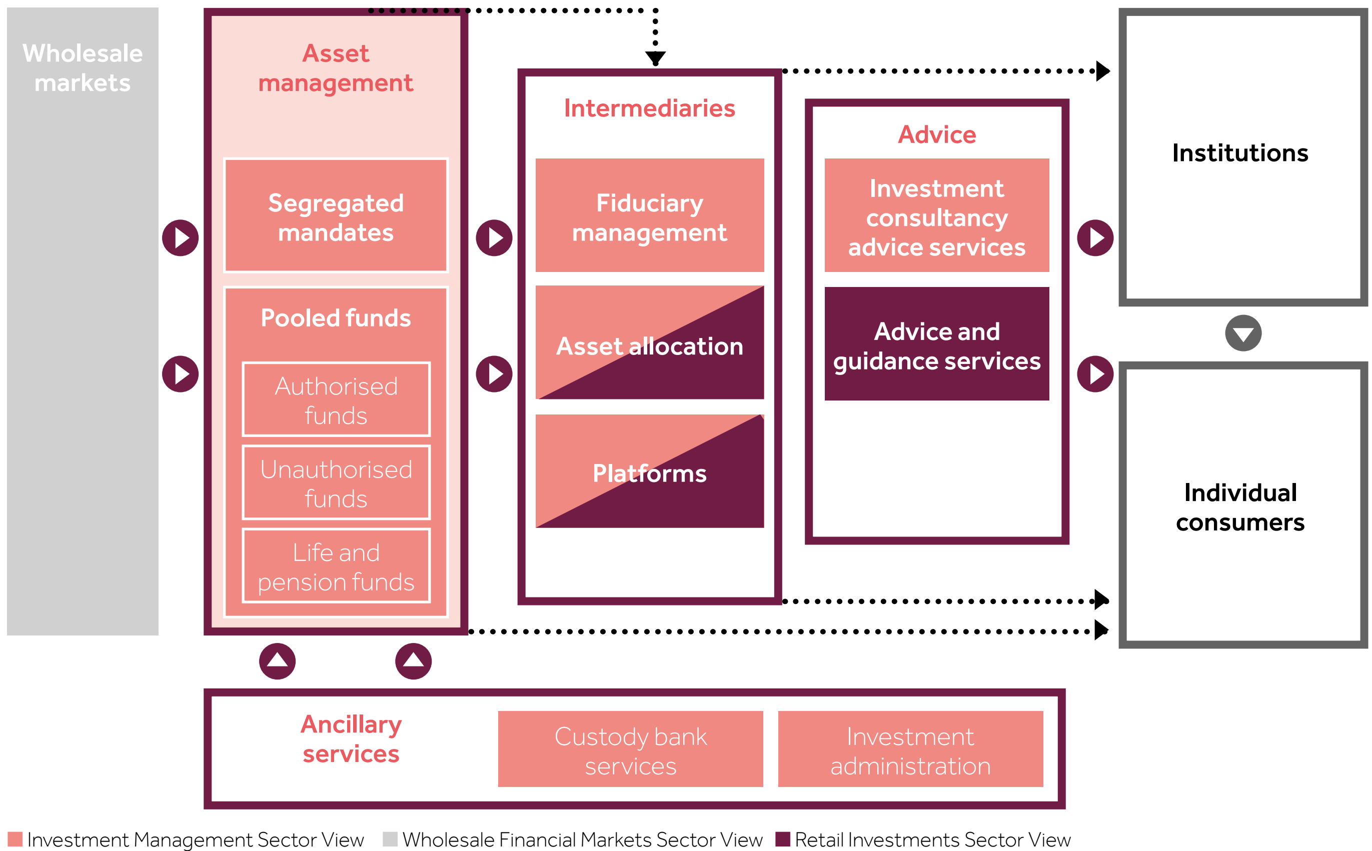
Assets under management in the UK's investment management sector grew to £9.1 trillion in 2017, up from £8.1 trillion in 2016 (Figure 1). The proportion of passively managed assets continues to increase steadily. A quarter of all assets under management (AUM) are now passively managed (Figure 3). The split between retail and institutional investors has been relatively stable for several years (Figure 4). Around 20% of AUM is managed for retail investors, 80% for institutional investors.

Figure 1: Total AUM in the UK (£tn) [1]



1. The Investment Association Annual Surveys, Asset Management in the UK 2013 to 2017.

Figure 2: Overview of the investment management sector



Together, the services covered in this sector are used by industry participants to construct and manage investment portfolios via segregated mandates, pooled funds, or a combination of these for institutional and retail investors.

Investment consultants, insurance companies, pension funds and other institutional investors (eg non-profits, family offices) are included in this sector as they are consumers or providers of investment management sector services, or both.

The distribution of asset management services to individual consumers through independent financial advisers, wealth managers, adviser platforms and direct-to-consumer platforms is covered in the retail investments chapter The pensions savings and retirement income chapter covers the construction and distribution of pension and retirement income investment solutions, including both accumulation and decumulation, and overlaps with this sector in a similar way to the retail investments sector chapter.

Figure 3: UK passive investments are increasing slowly, % total AUM[2]

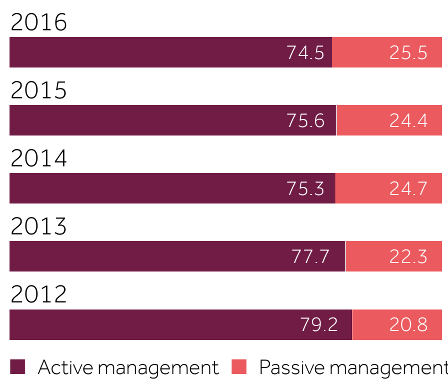
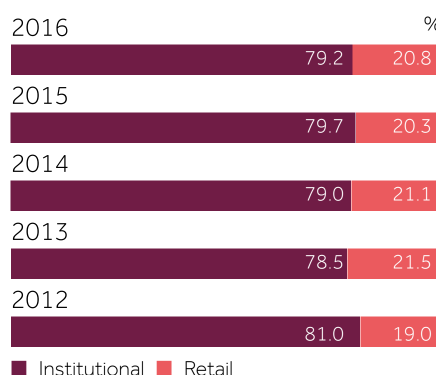


Figure 4: Retail investors account for only 20% of total AUM[3]

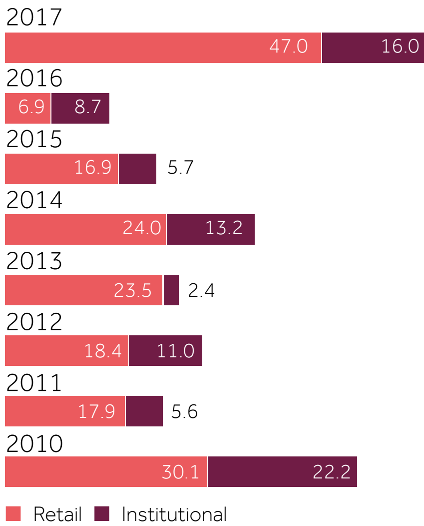


25%

of all assets under management is now passively managed

2. The Investment Association Annual Surveys, Asset Management in the UK 2012 to 2016.
3. The Investment Association Annual Surveys, Asset Management in the UK 2012 to 2016.

Figure 5: Net sales into UK funds (unit trusts and OEICS) (£bn)[4]



How the sector is changing

The UK's asset management industry continues to see growth in assets under management.

Total assets under management (AUM) in the UK reached £9.1 trillion in 2017.[5]

Strong stock market performance has contributed to asset value growth but there have also been strong net inflows in 2017 from both retail and institutional investors (Figure 5). In 2017 net retail flows into UK funds were over £47 billion compared to only £7 billion in 2016.[6] Net institutional flows also grew, although less significantly, from £9 billion in 2016 to £16 billion in 2017.[7]

The fall in sterling exchange rates has increased asset values for investments denominated in currencies other than sterling. It has also contributed to asset value increases.

Assets under management in the UK are largest in Europe

Assets under management in the UK remain much larger than those under management in other European countries. The value of assets held in France, the next largest, is half that of the UK (Figure 6). The UK manages as much as the next three countries combined.

Passively-managed assets in segregated mandates and pooled funds continue to grow

25% of total UK AUM is now passively managed,[8] with institutional investors accounting for most of this. On the retail side only 13% of funds are passively managed but this too is growing.[9] Passively-managed pooled funds saw net sales in 2017 nearly double compared to 2016, to £9.1 billion compared to £4.9 billion (Figure 7).[10]

The top ten asset managers manage around half of the UK's AUM

The sector is not overly concentrated, with the top ten managers accounting for around half of total AUM (Figure 8). With over 1,500 asset managers in the UK, there is a long 'tail' of small asset managers managing a very small proportion of assets.

Figure 6: European assets under management by country, May 2017[11]

Country	Share
UK	36%
France	18%
Germany	9%
Switzerland	7%
Netherlands	6%
Other European countries	24%

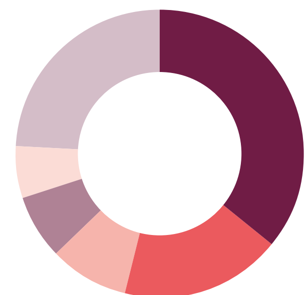
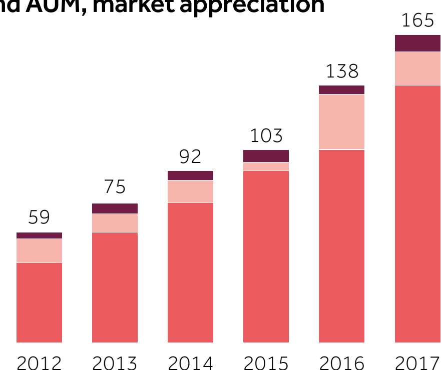


Figure 7: Total passive retail pooled fund AUM, market appreciation and flows (£bn)[12]

AUM at start of the year
Market appreciation
Net sales



£9.1bn
net sales passively managed pooled funds, 2017
▲ **109%** vs 2016

4. The Investment Association monthly fund statistics, 2010-2017.
5. The Investment Association Annual Survey, Asset Management in the UK 2017-2018.
6. The Investment Association monthly fund statistics, 2016-2017.
7. The Investment Association monthly fund statistics, 2016-2017.
8. The Investment Association Annual Survey, Asset Management in the UK 2016-2017.
9. The Investment Association monthly fund statistics, January 2018.
10. The Investment Association monthly fund statistics, 2016-2017.
11. EFAMA Asset Management Report, May 2017.
12. The Investment Association monthly fund statistics, 2012-2017.

What is driving change

Brexit continues to be a source of uncertainty

As highlighted in the cross-sector themes chapter, the UK's withdrawal from the EU will impact on all the sectors the FCA regulates. The long-term impacts are unclear but could be significant. The asset management market has expressed particular concerns over loss of passporting and whether delegation of portfolio management services will be affected.

A transition period, agreed in March 2018 by the EU Council, would extend UK and EU firms' access to each others' markets until end 2020. This would give firms more time to prepare for full withdrawal.

In addition, the Government has passed legislation to create a temporary permissions regime for inbound firms and funds if necessary. This further reduces the risks of discontinuity of business as it too gives inbound firms more time, even if an implementation period does not go ahead. More detail on the temporary permissions regime can be found in the cross-sector themes chapter.

Firms have already begun to implement plans which may affect how EU funds and UK asset managers operate and are structured, although plans vary. Firm restructuring could lead to a variety of outcomes, the effects of which are uncertain but could adversely impact services to UK investors.

Other macro and socioeconomic factors are also driving change in the asset management sector

In spite of a small rise in the UK's interest rate, the low yield environment continues to influence investor behaviour. Macroeconomic developments and their effect on the UK economy are discussed in the cross-sector themes chapter.

Political and social pressure for more responsible investing is increasing focus on the role of asset managers as stewards, and on the small but growing area of social impact investing. There is, however, a lack of consensus on how to define and benchmark social-impact investing.

The industry is undergoing significant regulatory change

In January 2018 MiFID II and PRIIPs were both implemented. The FCA has concerns over some of the new disclosure requirements introduced by MiFID II and PRIIPS. We launched a Call for Input in July 2018 to understand firm and consumer experience of PRIIPs disclosure requirements.

In April 2018 the first set of remedies from the FCA's Asset Management Market Study (AMMS) were announced. Regulatory focus is on fair treatment and value for money by improving transparency, comparability, accountability and investor protection. These all contribute to mitigating some of the drivers of harm in this sector.

Technology is set to disrupt all areas of the financial services industry

Technology is becoming increasingly important as a driver of change within financial services and is a key area of interest and focus for us. Within the investment management sector technology is being used in a diverse range of areas from investment advice to research and portfolio management, as well as in areas such as client engagement and distribution. Almost all front, middle and back office functions are making greater and greater use of technology. Technological advances will continue to bring benefits, in the form of innovation and efficiencies. It will also bring challenges in the form of increased spending, more complex oversight requirements and the increasing threat from cyber crime.

Figure 8: Top 10 firms by assets managed in the UK, 2016 (£bn)[13]

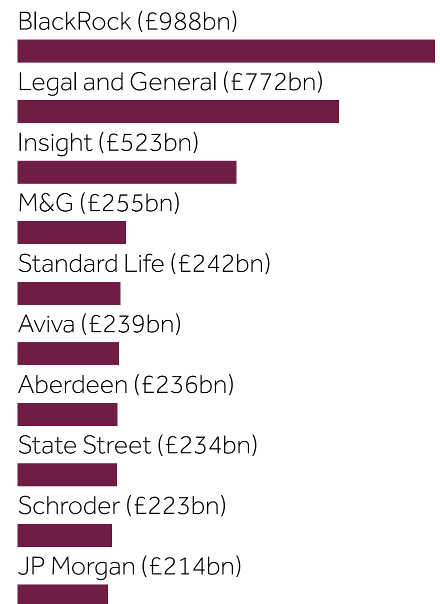


Figure 9: UK assets managed for overseas clients (£tr)[14]

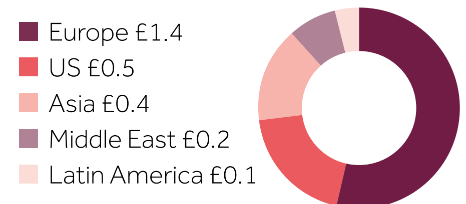
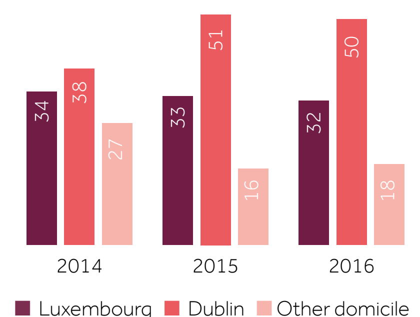


Figure 10: Location of overseas-domiciled funds managed in the UK (%)[15]



13. The Investment Association Annual Survey, Asset Management in the UK 2016-2017.
14. The Investment Association Annual Survey, Asset Management in the UK 2016-2017.
15. The Investment Association Annual Survey, Asset Management in the UK 2016-2017.

What we found on harm

The challenges identified in the investment management sector relate to:

- the pricing and quality of services provided in the 3 key areas covered (asset management, institutional intermediaries and advice, and custody and investment administration)
- threats to the stability and resilience of the UK's financial markets

Our findings are detailed below.

Pricing and quality of asset management products and services is the most significant issue in this sector

Our Asset Management Market Study (AMMS) and previous Sector Views identified an extensive range of drivers of high charges and low quality in this area. These range from consumers struggling to assess and compare fees and products to poor governance practices at asset managers. They result in investors:

- overpaying for asset management products or services (including insurance funds)
- receiving poor returns after fees have been charged
- holding investments in funds that diverge significantly from their stated objectives

The first set of remedies to be implemented as a result of the market study was announced in April 2018. The second set of proposed remedies was published for consultation at the same time.

These remedies, together with recently implemented regulation, such as MiFID II and PRIIPs, should contribute to improvements in this area over the next few years.

Pricing and quality of investment consultancy services and advice, including fiduciary management, is also a concern

In the institutional intermediary and advice markets, the AMMS found evidence of pension fund sponsors and trustees overpaying for investment consultancy services and struggling to assess the suitability of any advice received. This includes fiduciary management. We referred investment consultants to the CMA and they published the final findings from their investigation in December 2018.

The CMA has proposed a number of changes to these markets to deal with its concerns and improve pricing and quality over the next 5 years. These include:

- pension trustees selecting their first fiduciary manager must run a competitive tender and trustees who have already appointed a fiduciary manager without doing this must put the role out to tender within 5 years
- fiduciary management firms must provide clearer information on fees and how they have performed for other clients, so that pension trustees have the information they need to make meaningful comparisons between different providers
- the CMA is also making recommendations for new guidance from The Pensions Regulator, which would provide trustees with more advice on how to choose and scrutinise providers
- the CMA is recommending that the Government broadens the FCA's and the TPR's regulatory scope, to ensure greater oversight of the industry

The CMA investigation may also contribute to investment consultant service terms becoming more transparent. As noted, one potential outcome of the investigation is that investment consultants may be brought into our remit.

Pricing and quality of bundled custody and investment administration services, particularly for smaller asset managers is another area of potential concern

Our work in this area suggests that in general the market is working well despite the small number of providers. Some asset managers (particularly small ones), however, could be overpaying for bundled custody and investment administration services. This may be particularly relevant in some areas of service provision, such as foreign exchange transactions.

Given the current macroeconomic environment, we expect the likelihood of this concern growing to be low as there are no anticipated changes in the custody bank or ancillary services landscape.

Five sector-wide issues have the potential to threaten stability and resilience

Increasing use of automation in financial services and in outsourcing, and the oversight problems this can cause, are contributing to a greater potential for stability and resilience to be threatened.

Failure or disruption at one or more of the small number of custody banks and investment administration service providers could result in significant harmful side effects

All assets under management in this sector are held for safekeeping by a small number of ancillary service providers. Serious failure or disruption at one or more of these could result in widespread harmful side effects which could threaten stability and resilience.

Significant harmful side effects could result from failure at one or more of the small number of firms relied on for outsourced technology services

Outsourcing to third party technology providers is growing, meaning that the proportion of assets potentially affected is increasing.

Any increase in levels of outsourcing, which could exacerbate the likelihood of firm or technology failure, may be offset by increased regulatory focus on third party service provision oversight.

Technological failure or disruption, including from cyber crime could threaten market confidence and participation

Barriers to successful cyber-enabled financial crime are reducing due to technological advances. This increases the availability and commoditisation of sophisticated cyber-attack tools. Gaps in controls and oversight could also make cyber crime attacks more likely.

Inappropriate technology-led asset management decisions could also result in harmful side effects

The proportion of assets invested through technology-led decision making is currently small but growing. The speed of machine reactions could have serious consequences. If artificial intelligence using an algorithm were to make an inappropriate asset management decision, any resulting losses could be quickly compounded.

Greater use of Big Data and developments in artificial intelligence are likely to see growing use of machine-based decision making by asset managers in security selection, asset allocation and trade execution.

Growth in funds investing in less liquid assets could also have the potential to threaten stability and resilience

The potential threat here is if contagion were to spread from asset managers selling underlying less liquid assets in too great a volume and at too low a price to meet redemption demands if these increased unexpectedly.

Evidence from events following the UK's referendum on Brexit, when there was a spike in demand for redemptions from real estate funds, suggests, however, that the employment of liquidity management tools to avoid a sell-off of underlying assets was successful and resulted in no material consumer detriment.

Despite concerns in this area it is worth noting that investments in less liquid assets are increasing only at a slow rate. In addition, there have been moves by IOSCO and other regulators, including the FCA, to mitigate potential issues from funds invested in less liquid assets.

Wholesale financial markets
Sector view

The wholesale financial markets sector covers a wide range of wholesale activities, including transaction services, wholesale lending, advising, arranging, broking, execution, clearing and settlement. It spans multiple asset classes including equity, debt, derivatives, foreign exchange and commodities.

The sector is currently undergoing substantial change. New regulations should make markets cleaner, more orderly, transparent, resilient, and increasingly competitive. Changes arising from Brexit could impact how firms conduct cross-border business. Developments in technology will affect business models and services. Each of these developments can increase or reduce the harms that occur in wholesale markets.

For this sector, we group harms under the following seven themes: financial crime, market abuse, stability and resilience, conflicts of interest, market effectiveness, market power, and information asymmetries.

Sector overview

The market map shows the range of activities included within this sector. Activities include corporate banking, primary markets, secondary markets, post-trade services, and ancillary and third-party services. The market map shows wholesale services ultimately being provided to retail investors, corporates and investment managers. The latter two use these services to enable them to provide their own products and services to end consumers.

The wholesale financial sector is complex and large, and fulfils a broad range of financial needs. When such markets work well, they yield benefits for market participants and the end consumers they act on behalf of, and the economy. In this chapter, we have considered not just the activities we regulate, but also those overseen by other bodies, as indicated in the market map.

How the sector is changing

The UK is one of the world's leading financial centres. It is home to a sizeable share of global secondary market activity across a range of asset classes...

Nearly £6 trillion of UK equities were traded in 2017 and the UK has one of the largest equity trading venues in terms of market capitalisation (the London Stock Exchange).[1] The UK is also home to the world's largest foreign exchange market accounting for over a third of the c$2 trillion global spot FX traded daily (Figure 2) [2] and large debt, derivative and commodity trading markets.These markets enable the issuance and secondary trading of the financial instruments that companies, governments and public entities need to raise funds and manage their risks. The markets also allow investors to manage their exposures (eg to companies, markets and events) and generate returns.

1. Fidessa.
2. BIS Triennial Central Bank Survey of foreign exchange and OTC derivatives markets, 2016.

Figure 1: Overview of the wholesale financial markets sector

Corporate banking

Transaction services: Payment services; Cash management; Trade financing

Wholesale lending: Bi-lateral lending; Syndicated lending; Money markets

Corporates

Retail investors

Investment managers

Primary markets: Corporate finance advice; Arranging

Ancillary and third party services: Credit rating; Research; Middleware and similar services; Cloud services; Benchmark; Market data

Secondary markets

Broking services: Brokerage services (including prime brokerage)

Execution services, including market making: Bi-lateral (including systematic internalisers); On-venue (including exchanges, OTFs, MTFs)

Post-trade services

Clearing services: Central counterparty (CCP); Intermediate clearing

Reporting: Trade repositories; Data reporting service providers

Settlement and custody: Settlement services (CSD/ICSD); Custody services

Key

Regulatory remit: FCA regulated; ESMA regulated*; Bank of England (only) regulated; Outside FCA perimeter

Covered in other Sector Views: Investment management; Retail investments

*To be regulated by the FCA post-Brexit

... and UK firms are major participants in primary markets

In 2017, UK markets ranked fourth globally in terms of equity issued, behind America, China, and Japan, and fifth in terms of debt issued (Figure 3).[3] There has been growing global interest in Initial Coin Offerings (ICOs) as a form of capital raising. Although the market remains relatively small in the UK, we released a consumer warning recognising the risk of such investments.[4]

The sector is going through a period of substantial change...

Investment banks advise on and arrange securities issuance, facilitate mergers and acquisitions, and act as brokers for institutional traders. They provide liquidity as 'market makers'. They also arrange for, and in many cases provide, the settlement and custody of the assets underlying clients' trades. Investment banks therefore play a central role in meeting the needs of wholesale consumers, as well as the end consumers on whose behalf they act.

Brokers, for example, connect to multiple investment banks and venues to find the best prices and execute trades on their clients' behalf, while principal trading firms, including high-frequency traders, provide liquidity to secondary markets by taking positions with their own capital. All trades are either executed bilaterally, such as with a dealer, or on a multilateral venue, such as a regulated market or a multilateral trading facility. Tighter criteria on inducements and unbundling of investment research fees have led to changes in investment bank and broker business models.

New regulations are changing the way existing markets function and leading to the emergence of new markets. In execution, for example, early data suggest that Systematic Internalisers have taken on a large proportion of equity market activity previously carried out on Broker Crossing Networks,[5] and that periodic auction activity has increased. Organised Trading Facilities have also been established, as have mechanisms to enable firms to meet new reporting requirements.

3. Dealogic, April 2018.
4. FCA, ICO consumer warning, September 2017.
5. Fidessa Fragulator, April 2018.

Figure 2: Global spot FX daily average turnover ($tn)

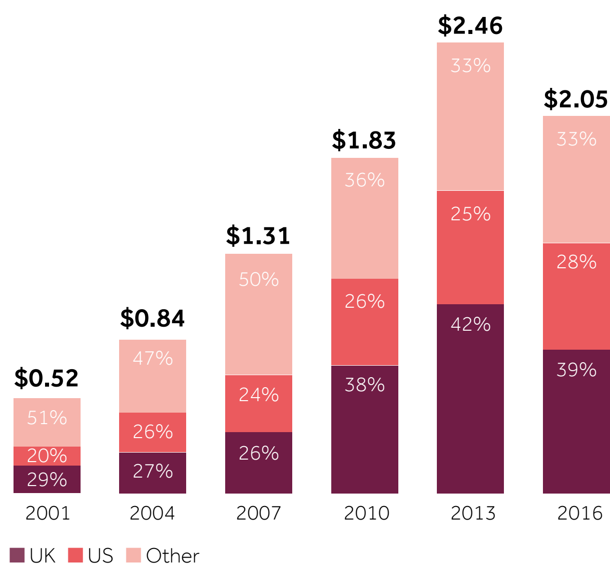
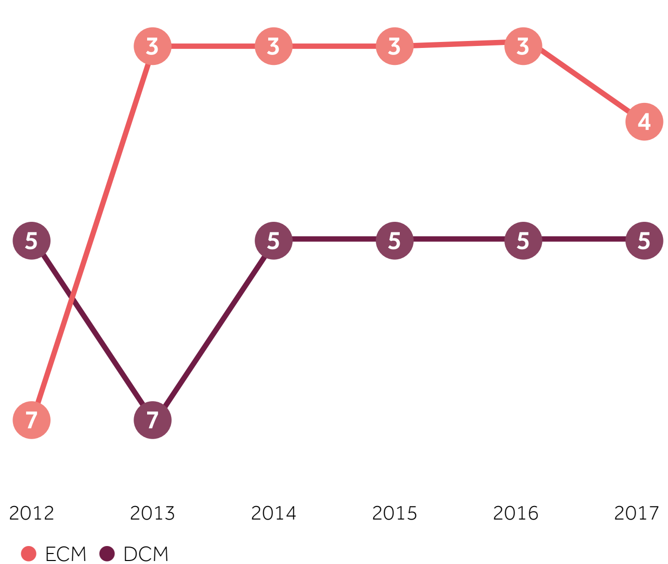


Figure 3: UK global ranking in equity and debt issuance



Major exchange groups operating in the UK remain dominant in the provision of execution and post-trade services in certain asset classes…

The London Stock Exchange Group (LSEG), for example, continued to account for the majority of trading in UK listed equities (Figure 4). LSEG is also a majority shareholder in LCH Clearnet, Europe's largest central counterparty by value of contracts cleared, clearing £583 trillion of transactions in 2016 (Figure 5). LSEG also runs UnaVista, one of the largest European trade repositories and approved reporting mechanisms, which many firms use to fulfil their regulatory reporting requirements.

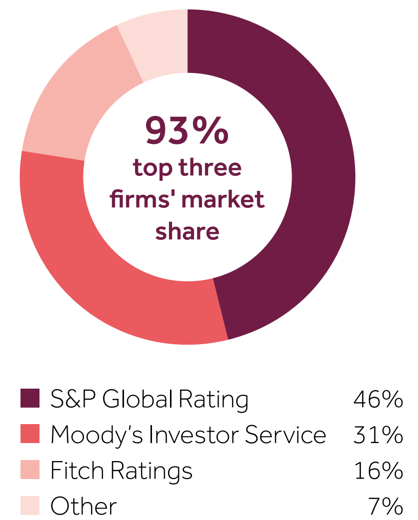
Other exchange groups with significant market shares in UK markets include Intercontinental Exchange (ICE), London Metal Exchange (LME), and Cboe Global Markets (Figures 4, 5, and 6).

… while wholesale firms are increasing their use of third-party service providers

Some third-party service providers are playing an increasing role in wholesale markets. This includes middleware infrastructure providers which connect wholesale market participants, match trades, compress portfolios and facilitate credit limit checks. Cloud service providers offer wholesale market participants advanced data storage and analytics services.

A large range of ancillary services are also provided to the market. Credit rating agencies (CRAs), for example, help investors to assess an issuer's credit worthiness, with 3 CRA's accounting for over 90% of the market (Figure 7). Benchmark administrators produce the indices referenced by many loan, derivative and other financial contracts. Research firms inform the price formation and risk assessment process, enabling consumers to take more informed decisions.

Figure 7: Registered CRAs' EU market share, 2016[9]



S&P Global Rating	46%
Moody's Investor Service	31%
Fitch Ratings	16%
Other	7%

6. Fidessa Fragulator, July 2018.
7. BIS Statistics on Payment, Clearing, and Settlement system in the CPMI countries, 2016.
8. Futures and Options World.
9. ESMA, December 2017.

Figure 4: Market shares of UK listed equity trading, 2017[6]

Figure 5: Value of contracts and transactions cleared, 2016[7]

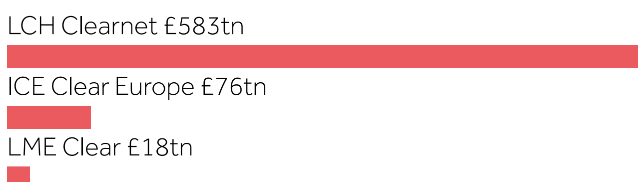
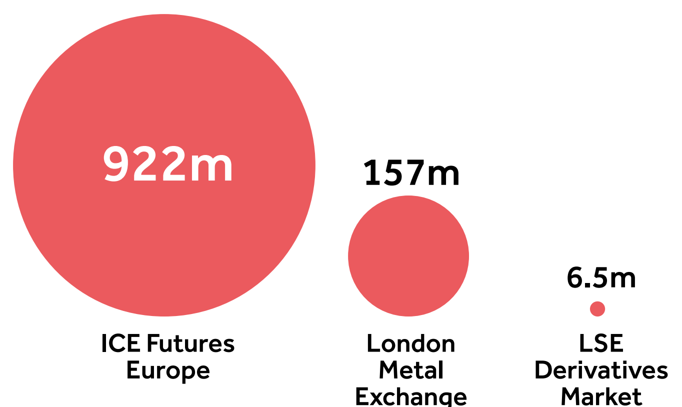


Figure 6: UK exchange-traded derivatives volume (in lots) by exchange, 2017[8]



What is driving change

Regulation is causing significant change across a number of markets in the wholesale sector...

The implementation of new regulations should lead to markets that are cleaner, more orderly, transparent, resilient and increasingly competitive. This should ultimately improve the way in which markets work, benefitting both market participants and end consumers. MiFID II, in particular, has been a significant driver of change in the wholesale sector over the past year. MiFID II has introduced a range of requirements to promote a safer, sounder, more transparent and more responsible financial system. This includes transparency requirements, more transparent venues, a trading obligation and a double volume cap (DVC) designed to limit dark trading. Among other changes, MiFID II has also introduced a new regime for Data Reporting Service Providers, expanded transaction reporting, and introduced rules requiring fees for research to be unbundled from other broking services.

Other regulatory developments are also driving change. The implementation of the European Market Infrastructure Regulation (EMIR) and capital requirements are encouraging the clearing of derivatives, as well as demand for risk and margin management services. Awareness of the risk that LIBOR may cease once official sector support is withdrawn at end-2021 has increased. Although challenges remain the industry has now begun transitioning to alternative interest rate benchmarks. Risk-free rates have been identified for all LIBOR currencies including the Sterling Over Night Index Average (SONIA), which is administered by the Bank of England and is the preferred alternative for sterling LIBOR. We continue to work with the market-led Working Group on Sterling Risk-Free Reference Rates, including in relation to its recent consultation on term SONIA reference rates. In September, together with the PRA, we issued a Dear CEO letter to major banks and insurers asking for the preparations and actions they are taking to manage transition.

...while the impact of Brexit will depend largely on the outcome of the ongoing negotiations

Given the sector's cross-border nature, wholesale firms are affected by Brexit and are making preparations accordingly. In general, they are seeking to retain 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 are being established to enable firms to continue to serve European customers, and/or ensure customers can meet EU requirements. There has been some movement of activity to the EU27, including clearing business and the relocation of some firms' offices.

In November 2018, the Government passed legislation to create a temporary permissions regime for inbound passporting EEA firms and funds. The Treasury is also in the process of publishing, and laying before Parliament, legislation that will establish other transitional regimes for financial services firms and other entities. In the event of no deal, this legislation will enable European firms to continue to provide services in the UK. In the longer term, the outcome of the negotiations and the approach taken by UK and European authorities will determine the extent to which UK and EU markets and business structures change. Brexit will also bring us new responsibilities relating to CRAs and trade repositories.

Technological developments and other innovations can improve services and lower costs, but may also give rise to new harms

As mentioned in the cross-sector themes chapter, technology is changing the way consumers and firms interact, the way in which decisions are made, and how and where activity takes place. In a number of asset classes, an increasing amount of execution is taking place on electronic platforms and venues. A significant proportion of activity in many secondary trading markets is also now provided by highly technology-reliant, non-bank proprietary trading firms.

Non-bank firms are also increasingly participating in, or engaging with, other activities, including wholesale lending.

Wholesale firms are also continuing to make use of third-party service providers, including middleware infrastructure and cloud services. As noted in the cross-sector themes chapter, the use of such services can lead to lower costs for firms, but it may also create oversight challenges for firms. While these developments provide new opportunities to commit financial crime and market abuse, they also provide new means for us and others to detect and deter these and similar offences.

What we found on harm

The wholesale financial markets sector is broader than other sectors and the range of harms is wider. We have therefore grouped the harms that we identify into seven themes, detailed below.

Financial crime – harm may be exacerbated by a reduction in the barriers to cyber-enabled financial crime

Financial crime covers a broad range of offences. They include offences involving fraud, dishonesty, misconduct and misuse of information relating to financial markets, as well as handling the proceeds of crime or the financing of terrorism. It can damage the confidence and participation of consumers in wholesale markets and can cause significant harmful side-effects for the economy. Effective deterrence is therefore key to market integrity.

Among the factors underlying this is the growing threat of technology-enabled financial crime. Barriers to such crime may be reduced by increased availability and commoditisation of sophisticated cyber-attack tools. This may be compounded by any gaps that arise in firm controls, and as firms outsource activities. We have increased our understanding of the sector's cyber resilience, with input from the

responses to our questionnaire that we issued to a number of firms.

Stability and resilience – harm could arise from the increased risk of cyber-attacks and the use of services where provision is highly concentrated

Markets that are not stable or resilient can cause client losses, unavailability of services, the compromise of confidential information, and wider side-effects for the economy.

There are several potential drivers of harm under this theme. As with financial crime, we expect the increasing availability, sophistication, and commoditisation of cyber-attack tools to exacerbate harm. High concentration in the provision of some wholesale services, including in certain infrastructure and third-party services, may also increase the potential for harm, especially where there are oversight challenges.

In July 2018, we published a Discussion Paper jointly with the Prudential Regulation Authority and the Bank of England[10] about strengthening the operational resilience of financial services firms. This highlights the risks posed by cyber-attacks and other disruptive operational incidents, and the financial system's increasing reliance on and connectedness through technology and data.

Brexit could present some stability and resilience challenges depending on the outcome of negotiations and any mitigating actions undertaken. This includes potential challenges relating to the continuity of derivative contracts, co-ordination between authorities, and the supervision of firms and activities where corporate structures, operations and/or trading become more complex. Brexit is also highlighted as a key area of focus in the cross-sector themes chapter. We are working closely with both UK and international authorities to ensure an orderly transition after leaving the EU.

Conflicts of interest – harm should reduce due to regulatory reforms

Conflicts of interest can lead to poor outcomes for wholesale consumers, particularly where firms have a poor culture or insufficient governance to manage such conflicts.

The constant changes in wholesale markets, business models, relationships and technologies mean new conflicts that require mitigation are continually arising. In general, we expect harms arising from conflicts of interest to reduce in the medium term. Interventions have been made to address some of the areas where such risks were particularly pertinent. For example, MiFID II has broadened best execution requirements and unbundled research fees from other broking services, while the EU benchmarks regulation and LIBOR reform aim to minimise conflicts in benchmark-setting processes.

We have also made several other interventions domestically. These include setting out a package of measures in October 2017 to ensure that the UK's primary capital markets remain effective, including reform of availability of information in the UK equity Initial Public Offering process, and in December 2017 issuing a 'Dear CEO' letter on Payment for Order Flow.[11]

Market abuse – harm should reduce due to regulatory reforms

Market abuse disadvantages law-abiding market participants and can damage confidence and participation in wholesale financial markets.

MiFID II and the Market Abuse Regulation should help to reduce harm in this area. They significantly increase the depth and scope of regulatory reporting and our capability to detect and intervene to mitigate market abuse.

Market effectiveness – advances in trading techniques, regulatory and benchmark reforms and Brexit will have wide-ranging impacts on future market effectiveness

10. FCA, Building the UK financial sector's financial operational resilience, Discussion paper, July 2018.
11. FCA, 'Dear CEO' letter, December 2017.

Well-functioning deep and liquid markets lead to more effective price formation, capital raising, and risk and resource allocation. When markets are effective, they enhance consumer confidence and provide benefits to the wider economy. Conversely, ineffective markets may harm market confidence and participation, adversely impact pricing and quality, or lead to detrimental economic side effects. As a consequence, a number of regulatory requirements are underway to prevent harm from arising in areas of the market that work less well. MiFID II obligations, for example, aim to address various issues relating to the fairness, openness and transparency of markets, while prudential requirements should enhance consumer protection. Over time, the transition from LIBOR to alternative and risk-free rates should also prevent harm from arising in the benchmark setting process and in the markets that reference these rates. We are working closely with the Sterling Risk Free Rate Working Group, the Bank of England, industry, ICE Benchmark Administration and international authorities, to achieve an orderly transition.

Meanwhile, Brexit could also drive structural change in markets and firms. Technology change could also increase effectiveness, but may also undermine it in some areas. For example, technologically advanced trading methods and firms may yield improved execution speed, liquidity and price discovery, but could also lead to challenges relating to transparency, oversight and predictability.

We continue to take steps to better understand and analyse the impact of such changes. This includes exploring the effect of MiFID II and Brexit on market structure, firms and consumer outcomes. We may also consider whether to intervene where adverse, unintended consequences arise, or may arise. For example, in February 2018 we reported on examples of good and poor practice relating to the use of algorithms in the trading activities of wholesale firms,[12] which included a focus on governance, oversight and conduct in this space.

Market power – network effects, vertical and horizontal integration, and regulatory factors mean market power will continue to exist in certain wholesale markets

Market power can enable incumbents to charge higher prices or offer a lower quality of service to wholesale consumers. This can then have repercussions for consumers further down the chain and for the economy. Firms with market power may also lack the incentive to innovate or invest in their product or service offerings. Market power can arise for many reasons, including network effects, vertical or horizontal integration, or through collusion.

During our engagement with the sector, wholesale market firms and consumers raised a number of market power concerns, including relating to providers of market data and infrastructure. Competition issues relating to data access and use are also considered within the technology section of the cross-sector themes chapter. Several interventions have been introduced to reduce market power or the harms associated with this, such as open access requirements and Reasonable Commercial Basis provisions under MiFID II. We are monitoring the impact of such changes to assess whether further interventions might be needed.

Information asymmetries – harm should reduce due to regulatory reforms

Information asymmetries arise where one party to a transaction has additional or superior information to the other. They can result in clients paying too much for a product or service, or buying a product or service that is not suited to their needs. We have seen numerous examples of information asymmetries arising across the sector, such as in products like Initial Coin Offerings where documentation is often lacking.

Overall, we expect the harms relating to this theme to be addressed by recent regulatory changes. For example, MiFID II should promote more transparent forms of trading, such as the shift that has been observed in equity activity from Broker Crossing Networks to Systematic Internalisers.

Other examples of developments that should reduce asymmetries include changes being introduced through the global FX code, including amendments to 'last look' practices, and product simplification, disclosure and due diligence requirements being implemented under the new EU Securitisation Regulation. We are playing an active role in driving changes in these areas.

12. FCA, Multi Firm Review, Algorithmic Trading Compliance in Wholesale Markets, February 2018.

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