

FCA Mission Statement Consultation – Responsible Finance Response

26 January 2017

Q1: Do you think our definition of a well-functioning market is complete? What other characteristics do you think we should consider?

Financial services markets regulated by the FCA are divided in the 'Our future Mission' documents into retail, wholesale and capital markets. Responsible finance providers operate in a retail environment, but customers who utilise responsible finance products and services usually do not access to the mainstream retail market. The goal of responsible finance providers is therefore not to compete with mainstream retail finance, but to serve customers who cannot access the mainstream market. This effectively means there are two retail markets operating simultaneously in a highly segmented fashion.

Any definition of the markets regulated by the FCA should acknowledge prime (mainstream) and subprime (non-mainstream) market segments either as two separate markets or as distinctive sectors of the retail market. This is a step to ensuring the competition principle is made to work for all.

Q2: Do you think our approach to consumer loss in well-functioning markets is appropriate?

The overall approach to consumer loss is correct. A distinction is drawn between retail and wholesale markets. A similar distinction should also be drawn between prime and subprime retail markets. In the subprime segment of the retail market, consumer loss can have the potential for severe repercussions for the customer given lack of savings or personal wealth buffers and is more likely to occur due to a lack of understanding regarding the financial product.

Q3: Do you think we have got the balance right between individual due diligence and the regulator's role in enforcing market discipline?

N/A

Q4: Do you think the distinction we make between wholesale and retail markets is right? If not, can you tell us why and what other factors you believe we should consider?

Overall the distinction is correct, however there is too strong an emphasis on retail finance serving household needs while only "some small businesses may be consumers" in this market. More than 99% of businesses in the UK are SMEs. Furthermore, 96% are microbusinesses,

employing 0-9 people.¹ The majority of businesses, therefore, are unlikely to fit the definition of “a very sophisticated and informed entity” non-reliant on third party advice as the typical wholesale customer is described in the existing Mission document. Most small businesses will rely on the retail market, so an alternative initial descriptor could read, “Retail markets serve household *and most small business* needs such as credit, insurance and investment products.”

Responsible finance providers lend approximately £100 million to small businesses each year, most of which is to microbusinesses and start-ups, which falls under consumer credit activity. These businesses are typically unable to access finance from mainstream lenders, and add value to the local economy through employment, regenerating high streets, and providing goods and services.

Q5: Do you think the way we measure performance is meaningful? What other criteria do you think are central to measuring our effectiveness?

N/A

Q6: Do you think the way we interpret our objective to protect and enhance the integrity of the UK financial system is appropriate? Are there other aspects you think we should include?

The second operational objective (market integrity) should include the principle of promoting inclusivity in financial services markets. Due to the far-reaching negative side effects that arise from a lack of inclusivity, the capacity and will of the wider UK financial system to grow and maintain its consumer base has implications for consumer confidence, market integrity and the over-arching goal of operational objectives “to support and maintain healthy and successful financial markets”.

The framework for defining harm includes consumer exclusion as a harm under the relevant FCA operational objectives ‘effective competition’ and ‘consumer protection’. Financially excluded consumers, such as those served by the responsible finance sector, are locked out of competitive markets altogether and exposed to negative outcomes. Often, these consumers are among the most vulnerable in society. The triggering of investigation and diagnosis of harm caused by exclusion through the intervention framework could let consumer harm continue for some time before being addressed. Financial exclusion is endemic in market segments that historically require more proactive intervention, such as the FCA’s work with debt management companies, due to persistent lack of competition and vulnerability to the entry of illegitimate or exploitative actors. For these reasons, addressing exclusion only through the framework for intervention, when the competition or protection objectives are threatened or breached, is not adequate.

Commercial viability and the principle of fair competition can coexist alongside the aim of providing an inclusive market. The Royal Mail has a universal service obligation,² on the basis of which it has successfully appealed to Ofcom, the postal services regulator, take to action to protect fair competition while maintaining Royal Mail’s mandate to provide universal postal

¹ <http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06152>

² <http://www.royalmailgroup.com/about-us/regulation/how-were-regulated/universal-service-obligation>

coverage in the UK³. While acknowledging that it is not appropriate to guarantee universal access to financial products, it is possible to recognise the unique environment, priorities and needs of market actors that seek to widen access to financial products where it is commercially viable, and to do so within the existing framework of operational objectives.

Q7: Do you think our intervention framework is the correct one?

We welcome the 'Our future Mission' document's inclusion of consumer exclusion as a type of harm, and therefore a basis for intervention.

Q8: Where do you believe the boundary between broader policy and the FCA's regulatory responsibility lies?

The following is acknowledged in the existing Mission document:

- the essential nature of financial goods and services to participation in UK society
- a well-functioning market provides more accessible goods and services to more people
- the failure of markets to meet consumer needs due to gaps in the existing range of products, consumer exclusion or the lack of market resilience are types of harm, addressable under competition and consumer protection objectives
- the Financial Services and Markets Act 2000 (FSMA) empowers the FCA to take action on consumer access, with specific reference to consumers in areas of social or economic deprivation

While the FCA is not responsible for financial inclusion policy, it has specific legal power to address access to finance as a competition issue. This can be actioned passively or proactively. Encountering the growth of innovation in financial technology, the FCA chose to take an active role, instituting measures such as the Regulatory Sandbox, Innovation Hub and Advice Unit. A similar approach to addressing financial exclusion, utilising only existing tools and remits, could play an important role in maintaining a healthy retail market, galvanising consumer confidence in financial service providers and improving the landscape for competition.

An example of a small action which could yield significant gains would be investigating how the FCA could use, or allow others to use, data it has from financial firms on lending activity, so that the FCA could map identify gaps. Without specific remedial action being taken, better insight into market coverage and lending behaviour can empower the market to address gaps through open competition, particularly from smaller firms specifically focused on market niches.

Q9: Is our understanding of the benefits and risk of price discrimination and cross subsidy correct? Is our approach to intervention the right one?

The FCA understanding of price-sensitivity references the distinction between 'sophisticated' and 'naïve' consumers, and consumer unwillingness or barriers to switching providers. The lack of awareness is another factor. In low income markets, price-insensitivity also occurs because

³ <https://www.ofcom.org.uk/postal-services/securing-universal-postal-service>

consumers are not aware of other finance options outside of mainstream retail banks and a handful of high-cost short-term credit providers.

Credit providers operating in low income markets typically offer credit at more expensive interest rates on repayments than mainstream providers. The purpose can be to make the overall rate of default sustainable, as opposed to price-gouging. In effect, they are using the higher repayment rates of those who do repay to cross-subsidise those who do not manage to repay. Cross-subsidy in this circumstance can be a form of consumer protection if the purpose is to allow the firm to write off more bad debt and be flexible regarding alterations to repayment plans. This is in the interests of the consumer.

Some firms such as HCSTC operate with higher interest rates on repayments in low income markets to take commercial advantage of the lack of awareness, naivety or lack of alternative options of sometimes vulnerable customers. Other firms do so to facilitate the provision of financial services to underserved markets at the lowest viably sustainable rate. It is important to recognise the distinction between the two.

Q10: Does increased individual responsibility increase the need and scope for a greater and more innovative regulatory response?

N/A

Q11: Would a Duty of Care help ensure that financial markets function well?

N/A

Q12: Is our approach to offering consumers greater protection for more complex products the right one?

It is overly simplistic to only vary the balance of consumer/firm responsibility depending on the particular product or transaction and how it is sold. Often, particularly in low income consumer markets, the danger for consumers is not just the complexity of the product but the wider social context and a lack of awareness or convenient access to more appropriate or beneficial products. Viewing consumer protection as the balance of responsibility within the confines of a discrete transaction does not provide adequate protection for such consumers.

This is a financial exclusion issue as well as a capability issue. While the FCA is not mandated to regulate for financial inclusion directly, encouraging or facilitating greater release of granular data regarding lending would empower the wider financial services industry, community interest civil society and local economics groups to identify market failure, inefficiency or consumer harm. These groups can then advocate for policy change on the behalf of low income consumers. While not direct policy intervention, it fulfils the capacity to 'have regard to the ease with which consumers who may wish to use those services, including consumers in areas affected by social or economic deprivation, can access them' in pursuing the competition objective.

Q13: Is our regulatory distinction between consumers with greater and lesser capability appropriate?

As mentioned in our response to question 12 regarding consumer protection, it is not enough to assess the capability of the consumer based on their ability to understand a particular product in itself and relation to similar products. Consumer capability should also be assessed with regard to whether they have ready access to, awareness and understanding of alternative products, and the wider social context, such as localised distrust of certain products or firms or familiarity with others. An interpretation of consumer capability that is too simplistic against the backdrop of complex consumer markets leaves room for ongoing harm and hampers the capacity of stakeholders to call for redress or policy change.

Q14: Is our approach to redress schemes for issues outside our regulatory perimeter the right one? Would more specific criteria help firms and their consumers?

N/A

Q15: What more can we do to ensure consumers using redress schemes feel they are receiving the appropriate level of personal attention?

N/A

Q16: Is our approach to giving vulnerable consumers greater levels of protection the right one?

The framework for defining harm includes consumer exclusion, which we welcome. However, in describing the FCA's approach on deciding when to take regulatory action to protect vulnerable customers, the 'Our future Mission' document states, "we focus on the potential harm of a particular product, firm or market and the capabilities of consumers using them." The approach to protecting vulnerable customers is therefore very much oriented towards issues arising from active engagement with product, firms and markets. It is not clear where financial exclusion as a form of harm comes into the frame, given that it is a passive form of harm caused by *not* having active engagement with products, firms and markets.

To fully protect the range of vulnerable customers, including low income customers, we recommend that financial inclusion is more clearly included in the general regulatory framework, from specific reference in the FCA's objectives through to the protection of vulnerable customers, recognising that more proactive measures are needed to minimise consumer harm, including creating a proportionate regulatory environment for firms such as community finance organisations, that exist to tackle financial exclusion.

Q17: Is our approach to the effectiveness of disclosure based on the right assumption?

N/A

Q18: Given the evidence, is it appropriate for us to take a more 'interventionist' approach where conventional disclosure steps prove ineffective?

Yes, it makes sense for the regulator both to initially adopt a more hands off approach initially. The exception would be when significant harm is occurring and the risk of not robustly intervening is that significant harm will continue to occur.

Q19: Do you think our approach to deciding when to intervene will help make FCA decisions more predictable?

Yes

Q20: Are there any other factors we ought to consider when deciding whether to intervene?

The responsible finance industry is an example of a sector of financial services which seeks to put benefit to the customer alongside commercial considerations and serve disadvantaged, underserved populations. In doing so, its firms operate with constrained budgets and smaller workforces. It is reasonable to expect that the FCA takes into consideration the consistent commitment to prioritise the interests of the consumer when considering whether to intervene and, if so, what intervention to pursue. Given the aforementioned constraints on resources and capacity, regulatory requirements that place unnecessary burdens on time or the finances of small firms can ultimately limit their scope for operation, particularly when they are working with vulnerable or underserved customers. This can have a negative effect on competition and ultimately harm the consumer, therefore we request the FCA makes a commitment to proportionality in terms of the size and scope of the firm.

Q21: What more do you think we could do to improve our communication about our interventions?

N/A

Q22: Is there anything else in addition to the points set out above that it would be helpful for us to communicate when consulting on new proposals?

N/A

Q23: Do you think it is our role to encourage innovation?

The FCA should facilitate innovation under the competition objective, without actively incentivising it. From the perspective of Responsible Finance, more active consultative engagement on regulatory issues would be welcome, with recognition of the unique market, mission and circumstances of the responsible finance sector. This is not limited to technological innovation. The responsible finance sector is, for example, seeking ways to innovate on funding models, in addition to the delivery of ethical finance. At this juncture, we lack an open avenue for discussion with the FCA to test proposals on what might be possible within existing frameworks or regulatory evolution.

Q24: Do you think our approach to firm failure is appropriate?

Yes

Q25: Do you think more formal discussions with firms about lessons learned will help improve regulatory outcomes?

Formal discussions in instances when there has been insufficient evidence to take action will help improve regulatory outcomes. Where possible and appropriate, these conversations should be opened up for public contributions.

Q26: Do you think that private warnings are consistent with our desire to be more transparent?

Private warnings may benefit from less contentious terminology, such as private statement of concern. The implication is that the firm has an opportunity to change its behaviour before harm occurs. Warnings should be a subsequent public step, as the implication is that some harm has occurred, or that privately stated concerns have not been properly addressed.