Financial Conduct Authority

FCA Risk Outlook

2014

FCA Risk Outlook

2014

25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk

MIX
Paper from responsible sources
FSC® C001785
FSC www.fsc.org

Contents

Foreword		4
Executive summary		6
Part A. Drivers of risk		12
1	**Underlying drivers of risk to our objectives**	14
	1.1 *Inherent factors*	14
	1.2 *Structures and business conduct*	20
2	**Changes in environmental conditions**	24
	2.1 *Economic and market environment*	24
	2.2 *Technological developments*	35
	2.3 *The policy and regulatory environment*	40
Part B. The evolving risk landscape		50
3	**Cross-market pressures and related risks**	52
	3.1 *Pressure on business model sustainability and strategies*	52
	3.2 *Continued pressure to balance profitability, shareholder returns, cost base and financial soundness with good consumer outcomes*	60
	3.3 *Misalignment of expectations with underlying fundamentals*	63
Box	**Prudential soundness and risks**	65
4	**Forward-looking areas of focus**	68
Links to the Business Plan and Conclusion		78
5	**Links to the Business Plan**	79
6	**Conclusion**	82
Glossary of terms		84

Foreword

This is our second annual Risk Outlook publication which sets out our current thinking on the main drivers of risks to our statutory objectives and signals the types of forward-looking areas the FCA will focus on.

This publication allows us to set out our view of the conduct and prudential landscape for the firms we regulate and the consumers who are served by them. It discusses the potential challenges we all face in achieving better outcomes for consumers. It allows us to communicate strategically the FCA's thinking on risks in a transparent way – enabling us to help firms, consumers and market participants better understand the approach we take to understanding risks, their drivers and implications for consumer protection, market integrity and effective competition.

This document should be read alongside our Business Plan. Some risks are already known to us and we have a whole programme of work, set out in the business plan to deal with them. Others may be more speculative – and may be issues at the limits of our ability to identify forward-looking risks. Some of the issues set out here may never crystallise, but we know some will. By their nature, some of these risks may need to be watched for many years and we continue to highlight a number of issues mentioned in last year's publication.

We have updated our views set out last year to reflect the very different operational environment we find ourselves in. With the financial sector and economy on a path of recovery, we have a responsibility to look at potential risks arising from this environment and the feasible responses of firms and consumers. If we are able to learn from past, the seeds of major future conduct and prudential risks may be sown in this period if we are not thinking ahead to the implications for firms' strategies and interactions in the upturn.

We also need to reflect the wider conduct issues we are experiencing now to inform our judgements. As a 'Risk Outlook' this document will unavoidably focus on what could go wrong and where risks to consumer protection, market integrity and effective competition could arise from changes in firm and consumer behaviours or misalignments of products and needs. It is not a report card on the financial industry. We hope by highlighting these issues, in particular the seven

> We hope by highlighting these issues, in particular the seven areas of focus, to increase the likelihood that firms will be able to avoid them or to minimize their impact and the detriment they cause.

areas of focus, to increase the likelihood that firms will be able to avoid them or to minimize their impact and the detriment they cause.

Over the last year we have seen many firms working with us to build a stronger financial system, efforts on redress for PPI and earlier intervention with consumers on interest only mortgages have been positive; but issues are still emerging, many of them quite recent in nature. Whilst we do not doubt the genuine commitment of many senior management teams to change their businesses, some issues appear to remain deeply imbedded and will require more focus.

Embedding cultural change in a firm that acts in the interest of consumers is the essential next step if firms are going to regain trust from their consumers. Cultural change may take years to achieve but every positive step towards embedding a culture which places consumer interests at the heart of the business will ensure the protection of consumers, market integrity and effective competition. A culture and strategy within firms that promotes these outcomes is in all our interests – particularly given London's importance in global markets as a centre for finance. The cumulative impact of actions – for example market abuse, which diminish the integrity of our markets – may challenge this role. As the regulator we can promote good and tackle poor behaviours through enforcement actions but firms and market participants need to take responsibility in maintaining the integrity of our markets through their own actions. Millions of people are employed by the financial sector and a vast majority of these individuals do not undertake activities or exhibit behaviours that require the FCA to intervene.

Recent events have demonstrated the importance of financial regulation and the importance of maintaining a focus on conduct in both retail and wholesale markets for example, in the foreign exchange markets. Whilst there are some issues that sit at the margin of our principles and rules such as when 'advice' is potentially being given using digital platforms; treating consumers fairly is a principle that is relatively easy to understand and adhere to.

This document covers risks we expect the industry to be mindful of in the mid- to long-term especially in their business development; and we would expect firms to reflect these risks in their current or future business plans and strategies. There are some issues that as a conduct regulator we are unable to tackle alone, particularly when it comes to the root cause of some of the risks we identify in this document. We also need to look at our wider rules and practices when they may contribute to potential risks or drive unintended behaviours. The FCA must ensure its regulatory response is proportionate to the issue it aims to address and remain conscious of the impact its own actions can have on firms and consumers.

The industry continues to have a responsibility to act in the interest of consumers to create a financial sector that can be trusted by consumers and investors. As the regulator, one of the ways we can play our part is by flagging issues of concern before they become major problems. Therefore the risks set out in this document should not just be of concern to the FCA but also to the industry as a whole.

John Griffith-Jones
Chairman, Financial Conduct Authority

Executive summary

Part A Drivers of risk

Chapter 1 Underlying drivers of risk

Chapter 2 Environmental developments

Part B The evolving risk landscape

Chapter 3 Cross-market pressures and related risks

Chapter 4 Forward-looking areas of focus

Conclusion

Introduction

Our Risk Outlook sets our forward looking view of the conduct and prudential landscape for the firms we regulate and the consumers who are served by them. We look at what causes risk in the financial markets and how these factors affect the firms and consumers that participate in them. This enables us to prioritise areas which we believe may require further focus in the future.

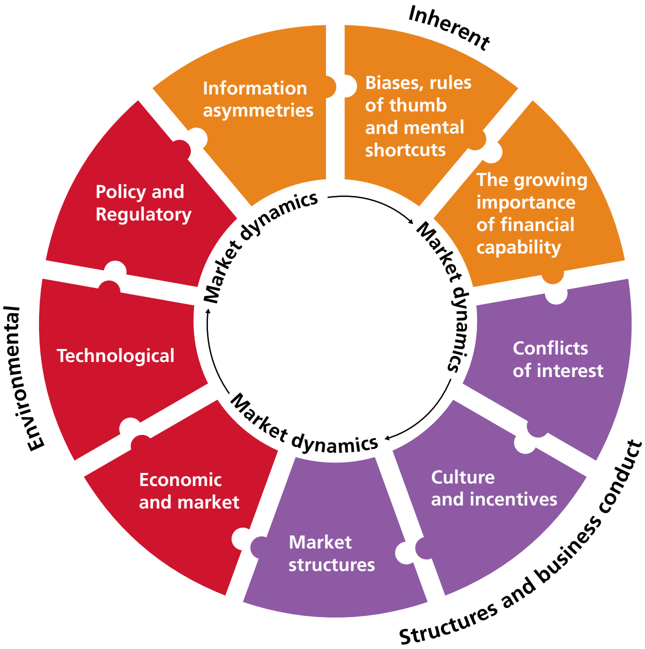
We will continue to monitor these risks to determine whether and how we should intervene, and we will monitor changing conditions and the responses and behaviours of firms and consumers.

Part A. Drivers of risk

This section sets out our approach to how we think about the drivers of risk to consumer protection, market integrity and effective competition – these factors are the features that often underlie the risks we see emerging in today's financial markets.

We have divided the drivers of risks into three groups. The **Inherent** factors and **Structures and business conduct** features are the internal characteristics of financial markets and market participants and are influenced by the **Environmental** developments.

Key drivers of risk



Chapter 1 explores inherent factors and structure and business conduct features that are present when markets are not working well and create risks to consumer protection, market integrity, and effective competition.

Inherent factors – characteristics found among financial markets and their participants – are our starting point for thinking about why markets might not work well. Firms and consumers may be taking advantage of these to further their own interests in ways that may have negative repercussions for our objectives. Particularly relevant factors are:

Information asymmetries – when one party in a transaction has more or better information than the other party – are common in most retail and wholesale financial markets transactions. They potentially affect outcomes along the distribution chain, causing mis-selling and reduced trust, and can affect market integrity if used to benefit the firm at the expense of one or more conflicted clients.

Biases, rules of thumb and mental shortcuts – systematic behaviours that consumers and market participants demonstrate in decision making – though rational, play a key role in decisions that can lead to poor consumer outcomes. These behaviours, often inter-related, also drive poor outcomes for consumers through ineffective competition. They can be particularly problematic in complex financial markets where decisions are often about risk, time and predictions about the future. Behavioural insights can be used to take advantage of consumer biases by selling unsuitable or overly complex products and services.

The growing importance of financial capability. Financial skills and knowledge are often insufficient for the complexity of decisions required within the financial environment. This is particularly important given the pressure on budgets and increased responsibility of individuals.

Structures and business conduct features are the features of financial sector design and the structure, processes, culture and incentives in businesses that are embedded in the financial sector, that create poor outcomes for consumers and prevent markets from working well.

Conflicts of interest that have become built into financial sector structures, processes and management, both in wholesale and retail markets, can create intractable barriers to good conduct outcomes. Conflicts often occur when combined with information asymmetries, which is the case in most financial products and services, preventing the ability to check if parties are acting in clients' best interest, and vice versa.

Culture and incentives motivate and drive the behaviour and thinking of an organisation; they define the strategy of a firm and how it conducts its business and may create conflicts by incentivising behaviour. When there is strong alignment between a firm's culture and its incentive arrangements, the two can strengthen each other.

Market structures define how well a market is functioning. Effective competition is a key element and can be restricted or distorted by barriers to entry, concentrated market power, complex fee structures and distribution chains, distorted price formation and infrequent market entries. These can lead to higher prices, lower efficiency and weakened incentives to innovate.

Chapter 2 discusses the role that environmental developments have on consumer behaviours and decisions, and firms' business models, strategies and financial soundness.

Changing **environmental** conditions interact with firms and consumers, causing them to adapt their strategies. Many of these have mixed impacts – benefits for some, risks for others. Although it is not the role of the FCA to influence macro-economic developments, nor to challenge the various forecasts reported by the government; we need to be alert to how likely developments may impact on the financial markets and activities regulate.

Economic and market environment – conditions and developments influence the perceptions of risk and return, and can be important in shaping the future expectations and long-term needs of consumers. Rising longevity is a key factor for consumers to consider when assessing their financial security.

While there has been improvement in the UK's economic and financial markets' outlook over the last year, underlying challenges could pose risks. Although employment has remained resilient, positive economic growth has not yet been fully reflected in wage growth. Meanwhile the low interest rate environment has continued to keep debt servicing costs low and has supported indebted households. The prolonged low returns on savings and in particular annuities have created significant challenges for savers, pension providers and insurers as they seek higher-yielding products. Asset prices remain elevated and for households this could lead to mortgage affordability being stretched particularly when interest rates start to rise.

Even in a period of sustained recovery, the expectations and responses of firms and consumers could lead to decisions that create risks to consumer protection, market integrity or effective competition, particularly as the environment starts to support higher interest rates.

Technological developments continue to affect the way consumers engage with financial services and how products and services are distributed. Technology may create effective and cost-efficient distribution channels, increasing competitiveness, innovation and efficiency, but can also be limited by vulnerabilities in the design and management of systems and infrastructure.

The growing demand and increased dependence on digital connectivity may result in increased exposure to these potential disruptive capabilities and resilience issues. Technology can affect decision making by creating information asymmetries and may help increase financial exclusion. Consumers purchasing

We explore how changing environmental conditions interact with underlying consumer behaviours and market features to create risks to our objectives.

directly through distribution channels may also come across products and services that are unsuitable for execution only sales.

Technological developments have also increased the availability and use of data insights as firms are increasingly able to capitalise on this knowledge, potentially affecting price formation and product features, as well as increasing the potential profits of cybercrime.

The *policy and regulatory* environment is bringing about changes to the structure of markets and the financial sector. Legislative and regulatory policies impact firms' funding strategies, positions and performance and affect consumers' financial needs and demands, influencing the products and services developed and alter the way firms conduct their business.

Part B. The evolving risk landscape

In this section we look at how changing environmental conditions have interacted with the underlying drivers of risk. In particular we look at; **Cross-market pressures and related risks** – risks that cut across financial markets, and seven **Forward-looking areas of focus** – areas where we see significant risks approaching a tipping point or that we have identified as potentially requiring our intervention.

Chapter 4 explores the **Cross-market pressures** we have identified:

- **Pressure on business model sustainability and strategies** – due to a combination of long running trends, market dynamics and external conditions – affect the profitability of core business, the design of products, the market segments and consumer groups firms rely on, firms' funding structures and their use of technology. If firms are unable to adapt to the environment it could trigger consolidation, affecting competition in some markets. Firms could also create new and innovative business models, increasing competition and delivering better value products and services for consumers.

- **Continued pressure to balance profitability, shareholder returns, cost base and financial soundness with good consumer outcomes**, can cause behaviours and strategies in firms that support their own prudential soundness but are not in line with consumers' desire for simple and transparent products. Firms experiencing financial distress may have poor back-book management in place, exit less profitable activities, apply cost-cutting strategies that affect their services, have resolution plans, that do not consider conduct implications, or adopt technology without adequate systems in place.

- **Misalignment of expectations with underlying fundamentals** can lead to financial decisions being based on ill-informed risk assessments, particularly in a low interest environment; where due to their search-for-yield, investors have become increasingly willing to take risks, underestimating potential downside risks and prospects of weaker future performance, and overestimating their understanding of risk and return. When interest rates start to rise they may be slow to respond to new market environment.

As firms and consumers continue to adapt to external conditions and deal with consequences of previous decisions, they are exposed to a wide range of conduct and prudential risks that may challenge consumer outcomes, market integrity and effective competition.

In Chapter 4 we have identified seven **Forward-looking areas of focus** that are of considerable importance in creating risks to our objectives in the future. These include:

- **Technological developments** may outstrip firms' investment, consumer capabilities and regulatory response

- **Poor culture and controls** continue to threaten market integrity

- **Large back-books** may lead firms to act against their existing customers' best interests

- **Retirement income products** and -distribution may deliver poor consumer outcomes

- The growth of **consumer credit** may lead to unaffordable debt

- **Terms and conditions** may be excessively complex

- **House price growth** that is substantial and rapid may give rise to conduct issues

The FCA seeks to protect consumers and the broader market against the potential impact of these risks. However, due to uncertainty about the future and as a result of changes in the broader environment, these risks may crystalize in a different way than expected, may not materialize at all or their impact may be less significant than expected. This uncertainty about the future may cause difficulties to our ability to resolve these issues – some may take years and others may proof impossible to resolve. We will work on resolving more developed and crystallized risks that we have identified through our ongoing regulatory oversight of firms and markets, as we will set out in our business plan.

Part A

Drivers of risk

Part A Drivers of risk
Part B The evolving risk landscape
Chapter 1 Underlying drivers of risk
Chapter 2 Environmental developments
Chapter 3 Cross-market pressures and related risks
Chapter 4 Forward-looking areas of focus
Conclusion

This section sets out our approach to thinking about the drivers of risk to our objectives – consumer protection, market integrity and effective competition – these drivers often underlie the risks we see emerging in today's financial markets.

Last year's Risk Outlook set out a high-level view of underlying consumer and market features that are the root cause of risks, as well as how past and current environmental conditions affect these factors.

This year, the *Drivers of risk* section will consider how these factors have developed over the past year and where particular markets are showing signs of not working well. Using this approach, we will share our thinking about how risks to our objectives begin to develop and evolve in retail and wholesale markets. This approach allows us to be more forward-looking – addressing the root causes and drivers of risks that cut across several markets, as well as intervening early on issues as they emerge. The risks arising from developments in these drivers are addressed in Part B.

The factors we explore are divided into three groups:

- **Inherent:**
  First, we take stock of the inherent features of financial markets that are recurring drivers of risk. These are a combination of market failures (e.g. information problems) and consumer weaknesses (e.g. inbuilt biases), which are often exacerbated by low financial capability among consumers.

- **Structures and business conduct:**
  Then we look at features of financial sector design (market and firm structures and processes) and management (culture and incentives) that may lead to markets not working well.

  Here we also introduce a range of possible issues that can weaken effective competition within financial services. Some of these issues are seen in non-financial markets, but may have particularly acute manifestations in the financial sector.

- **Environmental:**
  Lastly, we set out how developments over the last year in environmental conditions (in the economy and financial markets, the regulatory and policy landscape and technological advances) have affected and are anticipated to affect firm and consumer decisions and behaviours in the future. This could also influence what consumers need or demand from financial markets and what firms are willing or encouraged to provide.

The interaction of these three groups of issues impacts outcomes through market dynamics or the competitive process. Effective competition is an important part of helping to ensure good consumer outcomes and market integrity; as competitive markets can offer lower prices, deliver a wider range of products and lead to higher quality. It makes firms innovate and operate more efficiently, improving outcomes for consumers.

1.

Underlying drivers of risks to our objectives

The *Inherent* factors and *Structures and business conduct* features draw out the issues that are present when markets are not working well and are often at the root of risks to consumer protection, market integrity, and effective competition. These are the internal characteristics of financial markets and market participants which are influenced by the *Environmental* developments that will be discussed in Chapter 2. This combination can alter behaviour in a way that creates risk.

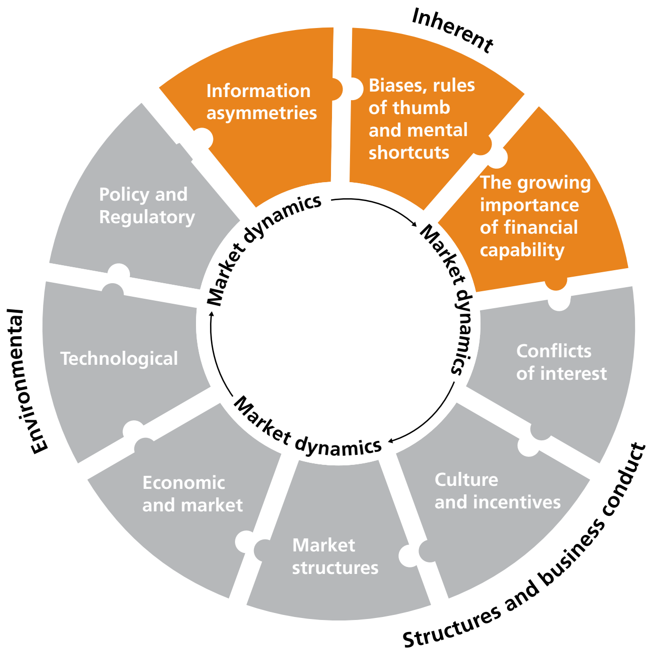
1.1 Inherent factors

Inherent factors are the characteristics found among financial markets and their participants (consumers and firms). We take these factors as a starting point for thinking about why markets might not be working well. An important shift in our work during our first year in operation has been to better appreciate and begin to integrate an understanding of these factors into our everyday processes.

For example, in our first Occasional Paper on behavioural economics, we explored some consumer behaviours in more detail.[1] These consumer behaviours can lead to firms competing less, reducing the offer of good value products. We continue to intervene to change behaviours or processes, where firms and consumers may be taking advantage of inherent factors to further their own interests in ways that may have negative repercussions for our objectives (see *Structures and business conduct* below).

Many consumers struggle to match their needs with the products and services on offer. This is partly due to low financial literacy rates and partly to the difficulty (or impossibility, in some cases) of knowing what future financial needs will be, given that circumstances and the external environment could change significantly. It is also partly due to the systematic behavioural biases that consumers and market participants demonstrate in decision making.

Here we pick out aspects of these inherent factors that are particularly relevant to the risks we highlight later on in this document.



Information asymmetries at the root of conduct issues

Information asymmetries – where one party in a transaction has additional or superior information to the other party – are at the root of many conduct issues in financial markets. Common in most financial markets, these information problems can leave even sophisticated (individual or corporate) consumers not understanding product or service details or unable to compare products. This may reduce take-up or switching of products and can weaken consumers' ability to drive competition. It can also create opportunities for firms to sell inappropriate products or act on conflicts of interest

1 The findings of this work can be found in Occasional Paper No. 1 Applying behavioural economics at the Financial Conduct Authority, April 2013

to the detriment of consumers. Information asymmetry can also affect confidence in individual firms and in financial markets or when products do not perform as consumers expected, particularly where consumers do not become aware for many years that they have purchased an inappropriate product. This is particularly true for longer-term products (e.g. mortgages, annuities and pensions). In addition, where there are long distribution chains from provider to consumer via an intermediary, if intermediaries are mis-informed or mis-interpret product provider materials or consumer needs, advice provided may not be entirely appropriate for the end consumer.

As in retail markets, information asymmetries are also at the root of many wholesale conduct risks and in many ways are more firmly entrenched in wholesale activities. The integrated nature of many wholesale and investment banking activities facilitates the flow of information to maximise revenue generating and cross selling opportunities. These provide firms with earlier insight into developing risks and trends; and the ability to use their analysis to transfer risks to other parts of the wholesale chain.[2]

Financial markets and activities where we are most concerned about information asymmetries include:

Consumer credit markets

Consumers often do not have full information about the credit products that they use and the price of credit is sometimes difficult to work out. This is particularly so when prices include multiple components (upfront fees, ongoing interest, default fees etc.).

Insurance markets

Underwriters and purchasers in insurance markets face information asymmetries in their interactions and may not have the same understanding of the insurance risks being underwritten. These information problems may not be apparent for some time as the risk may only manifest at the point of making a claim.

Investments market

In addition to consumers not being properly informed about what they are buying, it is also possible that Independent Financial Advisors (IFAs) are mis-informed by providers, which in turn is passed onto the consumer. There may be wholesale product providers, who push products to IFAs, reinforcing incorrect or unfounded views about them (for example, the benefits that active fund management can offer to clients and the justifications used for this). Current examples of consumer detriment in this market include the mis-sale of interest rate swaps but there are other analogous instruments – from the sale of corporate bonds in denominations which make them more accessible to retail consumers, to the sale of complex hybrid regulatory capital instruments with risk and return characteristics that are inherently difficult for less sophisticated investors to evaluate.

Wholesale markets

Where firms have an information advantage, this can create conflicts of interest if the information is non-public and has been acquired as a result of acting for other clients or in multiple capacities. This is particularly of note in corporate and investment banks, and could affect market integrity if used to benefit the firm at the expense of one or more conflicted clients.

Investment Banks

Investment banks that act as agents, for example corporate finance firms, may not be observing the requirements to either keep information private (away from trading desks) or to pass information to clients at the appropriate time as required by relevant legislation (including the Markets in Financial Investments Directive (MiFID), Market Abuse Directive and Disclosure and Transparency Rules). To reduce the effects of asymmetry we would expect firms to adhere to the standards expected of them under the relevant rules and manage conflicts of interest appropriately. Their responsibility is to provide fair and transparent information, which is then used to determine pricing and put consumers' (and markets') interests first.

Trading activities

Information asymmetries can drive market abuse and threaten market integrity evidenced, for example, by insider trading. The ability of some participants to abuse non-public 'inside' information undermines the integrity of the price formation process. It can also undermine trust and confidence in the integrity of markets due to the perception that some participants benefit from the ability to act on market sensitive data ahead of others. This happens for example in the case of front running, where a broker uses knowledge of a client's trading intentions or forthcoming disclosure of market sensitive information to commit market abuse by executing a proprietary in order to benefit from anticipated market movements.

Common in most financial markets, these information problems can leave even sophisticated consumers not understanding product or service details or unable to compare products.

2 Customer refers to investors

As a consequence of the increased influence of technology on markets, the abuse of information asymmetries increasingly threatens market integrity. The new market abuse regime will be extended to include these developments, for example by including abusive strategies through the manipulation of benchmarks and commodity derivative markets.

Biases, rules of thumb and mental shortcuts

There are a number of behavioural characteristics that play a key role in understanding why, even with good quality and accurate information, consumers can still make poor financial decisions and advisers can still give unsuitable advice. Rules of thumb and mental shortcuts in decision making are often highly evolved, rational and sensible, but sometimes they can lead to poor decisions being made when consumers do not focus attention on the most important product terms or features.

Systematic behavioural biases that consumers and market participants demonstrate in decision making, are driven by inbuilt and often unconscious factors that we discuss further in this section. These behaviours can be particularly problematic in financial markets, because of their complexity, and because financial decisions are often about risk, time and predictions about the future, which are especially susceptible to consumer biases. For example:

- In retail banking, consumers often leave their savings in low-interest bearing accounts, or do not shop around at the end of a promotional rate period for a better rate. This may be because in some cases consumers may value their time over higher savings rates.

- In consumer credit markets, consumers may take out short-term (high-cost) credit, where an alternative type of credit (stretched over a longer timeframe), or a reduction in credit use, could have been a more suitable option. In some cases consumers may underestimate the length of time it could take to repay, their likelihood of hitting contingent charges or possibility of having difficulty repaying which could lead to inappropriate credit products being used.

Firms can use behavioural insights to create positive consumer outcomes. For example, some firms have already started to draw on behavioural insights to better understand consumer needs and meet those needs through product design and sale practices in ways that are less likely to mislead consumers.

However, we know that behavioural insights or marketing can also be used to take advantage of consumer biases to nudge them to purchase more profitable products, prevent them from moving out of services, buy products that no longer offer value leading consumers to make poor financial decisions.

> Rules of thumb and mental shortcuts in decision making are often highly evolved, rational and sensible but can sometimes lead to poor decisions being made when consumers do not focus attention on the most important product features.

Behavioural characteristics can also provide firms with a clear incentive to create complex products that have prominent, front-loaded benefits and less-visible, back-loaded, contingent costs. These incentives in product creation can further distort competition and generate poor consumer outcomes.

Some of the most common biases are explored in more detail below. Rather than being individually responsible for specific problems, these biases are often inter-related and together drive poor outcomes for consumers through ineffective competition. For example, poor outcomes can be driven by a combination of firms' ability to frame information with consumers' limited focus on features, present bias and their overconfidence consumers have in avoiding charges and the affordability of products.

Present bias

Present bias is where consumers place too much emphasis on short-term outcomes or immediate costs and benefits, without thinking about the longer-term implications. It can also lead to consumers becoming passive and not shopping around for providers when they focus on the costs of identifying an alternative supplier, rather than the benefits they may derive from it. This may lead to competition to deliver lower immediate prices rather than improvements in product quality, which may not be in consumers' overall interest. The effect of present bias can be particularly strong when an opt-out as opposed to an opt-in system is used. Of particular concern is where present bias causes consumer inertia (for example, where consumers procrastinate; follow the default option and keeping product when they would be better off switching).

Overconfidence

Exacerbating the present bias, overconfidence is often at the root of mistakes that consumers make with their finances, for example about how affordable credit is likely to be or how well an investment will likely perform. Many consumers take little notice of contingent charges as they are overconfident about their ability to avoid them, or take out short-term deals because they are overconfident about their likelihood of switching when the introductory rates run out. Overconfidence can especially exacerbate other biases as it leads consumers to think they are less biased or more able than they are, while being willing to ascribe biases to other consumers.

Similarly firms may display overconfidence in existing risk controls, or display herding tendencies (by following what other firms do in loosening mortgage underwriting standards), or in senior managers being overconfident that their actions have reduced or eliminated risks.

Prominent features and complexity

Many financial products are incredibly complex, with huge numbers of features and extensive terms and conditions. Complexity can affect the extent to which consumers engage with financial product decision making. Consumers often use shortcuts or rules of thumb to focus on the most prominent features rather than every feature of every product they purchase. This can give firms considerable power to make the most positive features the most prominent ones, giving less emphasis to costs and other negative features. It can lead to consumers purchasing products that they do not need or fully understand. For example;

- In the investments market complexity can make it difficult for consumers to compare products or for those reliant on key services to achieve a good deal – this can lead consumers to default to existing providers and often fail to get the best rate or product. In retail investment products (e.g. structured retail products, insurance products for investment and investment funds), information may be confusing and overly complex for retail consumers to understand, making risks and costs difficult to compare.

- In wholesale markets, the price formation process can be complex and opaque. For example, opacity of pricing mechanisms for decentralised markets can cause consumers to make use of off-exchange price mechanisms that are not as efficient as on-exchange mechanism due to lower transaction and volatility. Because of the opacity of the market consumers interrogate the fundamentals of the mechanisms less.

Framing

How information is framed can significantly affect the choices consumers make. This relates closely to the time and attention consumers have as well as the way information is framed, as this can define which features consumers pay attention to and which are ignored. This means that by changing the frame firms can nudge consumers to buy different products and increase or reduce the transparency of different aspects, which may lead consumers to mis-understand the real costs or features that matter to them.

For example:

- For consumer credit products, marketing techniques may deliberately mislead consumers so they enter expensive credit arrangements, focusing on particular features and not necessarily all that are relevant. Combined with consumers' focus on headline rates, products framed in a way that discounts admin fees or early repayment charges can lead to unaffordable borrowing.

- Retail Banks and Building Societies may draw consumer attention away from the charges on overdrafts and other consumer credit products by only putting them in the terms and conditions, while making the ease of getting credit or a reward programme they offer more visible.

- Price comparison websites drive consumer focus to headline prices and consumers may buy unsuitable products when information is not shown transparently.

Box 1 – Consumer credit insight into lower income consumers

The FCA has recently conducted detailed consumer research into specific credit products and services (Credit cards, overdrafts, logbook loans, debt management services and payday loans) in addition to consumers on low income. This research indicated that initially, consumer credit is sold not bought, meaning consumers do not shop around but often accept the offers they receive as a short-term fix. This may be a credit card that is used to buy clothes, an overdraft to pay for a holiday or a loan to buy a car.

"I got lots of offers from credit cards they are always throwing stuff at you. I use hire-purchase providers for TVs and if I need furniture, I know its mad interest but I'm just used to doing it that way, just paying each week is easy."

This initial exposure to consumer credit can set off a chain of borrowing. In families where money is tight there is a conflict between the short-term priority of getting some extra money for monthly expenses, taking care of the family, paying the rent or mortgage, and the long-term goal, to get out of debt and build some savings.

"I used to use payday loans to help me through the month. This was ok as long as I didn't miss payment due dates as interest builds up at a very high rate quickly."

Consumers may not want additional debt, but feel the expectations of their families as well as their life enjoyment requires more money than they can afford in the short term. Illustratively, they may begin with an overdraft use credit cards and store cards to supplement income (or obtain discounts) and fund emergency bills with pay day loans.

"I couldn't believe it – I was just looking at a banking app and suddenly there was £2,000 in my account."

When money is already tight and accumulated debt needs to be paid off, people may end up using more expensive forms of credit to meet these needs. The urgency of borrowing or familiarisation with product takes precedence – the most convenient option is selected. Consumers are often struck by the ease of borrowing, through digital apps. Consumers often do not shop around for credit, but take the offer close to hand, for example the loan offered by a car dealer or home credit taken at your door.

"I had no idea we would be charged interest for the first year if we didn't pay in full by the end of the year; I thought interest would start then but they've backdated it! It's probably in the small print but they should tell you."

A number of consumers have little time or the inclination to remain on top of their debts with interest free periods coming to an end and unplanned for payments commencing.

The growing importance of financial capability

Financial capability is increasingly important for consumers given their need to budget (due to a squeeze on consumer balance sheets and potential cut in the welfare provisions individuals receive) as well as the shift in responsibility away from the state towards individuals (for example, with the forthcoming introduction of Universal Credit and pension reforms for retirees). Financial decisions in this environment are likely to require higher levels of financial skills and knowledge. Consumers need to better understand what their short and long-term financial needs are, as well as what sort of products they would need to hold to be able to meet these needs.

Research has shown that financial capability, the ability to understand information on financial products and services, is generally weak among consumers, as is their understanding of their needs. Consumers that are financially capable and well informed about their needs are less likely to suffer detriment. Well informed consumers can also put pressure on firms to compete more effectively.

A gap between a consumer's financial capability and the skills, knowledge and capacity needed to manage more complex financial responsibilities could increasingly drive risks to consumer protection. This is particularly true where greater individual responsibility is going to be required of consumers. Even where financial information is presented in a straightforward way and consumers do not face barriers to shopping around or changing providers, if financial knowledge and skills are lacking, even basic financial decisions can be misguided (see Figure 1).

Figure 1: Skills and knowledge need to manage money well

Skills

When shown a sample bank statement, 16% of people failed to correctly identify the available balance, with this rising to just under a quarter of those aged over 55.

This demonstrates the importance for the financial services industry of properly considering customers when drafting, reviewing and simplifying product information and literature, including terms and conditions.

There is a growing body of evidence that full disclosure of information is not helpful for a large proportion of the population who are not able, or indeed willing, to translate financial terms and conditions into implications for themselves.

More positively, 89% of people were able to identify the better deal from two financial options; but again, of those aged over 55, nearly one in five picked the wrong option.

Knowledge

When it comes to financial matters, a significant number of people have gaps in their knowledge, in particular among the under 35s.

More than one in eight (11%) believe the current Bank of England base rate to be over 10%. This rises to one in six (17%) of those under 35, figures which should be borne in mind when the implications of an increase in the base rate need to be communicated to people with mortgages.

Also worrying, not least with the ambition in mind of getting more people into workplace pension schemes through automatic enrolment, is the level of knowledge of how pensions work.

One in seven (13%) of those under 35 think it is better to start paying into a pension in your fifties rather than in your twenties. This compares with just one in 20 (5%) of those aged over 45.

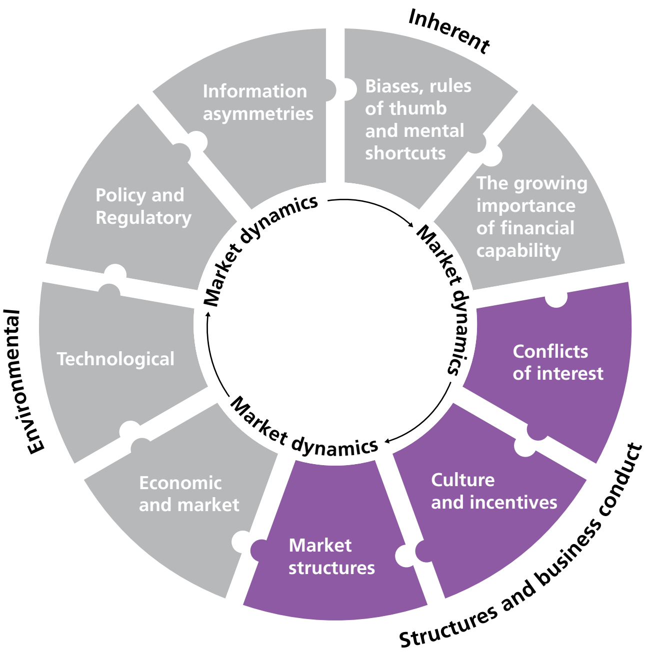
The impact of inflation is clearly not understood by a large proportion of the population. When asked to identify whether inflation at 5% would have eroded the purchasing power of money in an account paying 3% interest, a third of people got this wrong (33%). Startlingly, this rose to 44% of those aged under 35.

Source: 'The Financial Capability of the UK', Money Advice Service

Disclosure of risk statements can be formulaic and, where they may be required, don't give sufficient emphasis to risk warnings in an easily comprehensible form. This can lead consumers to skim over the disclosures and not think fully about their implications particularly when their intention at the point of sale is to comply with the terms and conditions. We believe firms can improve disclosure by making the statements shorter, more focused and clearer – building in lessons from behavioural insights (which firms often use in marketing material). There is also a role for us to take steps to support firms finding it difficult to navigate our disclosure requirements and ensure we work with industry to clarify requirements where appropriate.

1.2 Structures and business conduct

In this section we discuss the drivers of risk that have proved to be common features of financial sector design and business conduct (structure, processes, culture and incentives). When these are designed into, or become embedded in, the financial sector, they tend to create conflicts of interest and poor culture and controls.



Over the last year we have continued to seek to change the behaviours and processes that could prevent markets from working well. Work to correct these market failures has included a combination of market studies, our supervisory approach, thematic reviews and enforcement actions.

Conflicts of interest

At the root of many conduct risks are conflicts of interest which over time have been built into financial sector structures, processes and management. Exploitation of, or failure to manage, these conflicts can undermine market integrity and competition and can cause harm to consumers. Where a conflict of interest combines with information asymmetries, which is frequently the case in most financial products and services, this can make it difficult for consumers to check if the provider is acting in its best interest – creating principle-agent problems. There are clear rules in place which require firms to identify and manage conflicts of interest – this continues to be a regulatory priority, specifically in asset management and investment banking sectors.

Conflicts of interest are particularly pertinent in wholesale markets. Structural conflicts of interest are often deeply embedded in wholesale business models because the same firm is often acting in several different capacities. Long standing relationships can exacerbate the conflict. In addition, a single firm can act for multiple clients and in some circumstances it can be difficult to determine on whose behalf the firm is acting. When banking and security services are cross-sold, banks (as agent and principal in related transactions) may not manage potential conflicts well.

Our recent work suggests that many firms manage conflicts of interest effectively; however some market structures continue to create risks. For example, in the asset management market, where asset managers are buying services using client funds and where they are responsible for the governance of the products that they manage. Poor management of conflicts by asset managers when dealing with investment banks and other suppliers of services could lead to a failure to manage client costs appropriately.

Many regulatory initiatives, including the best execution arrangements in MiFID, seek to put in place measures to limit these conflicts or mitigate their adverse implications. Conflicts of interest are likely to continue to create intractable barriers to good conduct outcomes in wholesale markets if not managed appropriately by firms.

Culture and incentives

The culture of a firm can affect the way it implements its strategy and the way it conducts its business. Culture lies at the heart of how an organisation thinks and behaves. When there is strong alignment between a firm's culture and its incentive arrangements, aimed at delivering outcomes in the interest of consumers and market integrity, the two can strengthen each other in reaching this aim. When culture and incentive structures are poor or misaligned this can often present a risk to our objectives.

In recent years, many firms have focused on improving their culture and have made changes to incentives offered to their staff to remove or reduce any conflict with consumer interests or any adverse impact on the integrity of markets.[3] However, crystallised examples of poor outcomes continue to emerge across all sectors, suggesting that the quality and pace of cultural change in firms and the impact of incentives on behaviours continue to present material risks to our objectives.

Culture

Culture drives behaviour – it reflects the underlying values and 'mind-set' of the organisation and as such has a great influence on the behaviour of individuals within the firm. An effective culture is one that supports a business model, behaviours and practices that have the fair treatment of consumers at their core.

3 The Banking Standards Review, led by Sir Richard Lambert, is one example of a project that aims to help raise standards of competence and behaviour amongst bankers doing business in this country.

Culture drives behaviours – it reflects the underlying values and 'mind-set' of organisation and as such has a great influence on the behaviour of individuals within the firm.

The challenge for many is that the components of culture are hard to change. Embedding cultural change across businesses remains a major challenge for Boards and Executives. As noted by the Parliamentary Commission on Banking Standards (PCBS), cultural changes are unlikely to be achieved quickly and may take years to embed.

Some firms, particularly in the banking sector, have identified that significant cultural change is required. In addition, various sector initiatives are underway which may contribute to the 'mind-set' of firms. For example, the Chartered Banker Professional Standards Board (CB-PSB) aims to help build confidence and trust in individuals, institutions and the sector as a whole, by setting governance standards. However, having sector governance standards or corporate value statements in place is no guarantee for successfully addressing the problems with culture. Research for the PCBS revealed a gap between banks' stated values and corporate codes and the culture and standards that they demonstrate in reality.

The banking sector is not the only one where change is required. Consumer detriment has occurred right across the financial services spectrum and cultural change is also required in other sectors.

Incentives

Incentive structures are another important systematic way of motivating behaviours and they can often be an indicator of the kinds of behaviour that the firm's senior management values and rewards.

Levels and structures of remuneration can incentivise staff towards particular types of behaviour. When these do not align with the long-term interests of consumers or market integrity, it can exacerbate conflicts of interest (for example, when incentive schemes are designed solely to increase profitability). This is the case when business models which are overly dependent on sales incentives and targets encourage staff to sell products that are not needed or wanted by consumers (e.g. one-off bonuses or an accelerated rate of bonus for 'top sellers').

Over the last few years numerous examples of bad practice in incentive structures and remuneration policies have been identified and in certain sectors this has led to radical changes. Many firms have got better at identifying where the risks lie in their particular incentive scheme and how they can drive the wrong behaviours.[4] For example, firms have been removing higher risk features from some of their schemes for sales staff and improving the way they monitor sales activity. Some have introduced completely new incentive schemes, for example discretionary incentive schemes with balanced scorecards. This type of scheme, where employees are appraised against a range of objectives, and not just sales, can reduce risk, although it does not eliminate it, as sales results can remain a significant factor. Incentive schemes are also now more likely to include 'quality gateways', where certain standards need to be met for a member of staff to be eligible for their bonus.

At all levels of the firm, better alignment of remuneration and incentives to longer-term outcomes rather than short-term gains may improve the alignment of interests between firms and consumers. Long-term incentive plans (LTIPs) are an increasingly important form of remuneration for senior staff and reflect a significant shift. However, LTIPs do not necessarily go far enough in aligning to good consumer outcomes over the longer term. They can be hard to measure and in some cases have made remuneration disclosures more complex and difficult for shareholders to understand. Firms should consider how incentives for senior staff affect outcomes for consumers and market conduct, including effective use of performance adjustments ("malus") for firms and staff covered by the remuneration code.

Market structures

The structure of markets can be at the root of risks to our objectives and effective competition is often a key element of well-functioning markets. Barriers to entry (e.g. network effects and switching costs), may

4 The findings of this work can be found in Thematic Review 14/4 Risks to customers from financial incentives – an update, March 2014.

restrict or distort effective competition by giving firms market power that potentially leads to higher prices, lower efficiency and weakened incentives to innovate. Similarly, 'micro structures' (such as fee structures, bundling of multiple services or products under single pricing arrangements and the make-up of distribution chains) may reduce consumers' ability to understand the overall cost and value of products, or damage market integrity through over-intermediation. If chains are over-intermediated, higher costs could be caused by fee structures rather than value added meaning consumers will not be getting the best value by using more costly distribution channels.

Challenges to effective competition

Effective competition enhances market efficiency and helps ensure consumers get a wide range of good quality products at the right price. The rivalry inherent in competitive markets can incentivise firms to innovate and operate more efficiently, thus improving outcomes for consumers and the wider economy.

In wholesale markets the competitive landscape has changed dramatically over the last few years. For example, there is now increased competition between trading venues, narrower bid-asks spreads, and reduced transaction costs for participants.

In other parts of the financial services industry, achieving markets characterised by effective competition has been particularly challenging. This is due to difficulties in comparing products caused by complexity, consumer inertia, lack of consumer engagement and a lack of transparency. Difficulties in comparing and understanding products can prevent consumers from shopping around for the best deals. Often referred to as demand-side weaknesses, these can have an adverse effect on competition.

When new entry into the market is infrequent or on too small a scale, ineffective challenge to existing providers will not enhance effective competition. Due to potentially significant barriers to entry and growth, it may be difficult for new entrants to join the market at a scale that allows them to successfully compete with existing providers, as for example in retail banking. Strong brand recognition and reputation take a long time to establish and are important factors in consumers' choice of provider and new entrants may struggle to encourage consumers to switch. This reduces the pressure on existing firms to compete vigorously for consumers. The seven days Current Account Switch Service should encourage more consumers to switch their current account provider and could improve competition in this market.

Regulation can also pose a barrier to entry, as new entrants must meet a range of requirements to gain authorisation (for example, incurring costs setting

Effective competition can incentivise firms to innovate and operate more efficiently, thus improving outcomes for consumers and the wider economy.

up expensive systems and controls, appointing key personnel and meeting capital and liquidity requirements). Over the last year we have worked with the PRA to reduce this barrier, as per the commitments made in the March 2013 report "A review of requirements for firms entering into or expanding in the banking sector".[5] Mitigants include the introduction of a 'mobilisation phase' to allow new banks to undertake certain activities (e.g. setting up IT systems) after a shorter initial application process. Previous work on barriers to entry reduces this barrier by lowering capital requirements for new banks that the PRA judges can be resolved in an orderly fashion with no systemic risk.[6/7]

In some cases firms may have little incentive to compete due to a combination of large back-books and existing consumers' behaviour – for example where these consumers, including those of savings, current accounts, mortgages and some long-term savings products, are passive and do not respond to price changes. These behaviours give firms little incentive to compete and offer them more attractive rates, terms or services. These back-book consumers can face higher borrowing costs and lower interest rates on savings accounts if they choose to stay with their existing provider. Profits from back-book business may be invested in customer acquisition by offering attractive rates and terms on new business, which can make it harder for new entrants to compete.

New entrants and smaller players may find it hard to attract other providers' back-book consumers even where they offer better deals. In retail banking particularly, where switching rates are low, consumers often consider banks' products and services to be the same across providers. While poor service may be an important trigger for consumers to decide to change providers, their focus on price is often the focus in their choice of new provider.

5 The findings of this work can be found in Thematic Review A review of requirements for firms entering into or expanding in the banking sector, March 2013.

6 The PRA will not impose additional capital add-ons/scalers onto a firm simply because it is new.

7 The Capital Planning Buffer will be set as the wind up costs of the bank. These are typically operation costs for the next 12 months.

Technology

Technology is a key influence on the competitive landscape of financial markets. Technological innovation has transformed equity markets over the years and has influenced the competitive landscape, providing a gateway to new participants, new offerings and new investment strategies. Coupled with market fragmentation, market structures have previously seen an increase in competitive offers, with reduced transaction costs and new services.

Market participants have had to adapt to these developments. High frequency traders, attracted by equity markets because of the robust market infrastructure, liquidity, transparency and the small tick sizes they typically offer, have grown in numbers. High Frequency Trading (HFT) has helped the price formation process across venues by being able to rapidly assimilate and build new information into quotes and orders.

However, for some investors, the benefits of increased competition may be counter-balanced by increased search costs and reduced liquidity. The rapid rise of HFT has also raised concerns around the depth and resilience of market liquidity in some economic environments and whether the short-term nature of HFT investment strategies impairs the price discovery process. For example, some market participants undertaking large block orders are concerned that HFT trading may result in increased trading costs due to front-running of block trades once high-frequency traders have detected them.

In retail markets, online platforms such as price comparison sites – capitalising on consumers' focus on price – are influencing the competitive dynamics. For example, in general insurance where new market entrants (e.g. firms that domicile outside the UK) enter the market via price comparison sites, competition to drive down price has resulted in lower costs for some consumers; however, this dynamic also has the potential to distract from customer service standards, or other elements of the product that have been carved out to reduce the costs and consumers would expect to be covered.

When the profitability of existing products is affected by competitive dynamics it can also affect the business lines for other intermediaries. Some may cut prices to gain market share in response but in doing so may look for alternative ways to make up any losses. For example in general insurance products, low profitability causes intermediaries to look for different ways to make money, including selling secondary products that may not be needed, or charging higher fees. As intermediaries find profits and funding under pressure, debt financing is growing. This can drive firms towards cash generative sales to service this debt. Cash generative sales can lead to the sale of inappropriate products to consumers or, if firms are unable to maintain debt-servicing obligations, the sale of parts of their business.

Price formation in markets

The integrity of the price formation process is key to ensuring markets are fair, efficient and transparent. Integrity in the price formation process, and therefore fair access to markets and their facilities and increased transparency, is essential to allow for reliable price formation. It results in dissemination of relevant information as it minimises transaction and search costs, increases investor confidence and creates deep and liquid markets. In this context, greater transparency of prices could promote more effective competition.

In non-equity markets a variety of price formation mechanisms are used. Benchmarks, either based in traded prices or surveys, determine the valuation of financial instruments and payments and can measure the performance of investment funds. Auctions (or tenders when confidential) are used to price debt securities. Assets may be priced using mark-to-market, reflecting the current market values of a security, or mark-to-model, in the absence of a market value. This valuation may cause problems when insufficient accurate pricing information is available. For example, investment banks' securities desks may also be incentivised to flatter prices to increase demand.

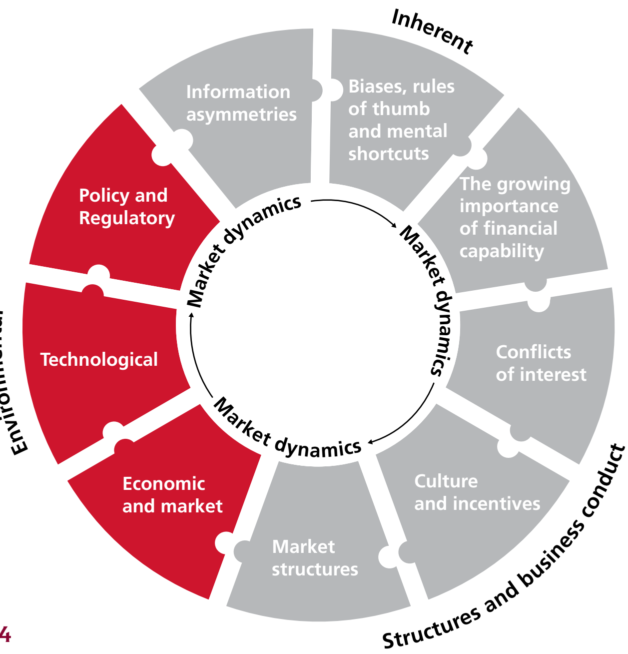
2.

Changes in environmental conditions

***Environmental* developments – economic, social and financial market trends, technological developments, and the policy and regulatory environment – play a central role in driving consumer behaviours and decisions. These factors are also a key driver of change to firms' business models and strategies as well as their financial soundness.**

In Chapter 3 we look at how these changing conditions have interacted with the underlying consumer and market issues outlined in Chapter 1 to increase pressure on firms and consumers that could create risks in the future to consumer protection, market integrity and effective competition.

This chapter focuses on how firms and consumers have adapted their strategies over the last year to account, and take advantage of, changes in external conditions. We also look at how the environment is likely to change over time and the possible responses of firms and consumers to these developments. Where risks have become particularly entrenched when firms and consumers have not fully adjusted to new economic or financial realities, their strategies may have proved to be unsustainable, and at times harmful, in the long run.



2.1 Economic and market environment

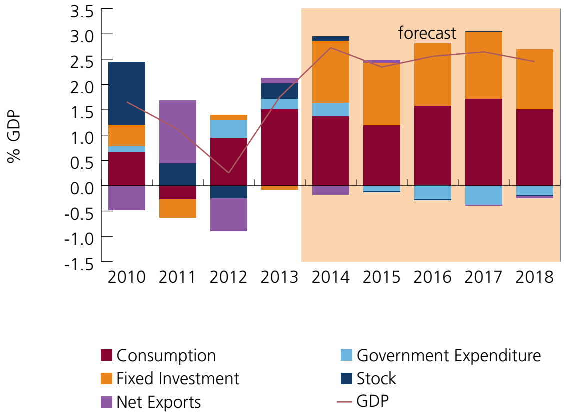
Developments in the economy and financial markets influence the products and services firms are willing to offer; the need and demands of consumers and the profitability and volume of financial products sold. Rising longevity is a key factor for consumers to consider when assessing their financial security. As life expectancy increases, natural strains on the sustainability of financial security will grow and it can be difficult to manage particularly when decisions are balancing current and future needs with expectations.

Current conditions and developments influence the perceptions of risk and return, and can be important in shaping the future expectations and long-term needs of consumers. The complexity and dynamism of the markets we regulate can make it challenging to keep pace with rapid market-driven change. The modest global economic recovery to date has placed pressure on financial firms' return on equity and profits. If conditions worsen, either through national or international developments, these conditions could have a negative impact on returns and income – affecting firms' financial soundness. While there has been improvement in the economic and financial markets' outlook over the last year, underlying challenges could continue to pose risks. Even in a period of sustained recovery the response of firms and consumers could lead to decisions that create risks to consumer protection, market integrity and effective competition.

Current conditions and developments

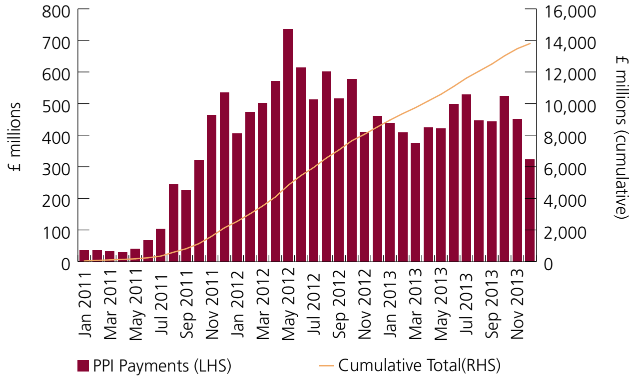
While the global economy has started to show signs of recovery, risks still remain to the overall economic outlook, including many underlying challenges to developed economies' recovery (high debt levels, low income growth and relatively high unemployment). These risks could create challenging features for the operating environment in which firms are looking to support their own recovery and consumers are assessing and responding to their financial needs.

Figure 2. Projected composition of economic growth



Source: Office for Budget Responsibility

Figure 3. PPI Payments to consumers since 2011



Source: Financial Conduct Authority

Global Economy

Several European economies are seeing positive economic growth; however the risk of deflation (driven by non-domestic factors) could place pressure on servicing sovereign debt – as the cost of debt starts to rise. Asset quality remains a key issue for Europe and improvements in the economic outlook could be challenged by the overhang of distressed loans. Investment firms still holding European sovereign debt could face a volatile period or potential stress on their prudential soundness if debts are written down as a result of deflationary pressure or Central Bank intervention.

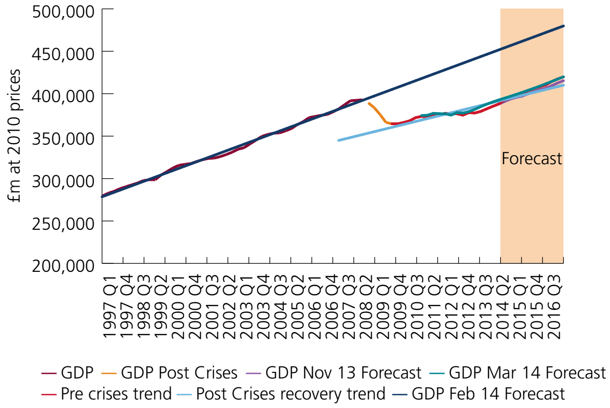
As the US economy continues to gain strength, the Federal Reserve will start to unwind the considerable post-crisis monetary stimulus currently in place. Quantitative easing has played a stabilizing role in equity markets and tapering could lead to a slowdown in returns. As prices realign to their fundamentals – consumers could find their financial wealth declining in the short-term as markets re-adjust to withdrawal of central bank support.

Weaknesses in the emerging market economies could be exacerbated by growing capital outflows from the region (in part triggered by signs of US tapering) may dampen the global outlook. Firms and investors with large exposure to the emerging markets, could face pressure on their short-term profits and business strategy. Capital outflows from emerging market economies (particularly bond funds) could affect the wealth of investors holding emerging market debts, for example, institutional investors and managed funds. This reversal of international capital flows to emerging markets has placed a number of emerging market currencies under pressure and could lead to a prolonged period of market turbulence as valuations of emerging markets fall and volatile price adjustment occur. Where normalisation of policy rates are not priced into the market, it could lead to mis-priced risk. Continued currency volatility increases risks for corporates borrowing dollars at low rates now, when they could face currency conversion risks at the same time as the US dollar rate starts to rise.

Economic activity in the emerging markets (in particular China) will be an important driver of commodity prices over the next year. Strengthening economic growth across the globe (and a return to normalised monetary stance) will support commodity prices, but risks from the Eurozone, the slowdown in China and other emerging economies could offset some of this recovery – leaving prices unlikely to advance as rapidly as seen over the past decade. For firms pursuing commodity-led investment strategies, a fall in prices could increase counterparty risk for these firms, particularly if the market becomes volatile (increasing volatility risk).

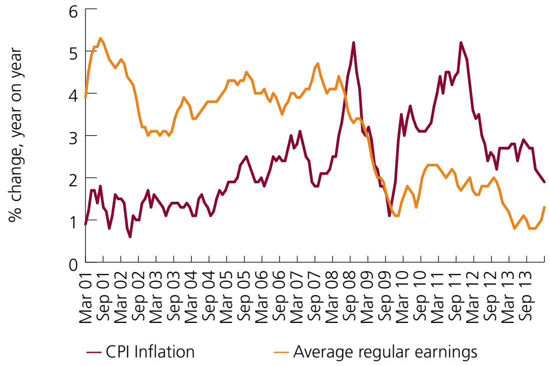
Supported by the improved signs of economic growth and ongoing stance of monetary policy, there has been improvement in global equity market performance over the last year. This momentum has boosted expectations for further performance in equities and has supported better returns for pension funds and equity investors. Trading volumes, although improved, remain low by historic standards. This could lead to increased volatility over the next year – as trading patterns and prices adjust to the normalisation of rates (as central banks move to withdraw support) – slowing equity price growth as returns realign to underlying fundamentals in the unlikely event of weak economic growth.

Figure 4. Trend growth rate-GDP projections



Source: Office for National Statistics, Bank of England, Office for Budget Responsibility, Financial Conduct Authority Calculations

Figure 5. Earnings growth and inflation



Source: Office for National Statistics

UK Economy

Improvements in the UK economy and financial markets (supported by government and central bank policy measures such as low interest rates and unconventional monetary policy – such as quantitative easing and Funding for Lending Scheme) have prevented any further post crisis deterioration in financial sector stability. Vulnerabilities to the outlook remain, which could have implications for consumers and firms – additional external shocks to the global economy could have a negative impact on the UK outlook and if the Office for Budget Responsibility (OBR)'s forecast for real incomes to grow in 2014 does not materialise this could dampen consumption.

The latest OBR growth projections reflect recovery in the economy (Figure 2), and to date have been reliant on consumption. In the absence of real wage increases in the UK – without relying on tax changes net of benefits – growth in consumption has in part been supported by the erosion of saving, the accumulation of new debts and may also be supported by redress payments from mis-selling of PPI (people receiving lump-sum cash tend to spend it rather than save) (Figure 3). Even now that economic recovery appears to be established and wages are expected to increase in real terms from 2014, it is possible a drag on wage recovery may lead consumers to increasingly rely on credit or savings to fill any shortfall during that period.

While employment has remained resilient, positive economic growth has not yet been fully reflected in wage growth. OBR forecasts for wages have worsened and although real household disposable income is forecast to increase each year and average earnings are expected to rise faster than inflation in 2014, average earnings are not expected to get back to pre-recession levels until 2017. Real wage growth is expected to pick up once slack elsewhere in the economy has been used up and productivity begins to grow (Figure 4). Many households have experienced a long period of below-inflation wage growth which has left households' spending power under pressure (Figure 5), this could lead some consumers to seek alternative sources of income through credit.

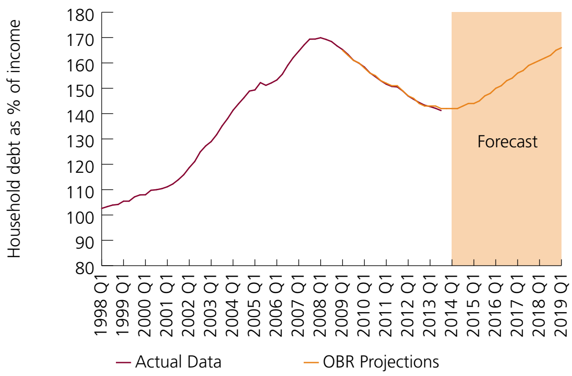
Employment levels have been supported by people moving into self-, part-time and temporary employment opportunities and towards lower-paid roles.[8] Improvements in full-time employment opportunities have been seen over the last year but unemployment among the younger age groups remains high, leaving a large group of young people out of the workplace unable to grow and accumulate their wealth. Another challenge to a sustainable recovery is the weakness in productivity.[9] Falling unemployment has been combined with weak labour market productivity, which is constraining growth in real incomes. Flexibility in wages has allowed employment to return to its pre-crisis levels much quicker than seen in previous recessions. Productivity per worker has fallen while hours worked has recovered to pre-crisis levels – this will reduce the sustainability of recovery if it becomes a long-term trend.[10]

Household debt remains high

Some deleveraging has been evident and the household debt-to-income ratio has fallen to under 140% from a peak of 170% (Figure 6). The possibility of further debt accumulation leaves households vulnerable to interest rate changes, income shocks and changes to credit conditions. With the current levels of household debt, the effective interest rate on debt (which shows the cost

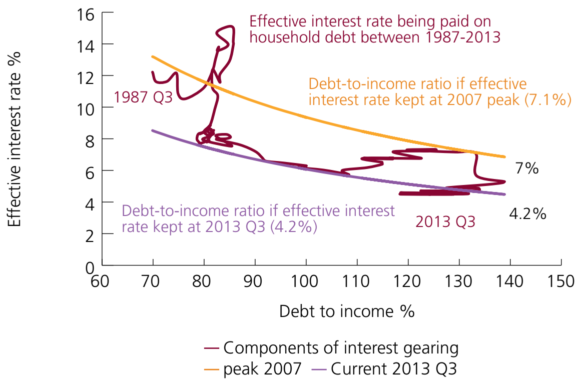
8 Source: ONS
9 Source: ONS
10 Source: ONS

Figure 6. Household leverage



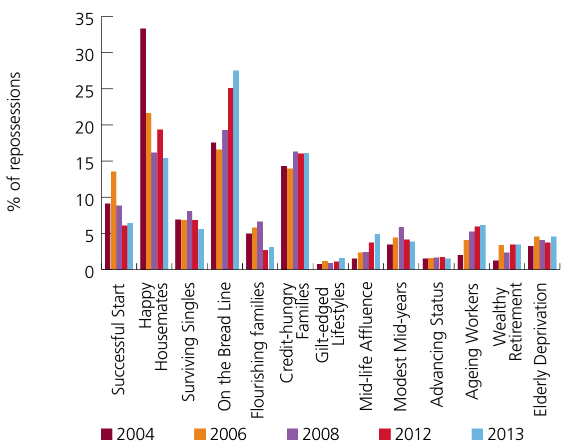
Source: Office for National Statistics, Office for Budget Responsibility

Figure 7. Effective interest rate on household debt



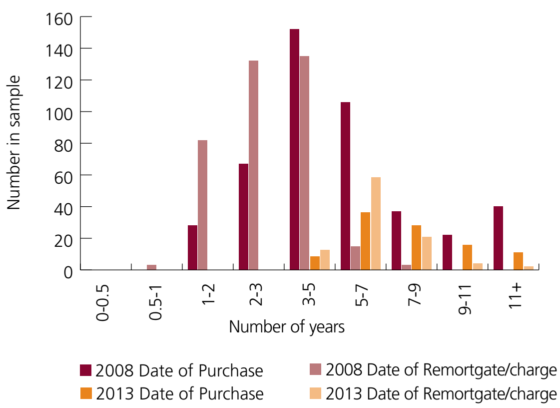
Source: Office for National Statistics, Bank of England, Financial Conduct Authority calculations
Note: Effective interest rate shows the amount of interest paid in each period on all household debt outstanding

Figure 8. Geo-demographic profile of repossessions



Source: Essential Information Group, Experian, Financial Conduct Authority calculations

Figure 9. Length of time between last secured loan and repossession



Source: Land Registry Records, Essential Information Group, Financial Conduct Authority calculations

of interest on household debt) is currently equivalent to a rate of 12% on 1990 debt levels, when debts were lower but interest rates higher (Figure 7).

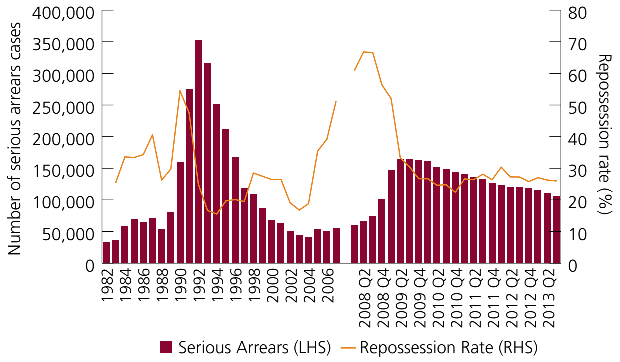
With reliance on credit likely to continue, potentially into later stages of the life-cycle for a growing number of consumers, there could be consequences for consumers' prospects for long-term savings and their financial needs in the future. In the lead up to the recession, low income growth contributed to a propensity to acquire additional debts, including re-mortgaging to withdraw equity, increasing household vulnerability to service debts, which for some resulted in default.

FCA analysis of mortgage repossession cases suggests that many repossessed borrowers are 'credit-hungry' and 'low income' borrowers whose characteristics suggest unsustainable levels of debt remains the key factor in their ability to maintain repayments rather than economic factors such as unemployment and interest rates (Figure 8). Additional debts, rather than the initial mortgage debt, are the main driver of mortgage default in many cases, with forbearance extending the length of time it takes from the date at which a borrow takes out their last secured loan to repossession (Figure 9). Households' broader debt portfolio is an important consideration for both firms and consumers in supporting sustainable outcomes.

Interest rate environment

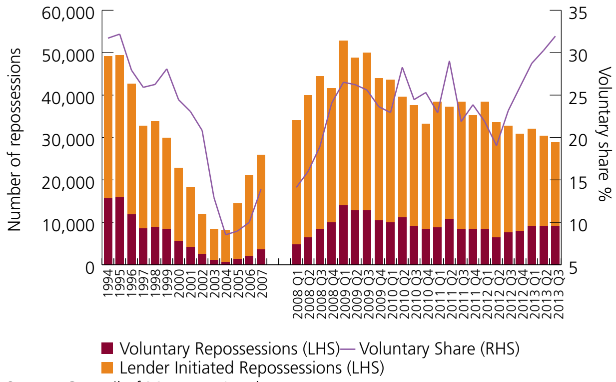
The low interest rate environment has continued to keep debt servicing costs low and has supported indebted households – in part off-setting the impact of inflation on living costs and negative real wage growth. Low interest rates and improvements in funding conditions for lenders (driven by several factors, including an improvement in the outlook for the euro area and the introduction of the Funding for Lending Scheme) have

Figure 10. Repossession rate and serious arrears cases



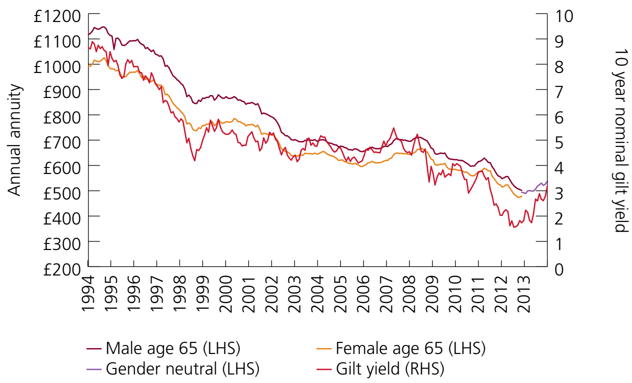
Source: Council of Mortgage Lenders

Figure 11. Voluntary repossessions and lender initiated repossessions



Source: Council of Mortgage Lenders

Figure 12: Annuity rates have fallen sharply since the financial crisis



Source: Moneyfacts Treasury Reports: Personal Pension and Annuity Trends
Note: Figures based on £10K annuity purchase price – for a standard level without guarantee annuity.

supported firms' use of forbearance strategies. These improved conditions have reduced the carry costs for non-performing loans and provided consumers with more affordable interest only options and payment holidays to help them repair their financial situation.

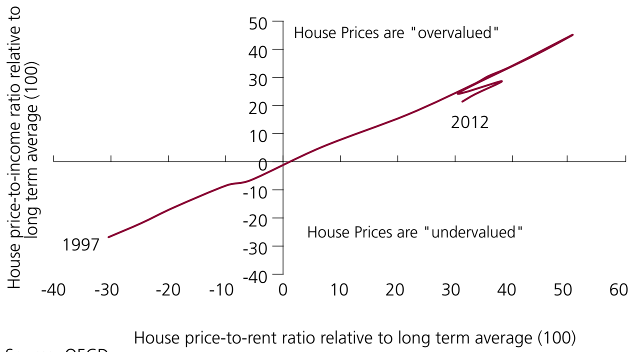
Arrears and repossessions have continued to fall over the last year and the repossession rate (repossessions as a percentage of the stock of serious arrears cases – six months in arrears – at the start of the period) has flattened off over the last year with nearly a third of serious arrears entering repossession at the end of 2013 – significantly lower than the 70% seen at the peak of 2008 (Figure 10). This trend has been supported by the favourable external conditions of low interest rates, improved unsecured credit conditions and forbearance being offered by lenders. Despite the low interest rate environment and lender forbearance voluntary repossessions are increasing and now account for 30% of repossessions (Figure 11).

Although the low interest rate environment has supported mortgage debt servicing costs and forbearance, the sustainability and suitability of this strategy over the long-term could lead to poor consumer outcomes if the ability for borrowers to recover their position is low in the event of an interest rate rise. Overall costs of forbearance strategies can be very high for consumers – including loss on sale, fees and charges and interest costs on cured arrears. Analysis using a small sample of lenders suggests the median cost to the consumer of long-term forbearance could reach between 6% (excluding loss on sale) and 25% (including loss on sale) per year as a percentage of the balance outstanding at the point of sale. Lenders must ensure that forbearance practices are suitable for those being offered debt repayment support on an individual basis and that there is a likely long-term ability to cure their arrears.

While low rates have supported some indebted households, low returns on savings have created significant challenges for pension providers and insurers. This is due to the decline in value from new business written and declining profitability. Insurers, trying to mitigate the impact of low rates, are seeking alternative higher-yielding investments and introducing new products.

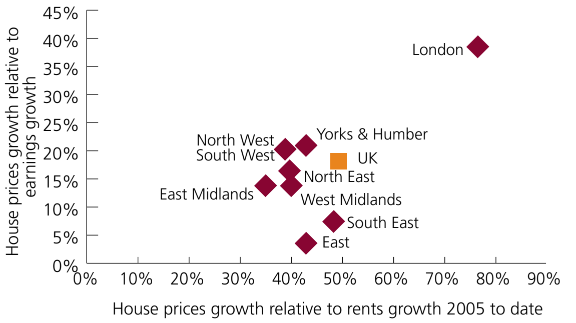
For households saving for the future, the low returns environment may push some to retire later than planned; and low rates may have distorted some investment choices – and could continue to do so during a period of interest rate adjustment. The long term trend of falling annuity rates has been exacerbated by the current low interest rate environment (Figure 12). Households that have taken out annuities in this low rate environment may be worse off than they expected to be. Where savers have suffered from low returns on

Figure 13. Measures of house prices relative to fundamentals 1997-2012



Source: OECD

Figure 14. Regional house price affordability 2005-2013



Source: Office for National Statistics, Financial Conduct Authority calculations
Note: An uplift of 20% has been applied to regional rental yields to align to UK position and relationship with prices in 2005

deposits, some have responded by moving to higher risk-return products such as venture capital.

Asset prices are showing signs of misalignment with their basic foundations

Consumer wealth is an important component of consumers' wellbeing, their financial needs and demands, and is reliant on their ability to accumulate assets and the performance of these assets over time. Households' wealth is made up of housing, pension and financial assets, making the performance of house prices, bonds and equities important in determining consumers' future financial needs. Where asset prices are showing signs of misalignment with their basic foundations consumers could be making ill-judged decisions about their current and future needs.

Relative to earnings and rents, house prices remain elevated. Compared to other economies that experienced similar pre-crisis growth and recession (e.g. Ireland and the US), the UK has seen relatively little adjustment in house prices since 2008 (Figure 13). Elevated prices could lead to mortgage affordability stretch, particularly when interest rates start to rise, and increases the possibility of price correction in the future if prices are unsustainable over the long-term given the prospects for income growth and rising levels of debt seen in the UK.

Average house prices across the UK have risen 5.2% in the last year – growth has been seen across the nation but regional variations show price growth is concentrated in London, growing 11% in the last year according to Land Registry data, taking them back to the 2008 peak. Housing affordability has been supported in other regions where prices remain below their peak and in some cases remain relatively flat. Despite house price falls in some regions, prices still remain elevated across the majority of the UK regions (Figure 14). Risks to consumer protection may grow if stronger housing market activity is accompanied by further substantial and rapid increases in house prices and a further build-up in household indebtedness, which is already elevated for some households.

Other asset classes are also showing misalignment with their market foundations. Equity risk premia have fallen steadily since their highs in mid-2012, but only to around historical averages (the risk-free curve remains low), and liquidity premia look compressed in some low-rated cash fixed income markets.[11/12] Equity prices by a number of other measures including CAPE and Tobin's q are elevated which could suggest that market value does not reflect the value of the underlying corporate.[13]

Responses and expectations

After such a long period of subdued economic growth and returns, a sustained economic recovery will bring with it a variety of opportunities as well as risks and challenges that could require firms and consumers to pursue new strategies. This will see benefits but there will also be new risks to consumer protection, market integrity and effective competition.

The move into a more optimistic mind-set of future prospects and returns may lead to poor decisions being made which underplay downside risks as well as challenges created by the period of adjustment itself as improvements in the economy will affect firms and consumers at different times and in different ways.

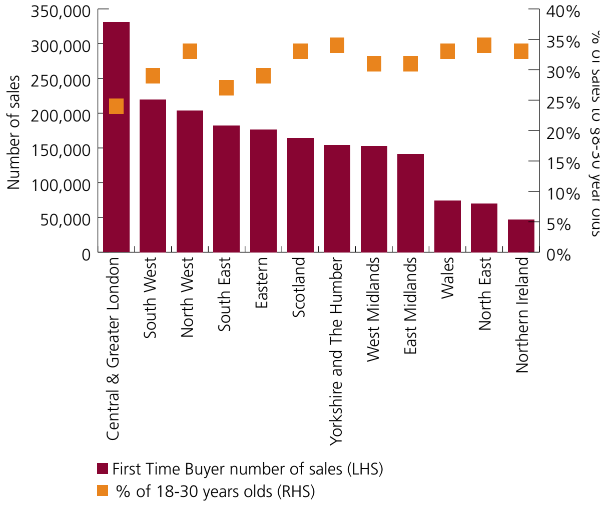
In some markets the competitive structure has been changed by the crisis and many firms are still dealing with some of the poor decisions made pre-2008 –

11 Bank of England Financial Stability Report, November 2013.

12 The CAPE (Cyclically Adjusted Price-to-Earnings) ratio is used in determining if the market as a whole is overvalued or undervalued.

13 Tobin's q-ratio is the ratio between the market value of an asset and its replacement value.

Figure 17. Number of first time buyer mortgage sales in 2009 - Q3 2013 and the proportion of sales to 18-30 year olds, by region



Source: Financial Conduct Authority

inhibiting their ability to compete with new entrants in some areas. This can lead to firms seeking alternative ways to make money, where they may not have the expertise or knowledge.

Moving up the risk curve

Improvements in external conditions have resulted in an increased willingness by investors to take on risk and the issuance of high-yield loans has been growing although remains fragile. A growing number of corporates are becoming reliant on the securities markets to raise funds via debt issuance despite market volatility. Alternative options, such as supply chain financing, crowd-funding and peer to peer lending are growing. If these continue to grow (particularly as investors are looking for higher returns), they could reduce demand for mainstream SME lending – reducing market size and increasing pressure on SME focused business models. The risks associated with crowd-funding – including mispricing of credit and investment risks, fraud and loss of money upon default of a platform (if funds are not segregated) – may not be fully understood by consumers investing in these platforms.

Moving away from low interest rates

Interest rates are expected to stay low for some time despite improvements in the economy due to the legacy of the financial crisis and the persistence of economic headwinds. When the Bank of England does increase rates, it is expected to do so only gradually (supported by sustainable growth which will support prices and incomes). As the UK economy continues to show signs of improvement and spare capacity starts to be absorbed – which comprises slack within the labour market – interest rates are likely to start to rise (as set out through Forward Guidance).

The environment in which rates start to rise will affect the impact of rising interest rates on both firms and consumers and their responses. In the period of transition away from the prolonged period of low interest rates, there is the potential for risks to emerge to our objectives. For example, in anticipation of interest rate rises, lenders may inflate the risks of rapid rate rises to encourage borrowers into high-rate fixes particularly where those borrowers may be in very low standard variable rate products at present. Longer term, lenders may fail to move borrowers into fixed-rate longer-dated products at an appropriate time. For borrowers, an increase in rates will translate into higher debt-servicing costs and without real income growth some of these consumers may be unable to meet higher debt servicing costs leaving them vulnerable to accumulating further debts or default.

Since 2009, around two thirds of first-time buyer mortgages have been used by borrowers aged between 18 and 30 years (Figure 17). This group of consumers are more likely to have become financially active during the period of unconventional monetary policy and low interest rates. As rates start to rise gradually it may take some time for this group of consumers to adjust their budgets to an environment where rates can rise more frequently and debt servicing costs can vary more than they may be used to. This group could be more likely to seek short-term credit options if they face budgetary stress.

Box 2 – The impact of rate rises on mortgage borrowers

The context of the economic environment in which interest rates rise is an important consideration when assessing the impact higher rates will have on UK households – it will also play a role in the behaviour of lenders. Conditions that support wage growth and higher price rises will offset some of the balance sheet stress arising from higher debt servicing costs. Interest rate are not anticipated to rise until overall conditions in the economy are more favourable and when they do rise they are expected to be slow and staggered.

Our analysis on the impact of rate rises on outstanding mortgage borrowers takes into account the conditions that could lead to base rate rises and changes in swap rates. The scenarios used calibrate interest rates, house prices and incomes under two potential scenarios which imply faster interest rate increases than currently expected. These results were then translated onto our product sales data to assess the impact of interest rates on mortgage borrowers under a central case, and two optimistic growth scenarios. The findings account for regional trends in house prices and income growth by decile to account for how different consumer groups are affected.

The results suggest that the majority of mortgage borrowers, who face potential affordability pressures, are those who have experienced payment difficulties in the past, rather than new or existing borrowers who have managed their debt-servicing costs in the past. Borrowers with these characteristics or past payment or impairment problems account for 1.1 million mortgage holders. The underlying driver of financial distress for these borrowers remains the overhang of unsustainable debts – where affordability of existing high levels of debt become unaffordable when rates start to rise. This is consistent with the current trend of repossessions which are concentrated in households with low incomes and high indebtedness. The number of additional borrowers outside this core 1.1 million affected adversely by rate rises is relatively small according to our modelling. This is due to the impact of income growth and rising house prices which allow for equity withdrawal (resulting from improvements in the economy), both factors that in part offset the impact of higher interest rates on borrowers.

Vulnerable consumers are defined here as those with an LTV>85% and payments to net income >30% or, those who have a history of payment problems (2 or more missed payments). Under the central case, borrowers with these vulnerable characteristics currently account for 1.3 million mortgage holders – 1.8% of mortgagors are 'vulnerable' on LTV and LTI metrics and a further 12% are vulnerable as they have a history of payment problems or impairment problems. As the economy improves in line with forecasts and incomes improve alongside this recovery the impact of rising rates is offset by growing incomes and house prices and the number of vulnerable consumers falls steadily over the period modelled.

Under the two scenarios, the environment modelled leads to interest rates rising sooner and more sharply than currently expected. These scenarios cause a lag between economic growth and the positive effect this has on incomes and house prices, which leads to a higher number of consumers becoming vulnerable to affordability stress in the short-term. Under scenario 1, the economy grows faster than the central case; employment and house prices improve more quickly than expected, creating inflationary pressure and pushing interest rates up sooner than anticipated. Improvements in disposable income are reflected. In this scenario the base rate reaches 4.96% by 2017 (3.43% above the base case) and unemployment falls 1.38% below the base case. The number of vulnerable consumers falls a lot slower than under the central case and remains close to 1.3 million consumers for most of the modelled period.

Under scenario 2, we have modelled the impact of a rise in the UK risk premia, which in turn pushes interest rates higher and faster than expected, placing pressure on household affordability despite improvements in the labour market and incomes (which lag the rise in rates). In this scenario the base rate reaches 7.06% by 2017 (5.53% above the base case) and unemployment falls 0.51% below the base. The number of vulnerable consumers is higher than under the central case, reaching 1.7 million (17.4% mortgagors) at its peak.

Figure 15. Number of vulnerable consumers under different circumstances grossed up for whole of market total 9.75m owner-occupied mortgages.

	Currently	2014	2015	2016	2017
Base case*	1,316,000 13.5%	1,264,000 13.0%	1,224,000 12.6%	1,209,000 12.4%	1,201,000 12.3%
Scenario 1*: Stronger economic growth than base case	1,316,000 13.5%	1,260,000 12.9%	1,279,000 13.1%	1,259,000 12.9%	1,210,000 12.4%
Scenario 2*: Rise in UK risk premia	1,316,000 13.5%	1,459,000 15.0%	1,696,000 17.4%	1,623,000 16.6%	1,501,000 15.4%

Source: FCA calculations
Note:* 12% of 1,144,000 of borrowers in the table above are vulnerable due to a history of payment problems or credit impaired and account for incremental number of vulnerable borrowers across different circumstances.

'Vulnerable' borrowers are concentrated in lower-income households (who are unlikely to see considerable wage growth in the recovery – following the pre-crisis trend) and in northern regions of the UK (where house prices have seen the sharpest falls – reducing the ability for equity withdrawal). Interest only borrowers are more impacted by rate rises than capital repayment borrowers as rate rises will impact their whole monthly repayment rather than a proportion of it (as is the case with capital repayment).

Figure 16. Vulnerable consumers under interest rate rises by geodemographic profile.

Source: Financial Conduct Authority
Note: Maroon bars show a higher concentration of vulnerable borrowers in a group, relative to group's market share. Orange bars show a lower concentration of vulnerable borrowers in a group, relative to group's market share.

Lower-income household types are proportionally more vulnerable compared to higher income household types.

The following consumer types account for 52% of all mortgages but 67% of all vulnerable consumers: Credit hungry, on the breadline, aging workers, elderly deprivation, surviving singles, happy housemates, modest mid-years.

The impact of a rise in Bank Rate would be felt widely by mortgaged households. Roughly 10mn UK households (~33%) have a mortgage and even those on fixed rates would likely see a rise in monthly payments in the medium term as their fixed terms end. These borrowers may be forced to roll-over onto a product with a higher rate.

Firms' approach towards forbearance to date has been supported by low interest rate and improved funding conditions. As the external environment starts to move towards recovery and interest rates start to rise, some forbearance strategies may no longer be suitable or viable and lenders may start to take a more direct approach to mortgage distress and repossession. Any improvement in margins and underlying profitability, interest rate rises and house price growth, would increase the carry-cost of forborne loans and could lead to changes in lenders' strategies. Higher rates may crystallise firms' understanding of whether consumers in forbearance have any long-term prospects to recover from financial distress and this could lead to higher repossessions. Firms must ensure they take proactive steps to identify borrowers susceptive to higher rates and have strategies in place that treat consumers fairly in these circumstances.

The transition into a period of higher interest rates could lead to price volatility, particularly as market expectations adjust to a new period of higher rates. This can create a difficult environment for investors to respond to falling prices on interest-sensitive bonds and will also have an impact on price formation. In addition, after a long period of low interest rates, it will be an adjustment for consumers to manage their balance sheets in a new period of staggered rate rises. Volatility in liquid markets could lead to private-sector uncertainty around spending which could dampen real-economy activity.

Low rates have supported rising bond yields but as monetary policy starts to tighten, the value of government bonds are likely to fall. Developments in banking regulation have changed capital requirements making it more expensive for banks to hold inventories of bonds on their balance sheet as part of their market-making activities, leading to reduced liquidity in some bond markets. At the same time retail investors have increased their holdings in bond funds. Investors in bond funds, particularly retail investors, may not be aware of the increased liquidity risk and associated risk of loss. This is of greatest concern where investors have invested in these funds as low-risk alternatives to deposit accounts, with a higher income.

If rate rise and bond prices fall, portfolio values for banks, life insurers, and other investors (including pension funds) that mark such assets to market would decline – this could leave consumers with lower pension wealth than expected, particularly if they do not have a flexible bond portfolio. If bond prices fall sharply in response to changes in monetary policy, it is likely that more sophisticated professional investors will move first, using up the balance-sheet capacity of investment banks to hold bonds for market-making and trading. This may increase losses on sales by retail investors or prevent timely sales as bond funds halt redemptions. If investors see prices fall and decide to reduce holdings of bonds, the lack of liquidity may result in further significant price falls and funds suspending redemptions, as market-making banks demand large price discounts or choose not to buy.

The period of transition between bonds prices falling and annuity rates rising could leave consumers purchasing their annuities with lower returns. Where advisers have used 'lifestyling' for clients' pension funds, this strategy may present more risk than they were previously aware of – this could require a review of the strategy.[14] In theory, the fall in bond prices should be offset by a rise in annuity rates. However, the pricing of annuities may be slower to adjust to market developments.

Banks and insurance companies that match their interest rate risk on assets and liabilities will not see a large impact from higher rates and pressure on returns is likely to remain. Life insurers, with assets in fixed-income products, will also face accounting write-downs on their portfolios, particularly if interest rates rise rapidly. Downside risks to the price of interest rate sensitive fixed income products could materialise as interest rates start to rise, which could crystallise cases where products have not been suitably selected for consumers. As discussed in Chapter 3, prudential pressure – caused by these write-downs – may cause firms to pursue strategies that do not create good consumer outcomes.

Mainstream investment funds typically use very little financial leverage. Higher interest rates may cause fund asset values to decline, which will have a direct impact on investors but is unlikely to have a major impact on the wider financial system. At the same time however, changes in interest rates may change the relative attractiveness of investment strategies, potentially leading to investor redemptions from certain funds, or fund managers restructuring their portfolios. Rapid portfolio adjustments by investment funds could create risks to the system, for example by creating liquidity pressures in certain markets, particularly where investment funds have large or concentrated exposures. We have identified corporate bond markets as potentially vulnerable to this scenario.

Unlike mainstream investment funds, some hedge funds are significant users of leverage, particularly via derivatives. Although not a material risk at present, in the event of significant market volatility or rapid changes in interest rates, highly leveraged hedge funds could potentially pose risks to the system, either through disrupting price formation in markets or through losses to counterparties, including systemically important financial institutions.[15]

14 Lifestyle pension funds move the bulk of pension pot investments from equities into bonds the closer consumers get to retirement.

15 See Bank of England, Financial Stability Report November 2013 p21-22 for further details

Lending trends and credit conditions

Improvements in the economy could start to drive optimism in consumers' ability to afford short-term (potentially high cost) loans and there is a risk consumers will overstretch themselves anticipating improved conditions. The FLS (Funding for Lending Scheme) extension will provide initial borrowing allowances to banks and building societies that participated under the first phase of the scheme and expanded their next lending, including to households until January 2015. However, participants will no longer accumulated additional allowances over their household net lending during 2014 and this could mean that lenders may begin to look for alternative sources of funding. When funding from the FLS is no longer available, some lenders may need to attract more retail deposits as they re-adjust and close down their customer funding gap. It remains to be seen how activity in the funding markets and improved margins for those able to obtain funding will change.

While there is some evidence of credit conditions have been loosening, secured household lending is still subdued compared to pre-crisis growth. And while secured lending conditions have been tight (as lenders deal with legacy issues), consumer credit activity by non-bank lenders has been growing over the last year – growth in unsecured lending is now back at 2007 levels, with significant growth seen in credit card lending (Figures 18 and 19). Given underlying conditions, demand is likely to continue, in particular in the non-mainstream and high-cost credit sectors.

Although still well below the pre-crisis level, mortgage loan applications have risen over the last year averaging around 200,000 applications per month (Figure 20). However, mortgage approvals have not seen a similar rise and activity remains subdued. According to surveys of house price expectations, households expect prices to rise over the next 12 months (Figure 21). Perceptions that house prices will continue to grow could lead consumers to make poor affordability decisions on their mortgages based on price expectations of their home rather than details of the loan itself, including interest rate rises, fees and charges.

Borrowers and lenders may also extend the term of mortgages to improve affordability. Since 2009, the profile of lending for residential mortgage loans shows an increase in Loan-to-Income (LTI) and term profiles across new lending, which could lead to affordability stretch (Figure 22). In the absence of real income growth, the accumulation of other debt and rising mortgage rates could mean these households become more vulnerable to default.

As funding conditions and market activity improves, there could also be increased competitive pressure from

Perceptions that house prices will continue to grow could lead consumers to make poor affordability decisions on their mortgages based on price expectations of their home rather than details of the loan itself, including interest rate rises, fees and charges.

new non-bank entrants who could move up the risk curve, targeting non-vanilla higher risk groups.

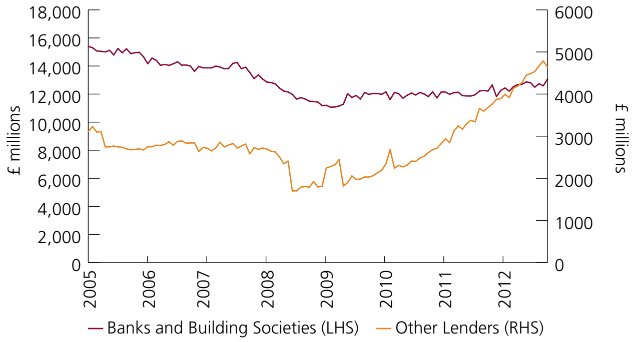
Many smaller lenders are looking to expand their lending into non-core markets as mainstream markets are concentrated in a few large lenders. For example, lending by building societies is increasing outside their core geographical locations – particularly lending to London by societies based elsewhere. In order to grow outside their core markets some lenders are likely to use intermediaries and packagers, potentially giving them less control over due diligence.

High levels of indebtedness could leave many households unable to save sufficiently for their future, leaving them reliant on debt in later stages of their life cycle. This is likely to affect their financial services' needs over the long term. Increased reliance on debt increases the likelihood that individuals may need debt advice or management services to help them cope with day-to-day spending needs.

It will be important to ensure that financially distressed consumers are made aware of the availability of free and impartial debt services, and that they do not fall prey to more predatory entities, which can be expected to seek to benefit from this trend should it materialise. This is a particular concern given questions around the financial viability of free services (arising from reduced funding and cuts in legal aid planned for 2013).[16] Although any reduction in free services could be expected to lead to an expansion in the fee-paying sector, there is continuing evidence from the OFT and from our own evidence gathering from firms and trade bodies of market exit and consolidation in the fee-paying sector. This follows the OFT's 2010 compliance review and may be partly in anticipation of the new regulatory regime in consumer credit as the FCA takes on this responsibility. This raises

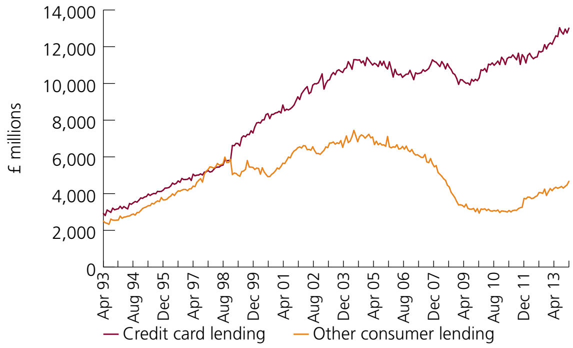
16 See Audit of the supply of debt advice services in the UK, London: London Economics, 2012 and Out of scope, out of mind, London: Citizens Advice Bureau, 2012.

Figure 18. Gross unsecured lending by type of lender to households: 2005 to date



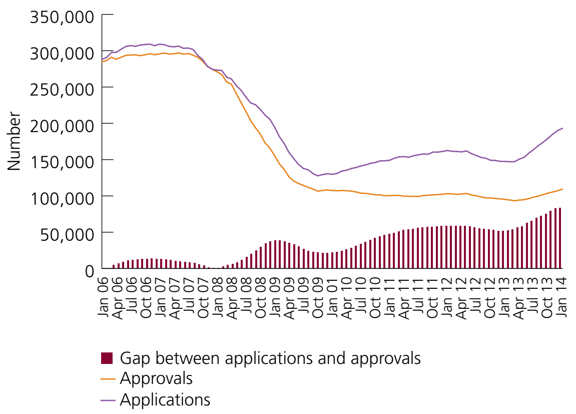
Source: Bank of England

Figure 19. Gross lending by credit card and other consumer credit lending



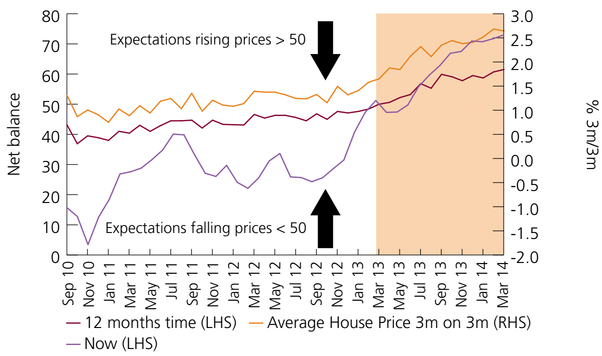
Source: Bank of England

Figure 20. Mortgage applications and approvals



Source: National Hunter, Bank of England, Financial Conduct Authority calculations

Figure 21. Actual house prices and expectations, current and 12 months ahead



Source: Knight Frank/Markit House Price Sentiment Index, Halifax, Nationwide

the importance of increasing consumers' awareness of free advice channels, such as that available from Money Advice Service.

2.2 Technological developments

Technology continues to grow in importance as increased dependence on digital connectivity affects both the way many consumers engage with financial services and the way products and services are distributed. By adopting and improving the use of technology in financial services, firms and consumers can benefit in many ways. Interactions can be quicker, less costly, simpler and more efficient, improving the functioning of markets. Consumers are able to source products with more ease and gain access to new channels for advice and information. This allows new entrants into the market, who could be more able to innovate, which would benefits competition.

The increased engagement between consumers and firms via technology also brings vulnerabilities. Financial firms and consumers are becoming increasingly reliant on technological systems and are more exposed to their disruptive capabilities (in the form of abuse, misunderstanding or operational challenges arising from the increased complexity of, and reliance on, these systems). Here we look at some of the growing trends in the use of technologies in financial markets.

Changing consumer demands

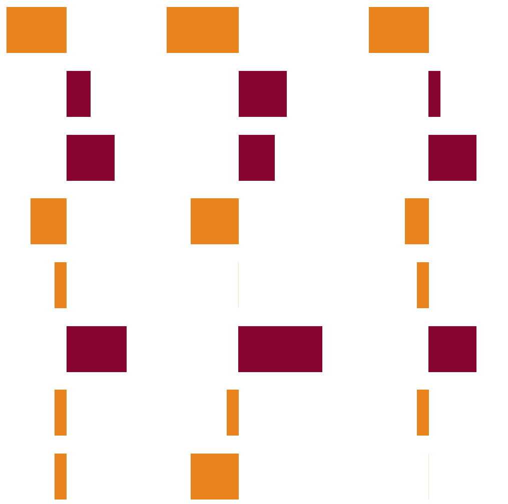
Consumer demand for online financial access is causing a shift towards more direct and immediate interaction with products and services. The scope for increased uptake and use of digital platforms (e.g. use of digital wallets or alternative payment systems) and the use of online sources of information on financial services

Figure 22: Profile of mortgage lending 2005 -2008 vs 2009-2013

Loan characteristics	All regions		London and South East		Other regions (excluding unknown regions)	
	2005-2008	2009-2013	2005-2008	2009-2013	2005-2008	2009-2013
LTV>=90%	7%	2%	7%	1%	7%	2%
LTI>=3.5	15%	16%	21%	25%	13%	14%
Term>25y	5%	9%	4%	7%	5%	10%
LTV>=90% and LTI>=3.5	3%	1%	5%	1%	3%	1%
LTV>=90% and Term>25y	3%	3%	2%	1%	4%	3%
LTI>=3.5 and Term>25y	4%	9%	4%	11%	4%	8%
LTV>=90% and LTI>=3.5 and Term>25y	3%	2%	2%	2%	3%	2%
None of higher LTV, LTI and Term criteria	60%	59%	56%	52%	61%	61%

Change in share of lending: 2009-2013 vs. 2005-2008

All regions | London and South East | Other regions (excluding unknown regions)



Source: Financial Conduct Authority
Note: The data presented is on regulated mortgage sales excluding equity release schemes and home purchase plans. Maroon bars show an increase in the share of lending and orange bars show a decrease in the share of lending within each category between 2005-2008 and 2009-2013.
The percentages next to the coloured bars show the difference between the shares of lending in each category between 2005-2008 and 2009-2013.

is growing and is likely to be an area where firms increasingly look to expand (Figures 23 and 24).

Growing responsibility for consumers to manage their own finances will be bolstered by technological changes that allow them to manage their own savings and investments. We need to be aware of the potential gaps in understanding of, or the impact on, consumer decision-making processes that technologies might have. There may be products and services that are unsuitable for execution only purchase. It will be important that services providing information and online access to products have oversight and controls in place that prevent consumers from making impulsive or ill-informed decisions, due to more direct, more frequent and faster interaction with financial services, particularly through execution only sales.

Technology-based distribution methods, such as platforms, are likely to take on a wider range of products (for example SIPPs), opening up some markets to a wider range of consumers. Consumers' increasing readiness to carry out financial purchases and transactions online needs to be accompanied by an understanding of the limitations and risks associated with online platforms. Awareness of these risks appears to have improved. As mobile and Information Communication Technology (ICT) platforms become more commonly used across different consumer groups and product types, this understanding will need to keep up with changing exposures and potential vulnerabilities.

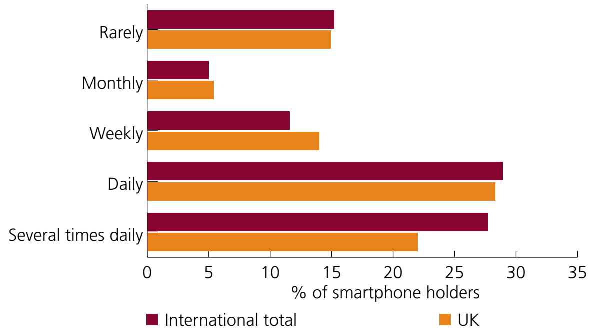
As consumers increasingly seek to engage with financial services through digital platforms and use technology to access execution only channels, the use of branches and the number of branches in operation will fall. Increasing reliance on technology and digital platforms may reduce access for certain consumer groups, due to the closure of branches or because some consumers do not have adequate access to computers.

The role of technology in decision making

The ways in which providers have responded to changing consumer preferences for more direct and (seemingly) comparable interfaces and self-service propositions, has in some cases distracted consumers from important product features or risks. This may lead them to make rushed or misguided decisions.

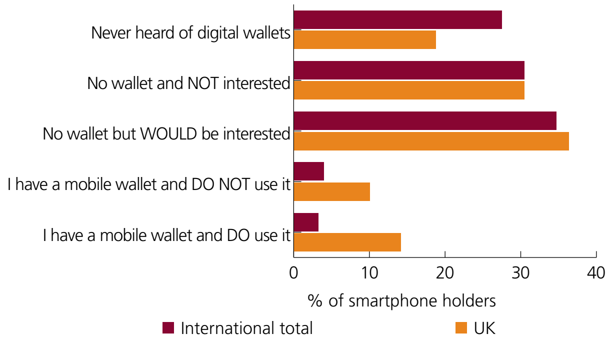
For example, in the consumer credit market, our consumer research indicates that consumers of online short-term high-cost credit are often focused on speed and convenience rather than price of credit, with some reporting in hindsight that they wish it had been more difficult for them to obtain credit. There are also indications that some borrowers, predominantly younger, look first to very accessible higher-cost online forms of credit before other potentially less-costly options that would also be available to them (see Box 1).

Figure 23. Usage of mobile internet devices while at home



Source: Copyright © 2013, Datamonitor Financial Mobile Wallet and Digital Content Analytics, reproduced with permission of Datamonitor Ltd.
Note. Based on consumer surveys in 21 countries.
Results are based on a UK sample size of 2,018, with research undertaken online in mid-2012. The sample is designed to be fully representative in terms of income levels, demographics and location of respondents.

Figure 24. Holdings of digital wallets



Source: Copyright © 2013, Datamonitor Financial Mobile Wallet and Digital Content Analytics, reproduced with permission of Datamonitor Ltd.
Note. Based on consumer surveys in 21 countries.
Results are based on a UK sample size of 2,018, with research undertaken online in mid-2012. The sample is designed to be fully representative in terms of income levels, demographics and location of respondents.

This has been facilitated by technology; the development of apps to facilitate quick borrowing and more generally, the ease with which consumers can be contacted by mobile phones and e-mail. It has been highlighted by our research that some consumers are being bombarded with promotions for credit and debt-related services, potentially increasing the likelihood they make a poor decision.

This will require consumers to gain a better understanding of the type of complex and important products they are purchasing and managing directly through distribution channels. This a requirement that is likely to be met in large part by other technology-enabled information services (e.g. online guidance forums for financial products), some of which will be unsuitable for some consumers.

In addition, technology can enable information asymmetries that affect the decision making of consumers. Firms could take advantage of technology where information asymmetries are created. For example, in the contracts-for-difference providers market, firms are able to take advantage of asymmetric slippage due to the lag in time between when they receive pricing information and when it is passed onto clients.

Technology as part of firms' growth and development strategies

Cost cutting and efficiency gains are core to firms' strategies to improve their productivity, profitability and competitiveness. Harnessing technologies on a larger scale, improving resilience of legacy systems and increasing levels of automation is a cornerstone of firms' strategy.

Efficiency gains through use of technology

Greater use of technologies improves efficiency and, especially since the crisis, has gone some way to reduce costs (although cost income ratios still remain high and well off optimal levels). However, there is still a backlog of legacy issues and investments in efficiencies are ongoing (e.g. collateral transformation). This in turn has affected the way in which markets function and consumers engage with financial products and services.

With falling business volumes, firms and traditional exchanges have had to review the fundamentals of their business models. Technological innovations have become crucial to the strategies they have implemented to increase the volumes of transactions they can handle, the margin they can earn and the cost-effectiveness of their operations. Combined with growing consumer demand for automated, online and instantly accessible financial services, this is an area that is increasingly driving how firms develop and distribute financial products and services.

In retail advice markets, technology has enabled firms to deliver products and services through effective and cost-efficient distribution channels, which should lead to better value for consumers as these reduced costs are passed on to them. In wholesale markets, technology improvements are allowing for faster execution, settlement of transactions and portfolio compression – this has increased the number of securities and derivatives transactions that can be carried out.

By taking on technologies that increase efficiency and respond to changing demands, the competitive dynamics in some markets are changing. New entrants, potentially better able to set up systems that respond directly to consumer requirements, may have a competitive edge on firms that need to integrate technologies with (possibly already overloaded) existing systems. Another aspect of this is the use of inherently scalable cloud technologies that may raise compatibility or resilience issues where firms are tacking these on to less scalable legacy systems.

Some firms in financial services rely on technological systems of firms that are emerging outside the perimeter. While unregulated entities – such as alternative payment platforms or digital currencies – sit outside our scope of responsibility, they can generate pro-competitive benefits. They can also pose risks to market integrity and consumer protection through technological interfaces with regulated activities. These activities may have the potential to create systemic and financial crime risks that would be outside our perimeter.

Increased use of data insights

With increased use of technology, the information available to firms to use in product development and marketing is growing. Firms' ability to capitalise on the changing shape of consumer demand, via new marketing channels – social media, data insights and more direct service platforms – means that access to information about financial products is changing quickly.

Firms must ensure that information is suitable for its use. Firms' improving data capabilities could mean that certain higher risk consumer 'profiles' may face increasingly higher prices and potentially be priced out of the market, or face affordability or access issues in the future.

In retail markets, growing consumer online activity and presence enables firms to use consumer information more to price and market their products, and target virtual guided sales. As these capabilities improve, issues around privacy, access and affordability could become more prevalent. Consumers may not be aware of how their information is being shared and used by firms through data insights – this could lead to further information asymmetries between providers and consumers.

Online technology preferences and capabilities across consumer segments vary and should be considered in firms' expectations of the consumers they service. As is already the case in other markets, some consumers (e.g. the elderly) may find that the products available to them and the service levels they receive are inferior to consumers who seek information and carry out purchases online.

In wholesale markets, use of data insights could also affect what price formation process information is

> By taking on technologies that increase efficiency and respond to changing demands, the competitive environment in some markets is changing.

available to different parties. Advances in transparency will continue to improve both risk management and price formation by increasing the quality of standardised data across a broad range of asset classes. For example, the potential advent of a 'consolidated tape provider' giving access to whole of market pre- and post-trade transparency data, together with mandatory trade reporting of OTC (Over the Counter) derivative contracts. Both pricing and risk assessment in many wholesale markets (e.g. structured debt) rely on complex proprietary internal models which are often only accessible by the originator of an issue. Sophisticated data interrogation and modelling will continue to play a significant role in driving information asymmetries and potential conflicts between market participants.

Technological vulnerabilities

Technological advances increase firms' dependence on underlying systems. Growing reliance on technology is increasing the exposure to the disruptive capabilities of technologies in ways that can prove costly to firms and consumers in the future. This makes the integrity of IT infrastructure increasingly important for firms' operational stability and, given the interconnectivity between systems, for market integrity more broadly. The growing importance of technology gives rise to concerns about whether, in the short term, current systems will be adequate to deal with rising demand. It is important that firms are able to integrate and implement effective oversight and controls for increasingly complex systems.

While technologies can reduce cost and improve efficiencies, there are direct and indirect costs associated with increased use of these new interfaces that also have to be considered. For firms becoming increasingly reliant on technology to deliver their business it could become increasingly difficult to undertake maintenance or fix IT problems while providing a continuous service for consumers.

Substantive operational load

The effectiveness of technologies may be limited by shortcomings in the way in which systems are designed and managed. Operational overload has resulted in some headline events that have had adverse implications on market integrity, consumer outcomes and firms' reputations. For example, a number of retail banks have experienced outages that have attracted media attention.

There are also some slower-burning issues resulting from the increasing complexity of systems needed to support required data processing and transaction levels that could create future problems across different markets. Vulnerabilities are especially evident where the quality of infrastructure is low. This is mostly the case for ageing, legacy or multi-layered/integrated systems, or where previous failures have been plugged with manual workarounds affecting cost issues and control risks.

In wholesale markets, increases in the speed and volume of transactions and the level of interconnectedness in markets has increased the operational load for firms undertaking trades (whether for themselves or on behalf of clients) and trading venues. Where firms do not have systems and controls in place that are appropriate to the nature, scale and complexity of their business, this could lead to market disruption. This requires investment in pre- and post-trade controls, including suitable monitoring capabilities, as well as systems capacity and resilience. Operational controls and oversight arrangements will need and improve in line with technological changes – and MiFID2 and EMIR (European Market Infrastructure Regulation) requirements – to ensure market disruption and consumer impacts are minimal and can be resolved quickly.

Dependence on data security

Increased availability and indirect connectivity of personal and financial data on systems has increased the potential profits that criminal elements can extract from financial services – to the detriment of consumers, firms and market integrity. While financial firms experienced increased targeting up to 2012 by online criminals (Figure 25), improvements to their oversight and controls, and increased law enforcement action in 2012 (along with improved consumer understanding of the risks involved in online transactions and data-sharing) could be a factor in the reduced financial impact of crime on consumers from the 2008 peak (Figure 26).

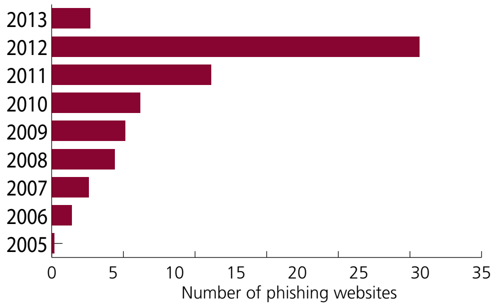
The rising costs for firms of cyber-crime (for example, through activist attacks and the increasing prevalence of distributed denial of service (DDOS) attacks) and of implementing systems to detect and deal with attempted financial crime against themselves and their consumers, has required firms to invest significantly to improve controls. However, indirect costs to consumers could rise as firms may need to recoup their costs by passing these back onto consumers, e.g. via the growth of indirect charges or lower service levels in other areas.

Cyber-crime has also received increased attention by operators of critical financial infrastructure, such as market exchanges and trading venues, since they have become high-profile targets for deliberate attempts to disrupt financial markets. These market infrastructures should review cyber security measures and pro-actively share joint intelligence to prevent any prolonged outage. The FPC recommendation for HM Treasury, working with the relevant government agencies, PRA, Bank of England and FCA, to work with the core UK financial system to put in place a programme of work to improve and test resilience to cyber-attack should support this work.

Growing reliance on technology

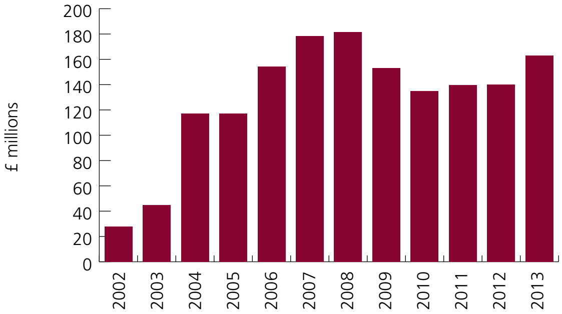
Firms rely on automated technology to improve efficiency and reduce costs. Where firms have the expertise and knowledge, the use of automated technology can deliver benefits to the firm and consumers by reducing costs. For example, many firms are adopting income verification models developed by credit reference

Figure 25. The number of phishing websites targeted against bank and building societies has been growing



Source: Financial Fraud Action UK
Note: the substantial decline in the number of phishing websites targeting UK Banks in 2013. This is due to the impact of law enforcement activity in the last few months of 2012.

Figure 26. Internet and e-commerce fraud losses on UK-issued cards 2002-12



Source: Financial Fraud Action UK

agencies to comply with new Mortgage Market Review (MMR) rules. However, risks can arise where firms have purchased technology without the right expertise or knowledge of how to use it.

For some firms, the ability to attract appropriate expertise and talent to operate and develop technology in a way that meets the needs of the firms and its consumers could be challenging when larger firms are also competing for the same experts – this is a reputational issue for all financial institutions.

Reliance on technology could reduce firms' willingness or ability to offer products and features that rely on judgements that cannot easily be automated. For example, lenders may no longer be willing to offer interest only mortgages or mortgages that extend into retirement, as these underwriting decisions require individual assessment and judgement around repayment ability and strategies.

Firms adjusting to the internet age for distribution may find the boundaries between advice and execution-only are blurred as firms and consumers navigate between advice and guided self-help. Where firms are struggling to developing automated, limited or simplified advice models, there could be non-compliance with our rules. Having in place rules and guidance that were established before the internet may not be fit for firms and consumers in an internet age and could lead to risks around consumer protection. As technology continues to drive change in the financial sector, we will need to ensure that our handbook works to support good business conduct, and that the controls in place and use of technology supports our objectives and does not drive products out of the market.

2.3 The policy and regulatory environment

The regulatory reform agenda, both in the UK and globally, is bringing about changes to the structure of markets and support for the financial sector aimed at achieving better outcomes for consumers by changing the way firms conduct business. This is also an important driver of how firms are looking to develop and reorient their business models. The policy environment over the last year has continued to focus on shoring up public finances, restoring economic growth and ensuring financial stability in the UK.[17]

Government policies are changing the way in which consumers manage their finances and where they will look to finance near-term and future spending needs (e.g. universal credit and pension reforms) and firms' response to this. Regulatory initiatives aiming to support firms' focus on conduct issues and shore up prudential soundness are shaping firms' strategies and the financial sector landscape in a range of ways (e.g. consumer credit rules, CRD IV, EMIR, MAR, MiFID 2, MMR, RDR and early product intervention).

Government policies shaping the demands from financial markets

Policy initiatives can have an impact on firms' funding positions or on performance in certain markets or asset classes.[18] In addition, they can influence the strategies that firms choose to pursue, affecting consumers' financial needs (now and in the future) and their demands from financial markets. Together, these changing conditions and their impact on consumer requirements are likely to influence the type of products and services that firms develop and where they seek to expand in UK markets.

17 Government, Central Bank and European policy initiatives.
18 We discuss some of these in chapter 2.1,

The response of firms and consumers to policy and regulatory reforms may create risks to our objectives in they are not measured or managed effectively.

Impact of key government policies on the financial viability of firms

The current policy agenda both bolsters and constrains some financial markets, and has an impact on firm and consumer balance sheets. Austerity measures are accompanied by a variety of targeted growth initiatives that influence financial market conditions, the viability of certain sectors and the decisions consumers and investors make. For example, the FLS and Help-to-Buy Mortgage Guarantee Scheme (HTB) have both supported the supply of mortgages in the market.

Similarly, the Government's investment plan for the Credit Union sector should support its expansion, albeit from a small market size. This could lead to new product development (e.g. current accounts, ISAs, alternative payment methods) and could take the form of growth strategies across the sector, both of which would increase pressures on existing oversight and control functions within firms.

Impact of policy on sources of funding

Current policies being implemented or planned for implementation will affect short-term as well as long-term financial requirements of consumers, including the type of financial products and information that consumers may need from the financial sector.

The impact of policy changes on the financial needs of consumers will depend on consumers' preparedness for welfare and interest rate changes. Consumers who are not well prepared for these changes may face challenges in adapting. For example some consumers may seek alternative financial support, such as credit, to make up any shortfall they face in income or seek budgeting advice from advice agencies. Policy changes can also influence the appetite for financial products consumers may demand in the future. For example changes to tuition fees mean some consumers will have high outstanding debts at the start of their working life this could have a psychological effect on consumers' appetite for credit in the future.

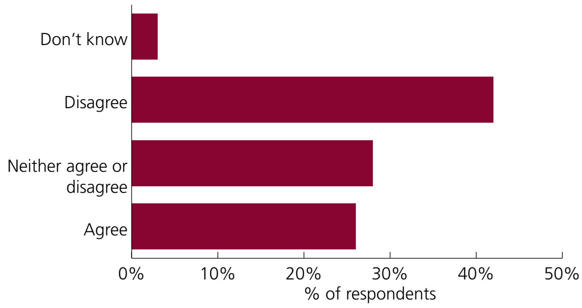
The response of firms to these changing needs will also be influenced by the impact of government policy at a macro and micro level. Due to the increased demand for pension schemes resulting from automatic enrolment, there is a risk that as an increasing number of smaller businesses' automatic enrolment duties come into force, pension providers will come under increasing cost and capacity pressure. This may lead some pension providers choosing not to serve the smaller employers enrolling.

Consumers may be ill-prepared for retirement due to a lack in saving combined with the low returns environment. Some may have not build up sufficient wealth during their working years to fund their retirement. Others may have built up an appropriate amount, but may make decisions about the withdrawal of their funds that are not in line with their long-term needs. Financial firms may seek to fill this gap with innovative products. For example, changes to long-term care could see new products that offer to provide income in the event that the consumer needs long-term care in old age. This could be in the form of increased prevalence of income drawdown to pay for care costs, benefiting from tax relief or products that allow assets to be passed on to heirs. The onus is likely to fall on financial firms to find solutions that are fair to consumers. Bringing about the sort of change that would support and enable consumers to improve their financial preparedness for post-retirement spending needs could take significant time and will require a sea-change in consumers' attitudes and ability to save (Figure 27).

Changing responsibilities

As responsibilities shift from the state to individual, the need for improved financial management skills

Figure 27. "I have a plan to pay for the care I will need in old age"



Source: Money Advice Service, 2013
Note. Base = 5,079

increases. The reforms to the benefits system through the introduction of Universal Credit (UC) will impact the way in which claimants manage their finances and interact with financial services. The current system, where claimants receive payments on a weekly or fortnightly basis, will be replaced and UC payments will be made on a monthly basis as a lump sum. These changes will require some consumer segments who have previously only used services outside the mainstream financial sector, to have transactional bank accounts to receive payments. Firms will need to ensure that they treat consumers fairly as they adjust to these changes.

Claimants and those on low paid work may need additional support around budgeting and managing these new monthly payments to avoid unforeseen costs of becoming overdrawn. Research we have been carrying out on lower income consumers who use consumer credit, suggests that budgeting over monthly periods is more challenging for some than for shorter term periods. In the transitional period consumers may take on consumer credit to manage short-falls as they adjust to budgeting and interacting with mainstream financial service providers.

Pension reforms will provide individuals with more freedom as to how they use their pension pots at age 55. The government recently announced that from April 2015, individuals aged 55 and over with defined contribution pensions will be able to withdraw these savings as they wish, subject to their marginal rate of income tax. It has also said it will help people make the decision that best suits their needs by guaranteeing that they will be offered free and impartial face to face guidance on the range of options available to them at retirement. These reforms increase consumer choice and aim to encourage saving for retirement. The increased freedom of choice should encourage competition and innovation, potentially benefitting price formation and consumer choice. The reforms increase individual responsibility, putting the responsibility of having sufficient funds in place after retirement in the hands of retirees. This may cause detriment as individuals could make decisions that are not necessarily in their own long term interests.

Where responsibility has shifted from the state to individuals, the need to improve financial management skills has increased.

Changes to the regulatory landscape

The wide range of regulatory initiatives is changing some market structures and bringing about changes to the way firms conduct their business. The reform agenda seeks to improve outcomes for consumers, market integrity and competition across retail and wholesale financial markets, and there are already signs of success in many areas. However, it is also affecting prospects for growth and expansion in certain markets and, at times, altering what firms are able or willing to offer their consumers. Firms need to assess the social costs of withdrawing from products and areas as part of a de-risking process against the wider policy objective to ensure financial inclusion. These impacts have the potential to drive risks to our objectives if not properly understood and managed.

The volume of the regulatory reform agenda can increase operational stress for firms at a time when other aspects of the operating environment remained challenging. Regulatory change can also make it difficult for firms to step back and strategically assess the adjustments they need to make to their business models and strategies to ensure they remain viable.

Regulatory agenda

Key regulations can affect market structures, firm business models and consumer engagement with financial services. There are several regulatory reforms underway or in the pipeline that are having, or will have, a material effect on the shape of the markets we regulate and on how both firms and consumers operate in these markets. In addition the Parliamentary Commission on Banking Standards reported 58 recommendations that relate specifically to the FCA along four key themes – holding individuals to account, governance and culture, securing better outcomes for consumers and regulatory judgment. We have published our response to the report and, more specifically, the recommendations that were addressed to the FCA, in October last year.[19] Here we look in more detail at some of the most significant

19 The FCA's response to the Parliamentary Commission on Banking Standards, October 2013 http://www.fca.org.uk/static/documents/pcbs-response.pdf

elements of the current UK and international reform agenda on particular markets within our remit and their impact. (For a fuller overview of the reforms underway and the markets these affect, see Figure 28).

Markets in Financial Instruments Directive 2 (MiFID 2)

MiFID is being revised in the light of the financial crisis, the G20 commitments to reform derivatives markets and, experience with the existing provisions. MiFID aimed to make financial markets more efficient, resilience and transparent and strengthen the protection of investors. In January 2014 political agreement was reached between the European Commission, Council of the European Union and European Parliament on the level 1 text of a revised MiFID (known as MiFID 2) and a new regulation on over the counter derivatives, central counterparties and trade repositories (known as MiFIR). The implementation of MiFID 2 and MiFIR aims to make markets more efficient and transparent by affecting the way in which the business models and strategies of trading platforms in particular will operate. The changes will have particular significance for the operation of wholesale financial markets in the UK with:

- the creation of a new category of trading venues, organised trading facilities (OTFs), for the trading of non-equity financial instruments;
- a comprehensive pre- and post-trade transparency regime for liquid non-equity instruments traded on trading venues;
- the implementation of the G20 commitment to trade certain derivatives on organised trading venues;
- a cap on 'dark' trading of shares on trading venues;
- position limits of contracts traded on commodity derivatives markets will need to be reported daily except where exemptions apply; and
- access will be given to third countries either via a branch in the EU or directly from the home third country where the third country has equivalent regulation and provides reciprocity to EU firms.

One of the trends initiated by MiFID was the growth in venue competition and the development of a range of new and continually evolving business models for trading venues. An increase in market fragmentation has been one of the consequences of venue competition. Market fragmentation has made it harder for brokers to achieve best execution for clients. Also, firms have to invest more in systems to achieve sufficient oversight of the market to achieve best execution. This has potentially been exacerbated by cross border issues (e.g. Dodd-Frank), resulting in reduced liquidity for market participants. The regulatory environment has continued to develop in response to these issues culminating in agreement of the level 1 text for MiFID 2 and MiFIR.

Regulatory and market structure developments continue in other jurisdictions, most notably in the United States through the implementation of Dodd-Frank, and market participants with cross-border activities are therefore facing a significant volume of regulatory change in respect of their global trading activities.

European Market Infrastructure Regulation (EMIR)

The European Union regulation on over-the counter (OTC) derivatives, central counterparties and trade repositories (EMIR), introduces new requirements to improve transparency in the EU derivatives market and reduce the risks associated with the OTC derivatives market. EMIR established common organisational, conduct of business and prudential standards for central counterparties (CCPs) and common operational standards for trade repositories. Generally, entities that enter into any form of derivative contract in the EU, including interest rate, foreign exchange, equity credit and commodity derivative, are required to:

- report every derivative contract they enter into (both OTC and exchange-traded) to a trade repository;
- clear, via a CCP, those OTC derivative contracts subject to a mandatory clearing obligation; and
- implement new risk management standards – including operational processes for resolving disputes, and having appropriately segregated exchange of margin/collateral – for bilateral (non-CCP) cleared OTC derivatives.

EMIR is a fundamental reform of the regulation of EU derivatives markets, implementing G20 pledges from 2009 to improve counterparty risk management and transparency. Once fully implemented, EMIR should significantly improve the overall robustness of the OTC derivatives markets, but there are some risks in the transition phase, in particular, for some market participants, the risk of a shortage of eligible collateral to post in relation to their trades. While the overall additional collateral required as a result of EMIR appears well within the total available stock, some market participants are likely to need to source additional eligible collateral to meet the requirements. Collateral transformation services being developed and used to meet EMIR requirements could pose some additional risk.

The new requirements have an impact on financial counterparties (such as funds, banks, insurers and brokers) as well as non-financial counterparties (such as big corporates) placing additional costs on firms affected – both through the reporting requirements (operational changes) and risk mitigation requirements (and the impact on hedging strategies). Where derivative contracts are for a long duration entities may be required to hold additional liquidity in their portfolios or put in place arrangements whereby liquidity can be accessed at short notice (for example, repo arrangements). In the medium term, there are indications of possible shortages of eligible collateral and concerns around collateral management (transformation). Growing interconnections created by exchange of collateral could potentially lead to risks to market integrity and consumer protection.

Capital Requirements Directive (CRD) IV

A large number of investment firms (which may include firms such as brokerage firms, broker dealers, spread betters and some asset managers) are subject to CRD IV legislation which came into effect on 1 January this year. CRD IV aims to minimise the negative effects of prudential stress by ensuring firms hold enough resources to cover the risk associated with their business, including strengthening their capital adequacy and liquidity positions.

There could be risk to market integrity if implementation of CRD IV and its reporting requirements (COREP & FINREP) are not on time or carried out across all relevant firms. The effectiveness of the stress testing requirements under CRD IV could be limited where firms have little (or no) expertise or capabilities to deliver credit stress testing. Firms may face additional costs where they need to build up knowledge and expertise in this area; in addition the results of testing could lead firms to alter their portfolio to address capital requirements.

CRD IV will also impose a cap on banker bonuses. In seeking to retain staff, firms may attempt to circumvent the bonus cap by devising complex remuneration structures which potentially ignore the underlying role that incentives can play in driving integrity and protection for consumers.

Retail Distribution Review (RDR)

Since the implementation of the RDR in December 2012, firms have responded to regulatory changes by adapting their business models and distribution strategies. We have seen a withdrawal of some banks from parts of the retail investment advice market (typically where people have smaller sums to invest) and there is some evidence of an increase in non-advised sales of retail investment products. This has given rise to concerns that some consumers may be finding it more difficult to get financial advice, particularly where their investment amount is modest. At the same time, however, there have been signs of increased innovation around new delivery methods, for example on-line advice or non-advised services, using new technology solutions which have the potential to bring down costs of advice, which should yield positive outcomes for consumers.

To the extent that business models change in response to the new regulation, have particularly affected access at the lower end of the market. Consumers in this part of the market may now be more likely to opt for execution only services rather than pay for advice on small investments. While the shift towards new technology in delivering execution only solutions could deliver benefits for consumers, they could also present risks if used to purchase complex products which may not be easily understood without advice. Moreover, there is also a risk that, without well-designed systems, there is a lack of clarity and that consumers using non-advised services may believe they are receiving advice when they are not.

There are several regulatory reforms underway or in the pipeline that are having, or will have a material impact on the shape of financial markets.

Mortgage Market Review (MMR)

The MMR, due to be implemented on 26 April 2014*, aims to ensure the mortgage market is sustainable and works better for consumers. Requirements for qualifications to provide advice aim to improve the integrity of the market and improve the outcomes for consumers. New affordability requirements aim to ensure that consumers who are able to afford a mortgage should have access to this market.

As firms prepare for the implementation of MMR, and particularly the move to an advised market, there has been an increase in reliance on the use of intermediaries as a distribution channel and increased use of packagers by some firms. This is changing the shape of the market and the potential risks, particularly those arising for firms using intermediaries and packagers to comply with MMR requirements for affordable lending decisions.

It is important that firms do not lose sight of the importance of continuing to lend responsibly, particularly in a rising market and when using new distribution channels such as intermediaries. We have seen a number of better lending practices in the market today, ahead of the MMR coming into effect and it is important that those standards do not slip. Firms using third parties must ensure there is effective due diligence and oversight.

Non-mainstream pooled investments

Since January 2014 new rules are put in place restricting the promotion of investment funds which are non-mainstream pooled investments (NMPIs) to the general public. In general terms, under the new rules firms may promote NMPIs to professional and institutional investors, but not to retail investors other than those certified as high-net worth or sophisticated. This product intervention aims to protect consumers from inappropriate promotions of risky and complex products which are likely to be unsuitable for them, and which consumers are likely to struggle to evaluate. NMPIs include unregulated collective investment schemes, qualified investor schemes, traded life pooled investments and certain investments funds structured as corporate entities or special purpose vehicles.[20]

* Amended April 2nd 2014.

New areas of responsibility for the FCA

In 2014 we will take on some important new areas of responsibility where the regulation we introduce, as well as market expectations of what this will involve, will affect how firms conduct their business, where they seek to expand and what products and services are available to consumers.

In the period of transition there is heightened risk of consumer detriment as firms embed our regulatory principles and we adopt a regulatory approach that seeks to meet our objective. This risk is compounded for second charge lenders where the delayed application of MCOB regulation for these firms could lead to poor treatment of consumers in the interim.

Consumer credit

Responsibility for the regulation of consumer credit is being transferred from the OFT, which will affect around 50,000 consumer credit firms. The transfer raises the risk of market exit by firms, for example, from perceived increase in regulatory burden. Our new consumer credit rules, particularly in debt management and short-term high-cost credit, will affect these markets. The new high-cost short-term credit rules, and our forthcoming price cap rules, may affect some firms' willingness to stay in the market, and may lead them to move to other credit products that fall outside the scope of these rules, or simply because they expect their business profitability to suffer. These could affect some consumers by making credit products more expensive, or harder to access. Price capping proposals in the payday sector could impact on firms' profitability.

20 None of these fund structures are subject to the rules applicable to retail-oriented regulated collective investment schemes. These funds often pool investments in unusual or speculative assets such as offshore property developments, projects relating to forestry, biofuels or agricultural land, land-banking schemes, investments in fine wine, diamonds and infrastructure projects.

Crowdfunding
As part of the move to regulate consumer credit, we will also be responsible for regulating loan-based crowdfunding (which includes peer-to-peer lending). A new regulated activity is being introduced, giving the FCA responsibility to protect consumers borrowing money (but not business borrowers) and the clients lending the money. While we acknowledge that crowdfunding and similar activities may benefit the economy, those seeking finance, and investors, we are obliged to consider the wider financial market and the need to protect consumers. We already regulated investment-based crowdfunding.[21] While we acknowledge that crowdfunding and similar activities may benefit the economy, those seeking finance, and investors through innovative and competition to traditional funding models; we are obliged to consider the wider financial market and the need to protect consumers.

Firms operating loan-based crowdfunding platforms will be required to meet our conduct of business rules (in particular, around disclosure and promotions), minimum capital requirements, client money protection rules, dispute resolution rules and a new requirement for firms to take reasonable steps to ensure existing loans continue to be administered if the firm goes out of business.

Although businesses may benefit from access to alternative finance, there is a high risk of 100% capital losses when investing in securities issued by early-stage or start-up businesses (the non-readily realisable securities investment-based crowdfunding platforms offer) which directly impacts consumer protection. So we proposed that firms offering such investments via investment-based crowdfunding platforms or by other media are only able to advertise to certain types of investor. These are: professional clients or retail clients that are advised, sophisticated, high net worth, or confirm that they will not invest more than 10% of their net investible assets in these products.

Where no advice has been provided, firms will also need to check that their clients have the knowledge and experience to understand the risks involved when investing in non-readily realisable securities. Firms operating in this market will face new compliance costs – although we have not observed any exiting from this market, costs could drive some consolidation between platforms.

EU Payment Services Directive
The EU Payment Services Directive has been reviewed, and amendments are in process of negotiation. The changes aim to mitigate the risks of new and emerging types of payment service which may fall outside the existing regime, and to reduce risks and complexity associated with inconsistent application across the European Union.

Key proposals include removing and amending some existing exemptions; bringing within the directive 'third party payment service providers' (which offer account information or payment initiation services); increasing scope to include all currency transactions and the part of international transactions which occurs within the EU; improving consumer rights in the case of unauthorised transactions; and improving protection of consumers from fraudulent use of their accounts or personal information by requiring strong customer authentication.

Although the draft directive has changed since the European Commission, the initial impact assessment suggests that by creating a more level playing field competition from new entrants and higher volumes of mobile transactions should be encouraged as a result of improved protection rules.

Regulatory risk as a result of features of the regulatory framework
Where risks to consumer protection, market integrity or competition are (in part or wholly) driven by a shortcoming in the regulatory framework or in how regulation is applied, this is a considered a regulatory risk. In the past, some financial market risks have been caused or made worse by regulatory failure.

In today's environment of increased complexity both across financial markets and in operating conditions, the potential for regulatory risks to drive wider risks to our objectives remains very real. Regulatory risks to our objectives can arise where there is a flaw in the regulatory framework:

- Where an event that poses risks to our objectives takes place outside the regulatory boundary.
- Where responsibility for acting to mitigate risk is unclear due to overlap or underlap with other regulators.
- Where the FCA does not have sufficient powers to prevent a risk materializing.

Risks can also arise where, despite the regulatory framework and the FCA's powers, we fail to act appropriately to prevent events that pose risks to our objectives:

- Where we fail to adhere to a risk-based approach/framework.

21 Investment-based crowdfunding platforms that allow investors to invest directly or indirectly in new or existing businesses by buying shares or debt securities, or units in an unregulated collective investment scheme.

- Where our approach was seriously flawed.

- Where the event/risk arises directly from the impact of our policymaking or rules.

We have a responsibility to use regulation to good effect and will seek to ensure that the reforms we introduce and implement do not make it more difficult for firms to conduct their business in ways that help meet our objectives. However, we are aware that regulatory actions have in the past created risks to our objectives and we will remain vigilant to areas that could have unintended consequences that work against our ability to achieve our objectives. For example:

- Poor coordination of regulatory approaches: Where coordination on structural reforms taking place internationally is lacking – responsibilities, approaches and processes are still being decided on and it is possible that areas of overlap, underlap or uncertain responsibility will arise in the future regulatory landscape. This could be the case when domestic policy initiatives do not align with European initiatives.

- The volume and pace of change: The size of the post-crisis regulatory reform agenda in the UK and internationally in itself also increases the complexity of interactions and raises the risk of unintended consequences or negative externalities. The aggregate impact of reforms underway on structures and performance across financial markets is especially difficult to foresee given the dynamic and uncertain state of the global economy and of public and private finances.

- Correcting previous market failures in today's still challenging conditions: There are some examples where regulation has created barriers to entry or stifled competition. Clarity in our approach and what is required by firms is important to enable market participants to understand the intention of our rules. We are currently reviewing these to ensure regulation helps to promote effective competition in the interests of consumers.

- Perimeter activity: The growth of activity outside the regulatory perimeter and the increasing interconnectedness of regulated and non-regulated activities (e.g. where firms outside the regulatory perimeter provide technological solutions or platforms for services that are regulated, this would blur lines of regulatory responsibility and make regulatory decisions increasingly challenging). It also becomes more challenging to foresee the full impact of regulatory decisions and interventions over time.

In the United Kingdom, most financial institutions are subject to supervision by the Prudential Regulation Authority (PRA), the FCA or both. But only those that are engaged in deposit-taking, insurance or brokerage activities are subject to prudential regulation by the PRA. The FPC is responsible for identifying and assessing systemic risks arising beyond the regulatory perimeter. In this regard, the FPC was given, in the Financial Services Act 2012, the power to recommend to HM Treasury that the existing regulatory perimeter be extended or modified.[22]

22 See also the Bank of England's November 2013 *Financial Stability Report*.

*Figure 28. Snapshot of regulatory reform agenda (2014-2019)**

Note: All dates are expectations only and therefore subject to change

Year	Quarter	Item	Retail deposits	Secured retail lending	Unsecured retail lending	General insurance	Retail investment, fund management & related services	Wholesale investment, fund management	Wholesale insurance & related services	Markets (primary & secondary)
2014	Q2	UK: Transfer of consumer credit and peer-to peer-lending regulation from the OFT to the FCA (April)		■	■					
		UK: Implementation of new Platforms rules (April)					■	■		
		UK: Implementation of Mortgage Market Review (April)		■						
		UK: Policy Statement on the client assets regime for investment business**					■	■		
	Q3	Global: Proposed implementation of US Volcker Rule (Effective Apr 1, conformance period to July 15)	■					■		■
		UK: Policy Statement on price cap for high cost short term credit		■	■					
		UK: Possible Policy Statement on GAP insurance				■				
		UK: Policy Statement on Solvency II (not confirmed- working towards end of 2014)				■	■	■	■	
		UK: Transposition of 4th Money Laundering Directive into UK Law (HMT)	■	■	■	■	■	■	■	■
		UK: Immigration Bill to prohibit banks/building societies from opening current accounts for illegal immigrants comes into effect (Oct 2014)	■							
		UK: Policy Statement on client money rules insurance intermediaries review**				■				
		EU: European Central Bank (ECB) to assume its SSM (Single Supervision Mechanism) supervisory role (Nov 2014)	■	■		■				
2015	Q1	Global: Implementation (revised date) of IFRS 9 (Jan)	■	■	■	■	■	■	■	■
		EU: Solvency II transposition deadline (March 31)				■	■	■	■	
		UK: Policy Statement on Mortgage Credit Directive (March 2015)	■	■	■					
		EU: Implementation of Alternative Dispute Resolution (ARD) Directive (dependent on BIS)	■	■	■	■	■			
		UK: Policy Statement on new Payment Systems Regulations	■							
		UK: Implementation of price cap on the total cost of high-cost short-term credit			■					
	Q2	UK: Possible Policy Statement on implementation of package of General Insurance add-ons remedies				■				
		UK: Workplace Pensions Reform: Independent Governance Committees (IGCs) embedded in FCA rules (by April 2015)					■			
	Q3	UK: Policy Statement on Capital requirements for Personal Investment firms (PIFs)					■			
	Q4	EU: Possible entry into force of PRIPs regulation	■			■	■			
		EU: Possible implementation of revised market abuse regulation						■		■
		EU: Possible implementation of UCITS V					■	■		
		UK: Implementation of ILAS regime	■	■	■					
		UK: Implementation of licensing and senior persons regime (replacement of approved persons regime)	■	■	■	■	■	■	■	■
		EU: Review of the Electronic Money Directive	■							
2016		EU: Implementation for Solvency II regime (1 Jan 2016)				■	■	■	■	
		EU: Implementation of Mortgage Credit Directive (early 2016)		■						
		EU: Possible implementation of revised MiFID/MiFIR (end 2016)					■	■		■
		EU: Possible implementation of Payment Accounts Directive	■							
		EU: Possible implementation of Payment Services Directive (PSD2)	■							
		EU: Possible implementation of IMD2				■	■		■	
		EU: IAIS to develop risk-based global insurance capital standard (ICS) within ComFrame, with full implementation scheduled to start in 2019.				■	■		■	
2018		EU: Proposed implementation of NSFR (part of CRD IV) (Jan)	■	■	■		■	■		
		UK: Full implementation of pensions auto-enrolment					■		■	■
2019		UK: FCA to carry out a formal review of the impact of MMR implementation (by April 2019)		■						
		UK: FCA to undertake a post-implementation review of the consumer credit regime (TBC) and retained parts of the CCA (by 2019)		■	■					
		Global: Full implementation of CRD IV liquidity coverage ratio (Jan 2019)	■	■	■		■	■		
Other		EU: Legislative proposals on UCITS VI : no date					■	■		

* Some elements will be consulted on in the near term, with others in due course

** Amended on 1 May 2014

Part B

The evolving risk landscape

Part A Drivers of risk

Part B The evolving risk landscape

Chapter 1
Underlying drivers of risk

Chapter 2
Environmental developments

Chapter 3
Cross-market pressures and related risks

Chapter 4
Forward-looking areas of focus

Conclusion

This section sets out a range of risks to our objectives. Conduct and prudential risks can manifest themselves in a number of different ways, but are often driven by the same underlying issues – *Drivers of risk* – set out in Part A.

In Chapter 3 we first highlight risks that cut across financial markets. These include:

- Pressure on business model sustainability and strategies
- Continued pressure to balance profitability, shareholder returns, cost base and financial soundness with good consumer outcomes
- Misalignment of expectations with underlying fundamentals

We then draw out seven *Forward-looking Areas of Focus* in Chapter 4 – these are areas where we see significant risks approaching a tipping point, affecting a large number of people or where we have identified a potential need for intervention.

Our approach for dealing with these *Forward-looking Areas of Focus* will be developed over time, as their nature and specific market impacts become more apparent. Work to mitigate these risks may require not only regulatory actions, but also actions from firms and consumers.

3.

Cross-market pressures and related risks

This year, we look at how changing environmental conditions have interacted with the underlying consumer and market issues outlined in Chapter 1 and how these drivers of risk combined, put pressure on firms and consumers. We look again at how these overarching pressures, affecting firms and consumers across markets, could create significant risks in the future to consumer protection, market integrity and effective competition.

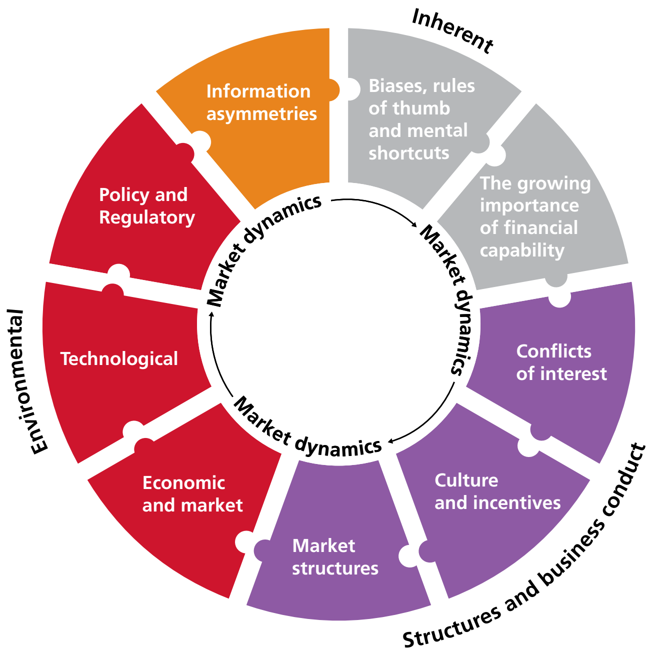
While the broad pressures at play are consistent with those identified last year, their nature may have changed due to environmental developments. As we explore further the interplay between these risks and our objectives there may be further evidence of where these factors may be affecting effective competition.

The areas we will be looking at are:

- Pressure on business model sustainability and strategies
- Continued pressure to balance profitability, shareholder returns, cost base and financial soundness with good consumer outcomes
- Misalignment of expectations with underlying fundamentals

3.1 Pressure on business model sustainability and strategies

Drivers of pressure on business models sustainability and strategies



We focus on where firms may be projecting growth in areas where expectations do not align with the market fundamentals. We highlight where these expectations are placing pressure on the ability for firms to deliver their strategies in a way that supports consumer interests, or where necessary adjustments could lead to increased risks. The acute and protracted nature of today's challenges increase the possibility that the way in which firms react and adjust to the changing environment could increase risks to consumer and market outcomes.

Firms are constantly adapting their business models and strategies to respond their operating environment

As the environment starts to show signs of recovery, there are some areas of the market where profitability pressures, combined with an increased appetite for risk, could lead firms to move into new financial markets, products or services.

and competitive dynamics, balancing new initiatives and attracting new business, with managing existing customers and the impact of past business decisions. A combination of long running trends, market dynamics and external conditions (which, for some firms, has lowered profitability and reduced business volumes at a time of significant operational pressure, fragile financial performance and high levels of regulatory change) have reduced margins and profits for many financial service firms. Despite improvements in the outlook over the last year some firms have found their strategies for growth in their core markets unsustainable.

Where firms have made adjustments to their business models, strategies and cost controls, changes could create risks to our objectives. In particular where they have not been supported by investment in control systems, or when risk management or governance become unsuited to new levels of complexity, activities or technologies. These risks may crystallise as the outlook starts to improve.

The prolonged pressure on business models in the post-crisis period has led to increased differentiation between businesses viewed as sustainable (where they have been able to use relative prudential strength or competitive advantage to restructure businesses towards more sustainable models) and strategies that are struggling to adapt to post-crisis conditions. For example, long-running low returns and falling volatility in financial markets have contributed to reduced margins in core wholesale activities and have been a key driver of firms' (reassessment of their) business models, trading strategies and cost bases.

Where firms are unable to adapt to the new environment, there could be further consolidation that could affect competition in some markets. For example, the dynamics of competition, consolidation and integration are changing stock exchanges, CCPs and multi-trading facilities (MTFs) due to pressure on business models and regulation initiatives.

As the environment starts to show signs of recovery, there are some areas of the market where profitability pressures, combined with an increased appetite for risk, could lead firms to move into new financial markets, products or services. Such movement could encourage firms to grow who are able to act as challengers in areas where there are already well-established firms operating. New and innovative business models may also be developed, increasing competition and delivering better value products and services for consumers. Where firms do not have the experience, management or oversight, risks to our objectives could emerge. Changing market structures may also affect the viability of firms' business models (as discussed in chapter 2.3).

It might be difficult for firms' senior management to fully assess the collective implications that prudential and conduct regulations will have on their business models and strategies. This could lead to ill-considered short-term decisions and fixes to support their strategy.

Specific developments and issues include:

Environmental conditions affect firms' ability to make profits from their core products and business lines.
This may encourage firms to undertake practices or seek strategies which pose risks to our objectives. (Consumer protection, market integrity, effective competition)

- ***Firms may adopt strategies to the detriment of consumers' outcomes.***

Firms that look to protect market share may move into new product lines, geographical locations or consumer groups, adopt practices or standards, to the detriment of consumers' outcomes or their financial crime responsibilities.

Firms may also move outside their core competencies and areas of expertise to take advantage of perceived areas of growth (potentially moving into niche markets or source income outside the regulatory perimeter). While new entry into other markets may encourage competition, it could also stress governance and oversight or lead firms to pursue growth strategies which ignore potential financial crime issues associated with their proposed plans. Examples of markets where we are observing potential changes include:

Credit unions

The credit unions sector continues to grow and attract new entrants that intend to operate on a larger scale. If they have unrealistic growth expectations for their core businesses, individual credit unions may begin offering more sophisticated products, such as ISAs and current accounts, before they are ready, or lend to less credit-worthy customers who would otherwise be reliant on high-cost credit.

Credit unions are a useful model and in some cases may provide a viable alternative to consumer credit lenders by offering loans, mostly direct to borrowers, with an interest rate that does not exceed the statutory cap (3% per month in Great Britain from 1 April 2014). However, credit unions do not have the resources or infrastructure to offer loans on the speed or scale of well-established consumer credit lenders such as payday lenders. Credit union legislation also provides for restrictions on the proportion of the balance sheet which can be used for lending which is often a key consideration for new entrants in determining their structure and business model. Where credit unions are expanding into these areas without expertise or appropriate governance, risks to consumer protection could emerge.

Mortgage lenders

As a result of funding and profit pressure, building societies and other smaller lenders may be driven into lending practices (non-mainstream, less traditional products with higher risk characteristics), where they may not have adequate experience, expertise or management oversight (at the stages of product design, underwriting or distribution).

Some lenders, looking to move into niche lending, markets and geographical areas where they have little experience, are becoming increasingly reliant on the use of intermediaries and mortgage packages to distribute loans. Without effective oversight or controls, these distribution channels could drive risks to consumer protection and financial crime. Lenders using intermediaries could expose themselves to poor practices where intermediaries may accept business from unregulated introducers they are not familiar with and that operate in different parts of the country. It is important that intermediaries know their consumers and therefore any relationships with introducers need to be tightly controlled.

Where lenders are looking to maintain market share in an appreciating housing market, underwriting standards could start to slip. As economic and funding conditions start to show signs of improvement, lenders could gradually loosen underwriting standards to maintain a share of the growing market, for example through term extensions, or by adjusting affordability criteria, to increase their share of the market.

The profitability of mortgage books is cyclical – resulting in front and back-books of mortgages being cross-subsidised over time. In current conditions, many front books are more competitive than back-books, which hold tranches of existing consumers on high spreads to LIBOR or base rate. Under these conditions, firms may look to target existing consumers with additional products (which they may not need) or alter terms and conditions (potentially offering different SVRs) to make them more profitable. Where firms target consumers holding non mainstream products with higher SVRs, for example shared equity, consumers may face barriers to switching because only a few providers in the market are offering any alternatives.

Wholesale markets

Prudential pressures on wholesale banks is resulting in an increasing focus on strategies to generate revenues from less capital intensive products and activities, and to improve capital utilisation and efficiency. This may see an increase in strategies directed at more agency and low touch execution business across asset classes.

With capital efficiency initiatives comes an increase in risks from regulatory arbitrage and optimisation. This could have a particular bearing on interactions between banking and shadow banking sub-sectors. Increased innovation in risk transfer trades could deliver better capital treatment for banks but lead to more risks being transferred to sectors – such as hedge funds – less equipped to manage such risks. Although some risk transfer is beneficial, as it spreads risks across the financial system, some shadow banking activities sit outside the regulatory perimeter and challenge our ability to oversee and monitor the management of these risks.[23]

Firms will continue to revisit business propositions, with new innovative fee structures and bundling of different products, activities and ancillary services, as the long-term low interest rate environment continues (for example, the monetisation and payment of bundled research and execution services).

The number of trading venues has been growing, with new entrants offering increased diversity in

23 Ongoing work by the FPC aims to identify and manage potential systemic risks arising from shadow banking and enhance these markets to support the development of diverse and resilient market-based finance.

Firms may move outside their core competencies and area of expertise to take advantage of perceived areas of growth.

product and operating model in an attempt to capture volume from established regulated markets. This risks a fragmentation of liquidity and increased opportunity for market manipulation across venues. The G20-driven pressures to reduce systemic risks from OTC trading has led to a movement of some commodity volume towards more transparent trading platforms and clearing houses, making previously opaque activity more visible to risk oversight.

In commodity derivative markets, there has been a trend towards non-bank entities taking a more prominent role at the expense of banks. This may continue into the future with non-bank entities able to leverage less stringent capital requirements and operate without enforced remuneration restrictions.

While investor activity in commodities has levelled and even declined over the last two years, if the low interest rate environment persists beyond expectations, investors could search for yield in other alternative asset classes. This could make market commodity derivatives an attractive asset class for consumers once again. A sudden unexpected pick up in prices and volatility from the relative stability we have seen, or changes to the term structure of the forward curve, could also bring investors back.

Investment banks

Where investment banks are suffering from declining income, they may be looking to move into other areas where Return-on-Equity can be higher, for example from trading into wealth management. This can result in selling inappropriate products or using undue incentives, facilitated by providers. These providers, such as platforms, may not take their responsibilities to end-consumers into account properly when facilitating the sale of these products. This could lead to poor consumer outcomes when they purchase complex financial products via a platform, without fully understanding the risks due to the way in which they are presented. For example products such as Constant Proportion Portfolio Insurance (CPPI) are particularly complex and include a counterparty risk that is not obvious to the end consumer – the costs, benefits and risks of this product may be difficult to understand and lack transparency.

Life insurance companies

Life insurance companies, who traditionally ran an intermediated model, are now looking to enter the direct market, increasing direct consumer offerings. Many insurers have had direct-to-consumer sales forces for a long time. Recently, as part of firms' diversifying distribution methods strategy, firms are making greater use of multi-channel distribution, including expanding the use of direct-to-consumer sales. This trend is in part due to the impacts of RDR on the distribution market – the number of financial advisers has reduced slightly due to the exit of retail banks from mass-market advice – and lower numbers of new intermediated advisers entering the market.

Employee benefit consultants

In response to auto enrolment, firms are now establishing their own trust based pension schemes, moving away from their previously limited financial services that were around providing advice. If not managed effectively (although outside the regulatory perimeter) this could create risks to consumer protection.

- ***Firms extract value through hidden costs and sale of low utility products***

Some consumers may face hidden costs or be sold products or services with low utility, as firms look for ways to extract value from (potentially unprofitable) existing consumers and distribution strategies. This could lead to:

Hidden fees and charges

Firms may offer products or services to generate revenue that have hidden fees and charges or admin fees, for example, on the renewal of motor insurance, or apply drip pricing – where firms advertise a price that does not reflect the final price of a product or service. Market participants may also look to lengthen the intermediation chain to gain fees. Concerns about charging practices and opacity have also been identified between wholesale participants, leading to an increased focus on bundled pricing arrangements. For example:

- o Trading firms, where an increasing proportion of trading volumes is generated by participants who, without necessarily having the status of market intermediaries, effectively act as such and tend to lengthen the intermediation chain between end investors and increase market opacity.

- o Debt management companies whose fees aren't clear to the consumer. Consumers may be unclear how much of what they are paying is going to creditors lead generators selling leads to debt management providers, high-cost short-term credit providers and claim management companies, all of which drive up costs for consumers (e.g. companies' fees being leading to little of the consumer's payment going to creditors which can lead to plans failing, leaving consumer in a worse situation).

Selling non-core products

Targeting consumers with non-core products they do not need to improve profitability particularly occurs where firms have large cash generative with-profits back-books (e.g. with general insurance add-ons). Where firms are struggling to maintain profits on core products they could also encourage consumers to purchase more profitable products or services that may not be in the consumer's best interest.

Vertical integration

Some financial advice networks are looking to move more to a vertically integrated model where they are also offering the funds their clients invest in. In such cases the investment management can be very profitable, but it might not be sufficiently clear to the consumer what they are paying for.

- ***Firms may focus on desirable business leading to reduced access for some consumer groups***

Firms' strategies are likely to focus on more profitable business or consumers, or withdrawing from non-profit making markets, products or service features e.g. current account market. This could potentially reduce access for some consumer groups. Where more providers are able to target the profitable, core business lines (e.g. 'vanilla' mortgage costumers), other firms may find themselves pushed into niche areas or moving towards more risky products or consumer groups who are no longer serviced by mainstream providers. Where current and projected conditions (economic and regulatory) challenge the viability and competitiveness of some business lines, firms may need to adjust.

> Consumers may be left with limited choice of provider that may be opportunistically filling gaps created in the market by firms' response to withdraw from offering some products or servicing consumer groups.

Firms unable to compete for preferred consumer groups or adjust products to meet the needs of consumers in the regulated market – may become increasingly reliant on non-regulated activities. This could lead to perimeter issues where consumers are unclear of the boundary between regulated and non-regulated services. Regulatory changes may cause firms to re-evaluate where they focus their strategies or cause investors to move out of areas where they see risks to the future security of returns. In such cases, firms may exit the market altogether or look to consolidate with other market participants – potentially reducing competitive dynamics. Firms facing reduced profitability could be willing to seek or retain highly profitable projects or customers even where there are known risks, for example, potential money laundering.

Reduced access

As firms rationalise offerings and move away from risky or lower-profit consumer segments or product and service areas, some consumers may face reduced choice. They could be left with limited choice of providers that may be operating outside their expertise and knowledge, opportunistically filling gaps created in the market caused by this rationalisation.

Firms may apply strategies where they become more selective about who has access to services or look to change terms of business of products or services that are no longer profitable. These changed terms could lead to consumer detriment. For example, where firms move out of specialist products, consumers will be left with reduced access to the market and potentially limited choice of alternative providers.

Cross-subsidisation of activities

Firms' strategies may link, or 'bundle', services together that result in cross-subsidisation. The custody and fund administration markets are made up of a mix of lower margin, more commoditised core activities and some higher margin, or value added, services such as foreign exchange and securities lending. Historically many firms have focussed on profitability by client rather than by service resulting in an implicit cross-subsidisation across products. This may suit some consumers but for others this may result in certain products not being provided on a standalone basis because they would be unprofitable at prevailing rates. This may hinder competition in the sector as consumers are limited in their ability to 'pick-and-choose' services from different providers, and overall product offerings might be hard to compare. This effect is accentuated by the logistical difficulties in changing service supplier.

SIPP operators

Competitive pressure and proposed increased capital requirements will likely lead to a decrease in the number of SIPP operators in the market. Larger providers may only wish to purchase parts of the books of the firms leaving the market. This could lead to a consumer needing to find a new provider to transfer to, or to schemes going into wind-down.

Consumer credit

The transfer of regulatory responsibilities for the consumer credit industry from the Office of Fair Trading (OFT) to the FCA and the new rules in this field may cause some smaller firms to exit the debt management market, due to the anticipated increase in regulatory burden. This may increase standards in the market.

As the consumer credit regime becomes embedded firms could look to second guess the regulatory approach and adapt to regulation which inhibits current practices. Forthcoming regulation, for example the new policy rules in payday lending, could lead to the creation of new products to avoid rules or to online firms moving outside the UK to be outside our regulatory perimeter.

Changes to retail advice markets

Withdrawal from the mass advice market by larger firms could lead to reduced use of advice by some consumers and increasing growth in execution-only sales, potentially across more complex products which may be less suitable for this distribution channel. Withdrawal from the advice market by some firms has placed increased reliance on intermediary firms to fill this gap. This move has resulted in innovation which should improve outcomes for consumers by reducing costs, for example alternative distribution models use 'guided non-advice' which is being driven by technology. Consumers seeking advice may be unable to distinguish between guidance for non-advised online sales and advice, believing they are getting a recommendation from general information on the website. In addition, firms changing advice models may not adjust their disclosure to ensure appropriate delivering of advice.

Consumers opting for self-advised products – where they are unable to distinguish between regulated and un-regulated products – potentially make misinformed decisions and purchase products that are outside our regulatory perimeter.

- ***New capital requirements may cause firms to move out of assets***

Firms that cannot attract capital needed under new and stricter capital requirements are likely to review their business models and balance sheet structure to reduce risk weighted asset (RWAs) and move out of assets that have high capital requirements. This could potentially lead to a withdrawal from some more complex products and greater concentration of such products among a small group of firms.

As highlighted earlier there is also the risk of increased reliance on regulatory arbitrage and optimisation to compete more effectively. Firms are beginning to develop innovative hybrid instruments (that convert to equity under stress with the potential to suspend coupon payments) that are eligible for regulatory capital purposes under CRD IV as 'Alternative Tier 1' regulatory capital. These instruments have risk and return profiles that can be difficult for investors to model or predict. There is a risk they could be distributed too widely or, via a 'captive placement' to consumers of the financial institution originating them. This may lead to consumers holding instruments that the market could perceive to be worthless under stressed conditions.

New collateral requirements
There may be a mismatch between firms' governance and oversight arrangements if these are not adjusted to suit new funding structures and collateral arrangements. Collateral needs (arising from post-crisis regulatory capital and margin requirements) could cause a shift into alternative asset classes e.g. commodities in a low interest rate environment, which could bolster financialisation of commodities.[24] The resulting increased liquidity in commodity markets to meet investment and collateralisation needs could increase the correlation between commodity and other markets. This potentially accelerates price distortion through copycat behaviours that is disconnected from market fundamentals.

Firms funding options may drive their strategy and cause poor practices

Firms looking for ways to fund themselves may opt for funding which ultimately drives their strategy, services and product offerings in ways that may not be in consumers' best interests or support market integrity. (Consumer protection, market integrity)

- ***Funding pressure remains a challenge for lenders***

As the effects of the withdrawal of the FLS starts to affect their ability to lend, some lenders could be left with a funding gap and searching to attract more retail deposits. Some could potentially use incentive rates or offering exotic savings products to attract new deposits where the risks may not be fully understood by sales staff or the end consumer.

As markets continue to improve it could boost the revival of securitisation markets, potentially resulting in lenders' product offerings and pricing being driven by investor appetite rather than consumer interests. Where securitisations cater for investor demand for specific features over consumer needs, consumers who are unable to switch providers due to unique product features may be locked in to a product that does not offer good value. Our work on structured notes highlights that product features often are demand-led, based on enquiries from asset managers looking for higher yielding investments.[25] Increased supply of such investment and funding products would need to be subject to oversight over suitability and appropriateness issues as well as clarity on the duties and responsibilities of issuers (banks) and distributors (asset managers and IFAs).

Firms looking for ways to fund themselves may opt for funding which ultimately drives their strategy, services and product offerings in ways that may not be in consumers' best interests or support market integrity.

- ***Retaining or broadening existing funding sources beyond sustainable levels***

Firms seeking to attract funding could retain or broaden existing sources beyond sustainable levels. Others may opt for higher risk funding sources or more complex structures, raising risks to market integrity and consumer protection.

Firms may also be increasingly driven by the needs of cash rich investors looking for quick returns on long-term investments rather than the long-term interests of their customers. For example, debt financing driving cash generative business in general insurance intermediaries to service these debts, could lead to a misalignment of interests when the desire to deliver a positive return on capital in challenging markets ultimately leads to poor customer outcomes.

- ***Growing demand for public funding***

With growing demand from corporates accessing financial markets through initial public offerings (IPOs), after a period of relatively low activity and growing expectations for issuance to continue, underwriting and advisory expertise will be in growing demand. Where firms expanding into underwriting activities to meet new demand do not employ expertise and controls around new activities, this could lead to poor practices. A resurgence of demand emphasises the importance of firms taking appropriate steps to secure investor protection through adherence to disclosure and other relevant regulatory requirements.

Corporates could disintermediate to a greater extent and launch IPOs directly via private placements, which may lead to reduced transparency and poorer investment outcomes. In turn, non-bank credit intermediation may rise for start-up businesses, disguising credit risk to investors in high-yielding investments.

24 Financialisation refers to the process by which financial market participants contributed to commodities price volatility

25 More information on structured notes can be found on our website.

Sustainability of firms' strategies and profits are undermined by a misalignment of underlying performance of markets with growth expectations
(Consumer protection, effective competition)

- ***Overconfidence in future conditions***

Funding sources and structures or growth strategies and profitability or market share based on overconfidence in future conditions could lead to weak oversight or operations outside areas of competence.

For example:

- o New entrants focused on gaining market share in core markets may have unrealistic growth prospects, given they will not benefit from the economies of scale enjoyed by their competitors. When this is the case and new entrants could find themselves unable to compete, they could be forced instead to move outside their core expertise.

- o Firms may take a cyclical and not structural approach to business strategies – for example by expanding into business areas that they have previously exited due to overly optimistic growth estimates, but because of improved market conditions, are now again viewed as profitable. This is a particular concern where firms do not have the core competencies to execute this expansion strategy effectively.

- o Where firms are unable to meet unrealistic profit targets they may look for further short-term cost-cutting strategies to increase efficiency. These cost-cutting strategies may also have an impact on firms' controls environment and in some cases further efficiency gains may not lead to effective service, for example automated helplines or less staff in offices, causing poor outcomes for consumers and increasing market integrity issues.

- ***Risks around low interest rate environment***

Financial products and services may be priced according to current market perceptions – supported by extraordinary monetary and policy measures – rather than underlying fundamentals, or misleading benchmarks, which could cause consumers taking on more risks than they realise.

For example:

- o In the search for yield, less sophisticated investors have been buying corporate bonds in smaller denominations. These smaller denominations make them accessible to consumers despite their risk profile, and the relevant market disclosures, not being appropriately calibrated for them.

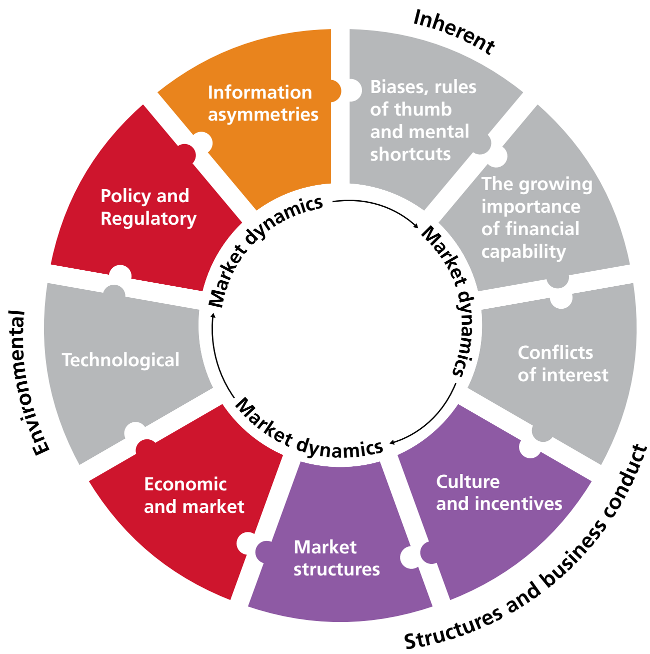
- o The current growth in house prices may be driving lenders and consumers to accept risks and debt levels that may be unsustainable in the long term particularly when interest rates start to rise.

- o Firms may face mispricing risks where benchmarks have been manipulated or confidence in price formation affected by reputational damage.

- o The re-emergence of securitisation as a funding model could also re-create challenges to appropriately pricing or valuing assets, particularly during the transition to normalised policy measures and funding conditions.

3.2 Continued pressure to balance profitability, shareholder returns, cost base and financial soundness with good consumer outcomes

Drivers of pressure to balance profitability shareholder returns cost base and financial soundness with good consumer outcomes



This section looks at where the need to respond to profitability, shareholder and cost base pressure could lead to firms adopting strategies which may create risks to consumer protection, market integrity and effective competition, if they are not carried out with appropriate governance and controls. Prudential stress driven by external factors can cause the behaviour of firms to result in outcomes that are not in line with our objectives.

While firms pursue strategies to balance profitability and prudential soundness, with the general demands of competition and consumer outcomes; these strategies may increase the risk of unfair consumer treatment and, for some, may limit their choice of provider. Under the current outlook, short-term fixes and strategies may not be appropriate or sustainable over the longer term, and examples of where cost-cutting strategies have been poorly managed may start to crystallize. Alternatively, areas that have faced cost-cutting strategies may no longer be able to support anticipated business volumes, which could lead to weaknesses in the pre and post-sales processes. More profitable initiatives targeting consumers may be driven by poor conduct terms which, although may deliver profits, could also result in poor consumer outcomes.

Balancing profitability, shareholder returns, cost base and prudential soundness with competition and good consumer outcomes can be challenging for firms.

Specific developments and issues include:

Firms may adopt strategies that support their own prudential soundness but are not in consumer interest
Firms' strategies for prudential soundness and market capitalisation may not be in the long-term interests of their consumers or the reputation of their business. (Consumer protection, market integrity)

- ***Implications of short-term cost-cutting strategies crystalize as demand starts to grow***

In the past, many firms opted for short-term and expedient fixes to support profits and deliver (in many cases) on shareholder expectations and offset falling profits. Cost-cutting that increases efficiency can often benefit consumers. However, after several years of challenging operating conditions, a prolonged strategy of cost-cutting increases the risk that customer-facing services may not be fit for purpose and that operational functionality is compromised and could lead to risky behaviours and poor practices. Business areas with low levels of investment and expertise could be left ill-prepared for anticipated demand in the period of recovery, leaving firms overstretched as demand starts to pick up.

- ***Poor management of firms' back-book***

Firms' back-book strategy to support profitability could lead to poor consumer outcomes, particularly where these do not reflect a change in consumers' underlying risk profile or circumstances. For example:

o As interest rates start to rise, the increasing carry cost of forbearance for firms may lead to a sudden change in strategy. Exit strategies for consumers who are unable to cure their position should ensure fair treatment.

o Implementation of strategies to mitigate claims' leakage – limiting the volumes of claims by discouraging claimants. For example, making claims processes over complicated which could cause legitimate claimants to be treated unfairly.

Firms' drive to improve efficiency, reduce costs and appeal to consumers' preferences could lead to the adoption of technology that is not supported by adequate systems, controls and expertise that is needed.

- Long standing consumers of workplace pensions may be in schemes that offer 'poor value for money' for those consumers.

- Transition of books of legacy investment advice clients to platforms may trigger changes to terms, costs and investment availability. It is important customers are treated fairly in these transfers (for example, consumers having enough time to understand all the price changes before they are implemented).

- Insurers change their claims handling approach as they enter run-off.

- ***Firms' forbearance strategies may not be in the long-term interests of consumers***

Whilst long-term forbearance may be in the best interests of some consumers, the implicit cost of forbearance (fees, charges and accrued interest) may outweigh the benefits of staying in the home for others. As the outlook improves and firms start to repossess loans, potentially disproportionate costs may become evident where consumers are unable to cure.

The adoption of technology may not be supported by adequate systems, controls or expertise

Firms' drive to improve efficiency, reduce costs and appeal to consumers' preferences could lead to the adoption of technology that is not supported by the adequate systems, controls and expertise that is needed. *(Consumer protection, market integrity, effective competition)*

- ***Increased use of online and mobile platforms***

The reduced accessibility of financial services due to increased use of digital platforms could leave consumers more susceptible to financial crime, and firms facing increasing costs.

Breach or theft of personal information, fraud or scams could lead to loss of privacy and costs for consumers and firms if they do not understand how to protect themselves. Firms suffering high costs from breaches and theft could pass these costs of enhancing data protection onto consumers through fees and charges or reduced interest rates.

- ***Insufficient spending on existing technology and oversight***

While investment in adopting technology could improve efficiency and costs over time, a lack of investment in ageing technology and software could weaken operational resilience and market integrity. This will leave firms struggling to meet consumer and regulatory demands. As the volume of digital and plastic transactions grow, the risk increases bridging applications, operational leverage and manual work-arounds create problems if investment in maintenance is not sustained. Additionally, firms with a global footprint, or with a large number of disparate legacy IT systems, may struggle to apply anti-money laundering (AML) systems and controls consistently across the group.

- Large firms who have undergone mergers, innovation of new products (which may not be supported by existing technology), or geographical expansion, may not have the expertise or oversight to ensure technological resilience – particularly where mergers have required adoption of acquired firms' existing technology.

- Compatibility and resilience issues could arise from firms linking legacy systems to 'new' systems to improve consumer access to online and mobile platforms. For example, there may be challenges aligning consumer data, information and online services, which could lead to inaccurate information being presented to consumers through different platforms. Also, outsourcing life insurance and pension firms operate with many legacy systems, and where an outsource provider takes on the maintenance of this business they will have to either continue using these systems or migrate the business to their own system.

- o Firms that rely on an old IT infrastructure where changes and support are difficult or impossible may create a risk to market integrity. If the system were to fail it could prove difficult to resurrect and take a long time to replace, impacting the firms' activities. Firms which have emerged from numerous mergers may have delayed or abandoned key IT projects because of prudential pressures. Consolidation may have led to IT systems being 'bolted together' leading to concerns about the efficacy and robustness of such arrangements. 'Short-term quick fixes' can quickly become 'long-term solutions' embedded in business model and delivering poor services for consumers.

- ***The use of Big Data without appropriate controls and governance***

Using Big Data could improve insight into consumers' preferences and behaviours and create a competitive edge – enabling more targeted campaigns and prices or more tailored financial planning tools and advice. Where firms do not develop suitable controls (validation and storage) around technologies that use Big Data to build intelligence and to inform decisions around pricing and access to product, there could be reputational risks and issues around consumer sensitivity to the use of personal information. This could create access issues for consumers classified as undesirable once information on consumer finances are pulled together.

- ***Increasing reliance on technology could reduce some consumers' access***

Firms that adopt technology to improve efficiency and engage with consumers in financial services may increasingly fail to meet the needs of certain consumer groups (e.g. within certain age groups or regions) who do not have access to computers or who are not computer literate. Similarly, firms may not be adequately considering the needs of different consumer groups in developing and marketing digital banking and payment services, which could lead to poor outcomes for certain consumer groups.

Firms could move more activities to digital tools, developing current technology to encourage out-of-branch banking and automated in branch consumer services to reduce costs. As firms move to delivering information online, consumers may be even less inclined to read information than they were when they had a physical document. While the shift to online and mobile financial services is making financial dealings easier for a vast number of consumers, the move is likely to lead to reduced access for those consumers who do not or cannot access or use the internet.

In wholesale markets, the development of proprietary technology platforms or execution arrangements to facilitate trading activity enables firms to exploit execution latency or a lack of available price transparency and can result in either direct client detriment or undermine wider market integrity. Market models may put participants at risk of poor execution quality, particularly where they are 'captive traders' and are unable to switch their business to competitors because the financial instruments in which they are trading are not fungible.

Firms plans to mitigate the risk and or consequences of firm failure may not include adequate consideration of conduct implications
Dual-regulated firms, which are subject to the PRA's recovery and resolution planning (RRP) framework, and FCA solo-regulated firms, that are expected to have wind-down plans, may fail to incorporate adequate consideration of our consumer protection and market integrity objectives.
(Consumer protection)

- ***Consumer at the heart in times of financial distress***

Recovery plans developed by firms may not always lead to the best outcomes for consumers. Firms may focus on actions to mitigate financial loss or damage to their financial performance, solvency or financial resources, without also considering actions to mitigate potential consumer detriment.

Firms may fail to demonstrate effective consideration and management of the potential non-financial loss or detriment that may be generated by their business model, strategy, culture, operations and prudential health. They may not consider any potential inter-connection between prudential and conduct-related impacts and events, for example. the potential for a financial loss to trigger undesirable consequences for consumers and other key market participants (and vice versa).

- ***Terms and conditions in times of financial distress***

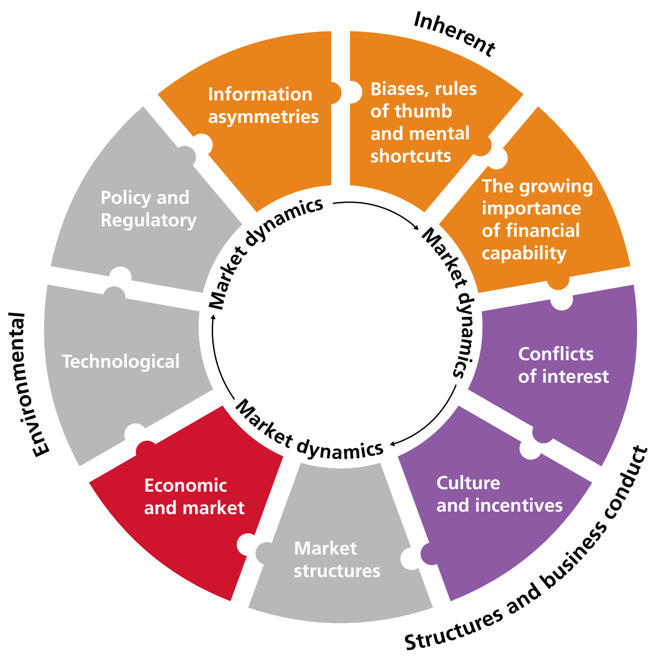
When a firm is in financial distress it may introduce changes to the terms and conditions of its products and services. This may mean that products consumers hold are no longer viable, for example, mortgage borrowers may be subject to terms or pricing that are unsuitable or unaffordable.

Firms may also sell parts of their books to ensure consumers continue to be serviced. However, this may result in a risk to consumer protection where, for example, firms acquiring the book do not have the expertise to manage this business in a way that treats consumers fairly (e.g. poor arrears handling).

During the period of transition to normalised interest rates consumers and firms may be slow to respond to changes and adjust future expectations.

3.3. Misalignment of expectations with underlying fundamentals

Drivers of misalignment of expectations with underlying fundamentals



This section captures the challenges consumers and firms face in making financial decisions due to expectations that are not aligned to underlying fundamentals. This could lead to financial decisions being based on ill-informed risk assessments, particularly where they are influenced by the underlying consumer and market characteristics or environmental conditions, set out in Chapters 1 and 2.

Low real returns continue to challenge consumers' ability to grow their wealth and asset holdings. Growth expectations for some better performing markets in the near term may be over-optimistic and lead to mispricing of risk. Market participants may be underestimating potential downside risks or prospects of weaker future performance.

After the long period of adverse economic conditions, recent improvements in the environment are likely to fuel consumers and firms focus on the short-term and overconfidence, which could lead them to mis-assess the risks they are taking on.

The appropriateness of consumer choices continues to be challenged by understanding risk and return

Consumer choices continue to be challenged by their understanding of risk and return and their search for yield in the low interest rate environment.
(Consumer protection, effective competition)

- ***High yield product availability and uptake***

In response to a long period of low returns, signs of improvement in the economy could leave consumers seeking quick returns on savings to balance the long period of poor returns. Consumers may be quick to move towards higher yielding products that reflect their optimism at an improved outlook may be exposed to risks that are not fully understood (particularly where advice is not being sought). Particularly in products that sit outside the regulatory perimeter. SIPPS are an example of where consumers' search for higher yielding assets has led to an increase in more risky investments in SIPP wrappers. This remains a concern as the economy starts to show signs of recovery and consumers anticipate higher returns.

- ***Long term investment***

Consumers may be opting for riskier accumulation and decumulation options, without fully understanding the related risks. For example, riskier investments sought in the hope of better returns, or income drawdowns and increased exposure to alternative (potentially non-regulated) funds.

In an increasingly digitalized age, which is enabling consumers to exercise more direct management of financial products, and in the period of adjustment to RDR, consumers may be unclear about whether they need guidance or whether they need regulated advice when making financial decisions. Due to present bias and lack of engagement and understanding of their long-term savings, consumers may, in the absence of access to appropriate guidance, make sub-optimal decisions when planning for their long-term needs. In addition, consumers may be drawn towards unregulated options (e.g. pension liberation).

Commission is still allowed for non-advised sales. Consequently, where consumers are buying an annuity without advice they may still be charged a percentage of their pension pot as commission. This is a charge they may not be fully aware of and it could work out as comparable to the cost of purchasing advice.

- ***Overconfidence and short-termism***

Overconfidence and short-termism leads to stretched affordability in anticipation of better times. Consumer and firms could be stretching affordability of mortgages and other debts in anticipation of continued price growth. For example, despite house prices being elevated relative to incomes and rents, consumers and firms continue to stretch loan affordability through higher loan-to-income and term features. This could create future pressures for consumers, particularly as interest rates start to normalise.

In consumer credit, an improving economic outlook is likely to increase borrower confidence in their ability to manage debt. This, combined with continuing squeeze on household incomes and the changes to welfare payments, reducing income or making it more difficult to manage, is likely to drive increase demand for credit, particularly among consumers more affected by these changes. This could lead to consumers overstretching themselves financially with debt. Consumers making decisions in the short-term in the hope that finances will improve in the future – may take on more short-term credit rather than opting for long-term options, which would be repaid over a more realistic timeframe and could be available at a better rate.

The prolonged period of low interest rates becomes entrenched and adjustment to higher rates may be slow

During the period of transition to normalised interest rates consumers and firms may be slow to respond to changes and adjusted future expectations.
(Consumer protection, effective competition)

- ***Consumers may not be equipped to manage their budget effectively***

Consumers who have become financially active during the crisis and economic downturn may have little or no experience of a normalised interest rate environment where interest rates can change frequently – particularly upwards. This could place pressure on debt-servicing costs or fuel a search for better rates where, due to a lack of experience, consumers may not consider other product features.

Consumers may not be equipped to manage their budget effectively under these conditions, or they do not align expectations with actual market developments, particularly where they have low financial capability or lack the knowledge of how to respond to changing costs. This could lead to decisions that may not be sustainable over the long-term.

- ***Firms' response may not be appropriate***

Consumers' ability to benefit from higher interest rates may be inhibited by a slow response by firms in passing on improvements in savings rates. Firms may also nudge consumers towards products which offer early fixes at higher interest rates on the back of consumer fears of rising interest rates.

Prudential soundness and risks

Prudential soundness should be aligned to, and support effective competition in markets, whilst sometimes, the balance with good conduct outcomes can be challenged by financial pressures. In this section we assess the current prudential challenges faced by our solo regulated firms and take account of the downside risks that could affect their prudential soundness and impact our objectives.[26]

We are the prudential regulator for at least 23,000 individual firms of many different types. Our prudential standards aim to reduce the risk of harm to consumers and markets by ensuring that firms responsibly manage their business.

Through our assessments of prudential soundness we seek to ensure that firms have enough financial resources freely available to cover any losses that they can reasonably expect to incur under normal and stressed conditions. In addition firms need to meet obligations as they fall due, including any that arise from compliance failures and the need to pay redress.

Our approach to prudential regulation

Our prudential approach for all FCA solo regulated firms is one that reduces harm to consumers and markets arising from financial strain and failure. The purpose of prudential supervision is therefore to support all of our objectives, consumer protection, market integrity and effective competition. Our prudential regulation is not focused on the likelihood of failure, but rather on the impact this may have on our objectives. Our approach starts from the principle that FCA solo regulated firms should be allowed to fail and our focus is on mitigating the impact of their failure and our objectives.

Prudential risks and our objectives

Many of the firms under our regulation have a small prudential impact; being very small or not holding client assets. Others are prudentially significant and play an important role in the functioning of markets and infrastructure and may have a large number of consumers. In aggregate, a number of firms with a small prudential impact could have a significant impact on the functioning of markets in which they are a key player. This could create risks to market integrity. We are accountable for the regulation of the risks that these firms pose to the financial system in aggregate.

Although the FCA does not prudentially regulate banks, many of the firms that the FCA does regulate play an important role in the provision of credit to the UK economy. For example, through their investment decisions about where to deploy managed funds, asset managers may increase or decrease the supply of credit to large corporate borrowers that issue bonds in the wholesale markets. Another example is non-bank consumer lenders that are taking an increasingly active role in lending to retail consumers. Non-bank consumer lenders are taking an increasingly active role in credit provision, see Figure 18.

If a firm with significant prudential impact were to fail, it may pose a risk to our objectives in a number of ways. Counterparty positions must be closed or unwound, client assets must be returned without unnecessary delay, and consumers must find alternative financial services providers. All of this has to take place in a relatively short period of time and with a tightly controlled stream of information to affected parties, including those in other jurisdictions. This places a great deal of pressure on management, people and systems.

Prudential risks can also be the result of more idiosyncratic or firm-specific factors such as poor financial management decisions or inadequate systems and controls. Some of these risks are discussed in more depth in Chapter 2.

Environmental conditions

Prudential risks can be caused by environmental conditions – economic, financial markets, policy and regulatory developments. Environmental conditions likely to impact the financial soundness of financial firms include the interest rate environment, squeezed balance sheets, the slow economic recovery, commodity price changes and potential stress on European sovereign debts. Changes in these conditions may affect the financial soundness of firms.

The latest version of the main European Directive governing prudential regulation, Capital Requirements Directive IV (CRD IV), came into effect on 1 January 2014 together with its supporting Regulation. It aims to

26 Comments on prudential soundness and prudential supervision in this section do not extend to dual-regulated firms entities that are subject to the PRA's prudential regime.

minimise the effect of firms failing by ensuring that they hold an appropriate amount of financial resources to cover the risks to which they are exposed. CRD IV increases the quality and the amount of capital that certain investment firms are required to hold and introduces an EU-wide liquidity regime that applies to some firms. We talk about these risks in more depth in Chapter 2.

Prudential risks

Changing business models and compliance with Threshold Condition 4

Threshold Condition 4 (TC4) is one of the five conditions that the FCA requires a firm to meet to become authorised to undertake any regulated activity. Under TC4, the FCA aims to ensure firms have adequate resources for the regulated activity they carry out or plan to carry out. This covers all types of resources, including financial resources, both in terms of quantity and quality.

Under TC4, firms demonstrate that they have adequate resources in place at the point in time at which a firm first starts to carry out its regulated business. On an ongoing basis, it is of great importance to assure that firms have enough financial resources to continue to carry on regulated business.

Over time, firms' business models develop, potentially increasing the universe of risks to which they are exposed and increasing their footprint against our objectives. The resources in place when a firm starts its business may no longer be adequate. Therefore, all firms need to be alert to the need for financial resources to match the changing nature of their business.

Planning for 'wind-down'

The impact from financial strain and failure of firms may cause a risk to consumer protection and market integrity. To constrain this impact, firms have to plan effectively to enable them to exit their regulated business without causing unnecessary loss or disruption. For FCA solo regulated firms these planning documents are an important tool to help firms and us to understand both the key issues to be managed during a firm's exit and the financial resources required to support the firm during the exit period. A good 'wind-down plan' will need to contain a detailed plan of how a firm would handle their own wind-down as well as a comprehensive stakeholder analysis, including the communication with consumer and the 'consumer journey' during the transaction.

All FCA solo regulated firms, particularly those that are prudentially significant, should consider in detail how they would manage their own exit. In the absence of a rulebook for wind-down, firms may not have adequate insight into the impact of their wind-down or develop effective plans including detailed analysis and documentation of key assumptions and dependencies, triggers for management action, and identification of viable options.

Shadow banking

Many non-bank financial institutions engage in some or all of the risk-taking activity normally associated with banks, such as providing credit directly to borrowers or maturity transformation, whereby short-date liabilities are invested in longer-dated assets. The many forms of this type of activity are sometimes described as 'shadow banking'.

Firms that we prudentially regulate are engaged in many forms of shadow banking:

- Investment firms with client assets permissions using non-segregated client assets as a source of cheap, ultra-short term funding from which to fund assets in much the same way that a bank leverages deposits to fund its loan book.
- Investment firms that provide market access, clearing and settlement services to clients engaging in 'margin financing', whereby clients are provided with short-term working capital loans to meet margin and collateral calls.
- Investment firms providing 'inventory financing' to clients in much the same way as banks provide trade finance loans.
- Investment firms that deal on own account buying and holding securities, particularly – though not only – illiquid bond positions. Illiquid bond positions that firms fail to periodically realise are economically the same as term loans.

- Asset managers providing a range of financial support to managed funds, typically in the forms of seed capital positions. Firms that engage in these and other more opaque or 'off balance sheet' activities may not fully understand the risks that all of these activities pose to their financial condition.

These activities could result in the inappropriate use of client assets, firms taking risks that are hidden which may damage individual firms and the wider economy and firms not holding adequate financial resources to support all types of risks, that would be required if capital standards did apply.

Operational risk

The failure of a firm to manage proactively its operational risks (i.e. risks due to inadequate or failed internal processes, people, systems or from external events), can result in material financial losses and can ultimately impact the financial soundness of the firm. Inadequate operational risk management can also lead to significant consumer detriment and or damage the integrity of UK financial markets. Recent examples of significant operational risk related incidents have included key systems failures, client money breaches, cyber-attacks, fraud and mis-selling.

In the absence of an effective risk management framework and a supportive culture, firms are unlikely to improve their ability to identify, capture, assess, monitor and mitigate consistently the operational risks and their conduct impacts that are inherent in their business model, strategy, activities, products and services. This includes firms whose approach to risk management does not provide senior management with a holistic, ongoing view of the firm's risk profile and performance relative to their Board's stated risk appetite, or encourage the timely and effective challenge of key decisions. Inadequate management of operational risk can lead to financial costs for firms which may impact their financial soundness.

Inadequate stress testing

Although the financial crisis exposed many shortcomings in risk management practices that have been documented thoroughly elsewhere (see for example the Turner Review, published by the FSA), the financial risk management profession has yet to undergo a 'paradigm shift' and it is still largely reliant on the same risk measurement techniques that prevailed before the crisis.

Firms that are not modelling their risk appropriately may not take large or infrequent risks under extreme but plausible conditions into account in their analysis. This may prevent them from understanding their capital requirements and could cause firms to be unprepared for adverse economic market conditions.

Firms often continue to base their internal capital allocation decisions only on Value at Risk (VaR) or similar statistical approaches. Use of these techniques should always be supported by thorough analysis of large or infrequent risks that are not easily predicted or explained by the statistical model. Commonly used supplementary methods include 'Stress VaR', expected shortfall analysis and, of course, stress and scenario testing.

Stress and scenario testing practices are an area that all firms need to continue to focus on improving. Sensitivity-based stress tests need to be severe enough to represent extreme but plausible conditions. Where stress test outputs assume that management will take defensive action to reduce the financial impact of the stress to the firm, there should be very limited allowance given for those actions and only where they are highly credible (for example, the actions have actually been taken in the recent past).

Reverse stress testing (RST) is a form of scenario testing that we require of many larger firms. An RST is meant to explore the impact of a stress scenario that is severe enough to push the firm to the point of business model failure. Depending on the nature of the firm's business and its own risk appetite this may be a condition of financial distress that is well before the point of insolvency (for example, an enduring failure to comply with minimum regulatory capital or liquidity requirements that constitutes a breach of TC4). Firms' RST scenarios that do not model this magnitude of event and present a situation of only mild financial discomfort before continuation of the normal course of business, could leave a firm with poor understanding of their capital and liquidity requirements.

4.

Forward-looking areas of focus

Based on the underlying consumer and market characteristics, the environmental conditions and, the resulting overarching pressures affecting firms and consumers, we have identified seven *Forward-looking Areas of Focus*. We believe these issues are of considerable importance in posing risks to our objectives.

As these areas of focus are forward looking, there may be cases where they will not materialize or their impact is not as significant as expected. This could be the result of changes in the environment which reduce the probability of a risk crystalizing – potentially altering its shape and impact or changing firms' and consumers' behaviour or response.

Firms and consumers continue to adapt to challenging external conditions and the consequences of previous decisions that have affected their financial positions. As outlined in the previous chapter, these ongoing pressures give rise to a wide range of conduct and prudential risks that may challenge our ability to protect consumers, ensure market integrity and promote effective competition.

Our day-to-day supervisory and regulatory activities seek to protect consumers and the broader market against many of the risks we outline in this document. These are set out through our annual Business Plan. We are also keen to highlight areas where, over the last year, oversight of different areas of the financial sector are newly within our remit or where trends have become more acute (potentially reaching a tipping point) and may require a more focused regulatory approach.

The forward-looking areas of focus are:

- Technological developments may outstrip firms' investment, consumer capabilities and regulatory response
- Poor culture and controls continue to threaten market integrity
- Large back-books may lead firms to act against their existing customers' best interests
- Retirement income products and -distribution may deliver poor consumer outcomes
- The growth of consumer credit may lead to unaffordable debt
- Terms and conditions may be excessively complex
- House price growth that is substantial and rapid may give rise to conduct issues

Technological developments may outstrip firms' investment, consumer capabilities and regulatory response

Protecting consumers, market integrity, promoting effective competition

Whilst utilisation of technological developments by firms can be advantageous for consumers and firms, the increasing reliance on technological platforms and engagement with technologies could give rise to a number of risks to our objectives. Utilisation of technology may outstrip firm and consumer capacity and capability and may outperform the regulatory responses to the resulting risks. This is enforced by the misallocation of firms' investment in technology. By monitoring developments in technology and its use in the financial sector we could help better shape outcomes for firms and consumers. This includes working with firms to facilitate the safe use of innovative technologies to drive competition. Consumers should receive appropriate levels of protection in products and services offered through these new technologies as they would through more traditional channels.

The acceleration of technological developments creates challenges for firms over the controls they put in place and protection they are able to provide their consumers, whether in respect to the products and services they provide, or the trading that they or their clients undertake in the markets. Adopting and developing technology can also lead to firms allocating more investment in new opportunities rather than fixing some of the legacy problems that have built up over time. The reduction in profitability in the financial sector since the onset of the crisis has likely meant that investment in technology and systems has not kept pace with the growth in demand for remote services. This has contributed to the prevalence of ageing legacy systems which may be less resilient to shocks.

In large firms that are adopting technology and adding to legacy and ageing systems, there could also be resilience issues and challenges in aligning consumer data, information and online services. Risks can also arise from the way in which consumers access financial services (impacting consumers in different ways) and how firms and regulators respond to risks created by evolving market structures. New entrants, able to take advantage of new technologies, may alter the competitive landscape and create better outcomes for consumers by responding directly to changing consumer needs and demands (e.g. through digital interfaces). This could push existing firms to adopt similar technology to compete, which sit outside their expertise and knowledge base.

Specific risks include:

Over-reliance on third parties

Where firms choose to outsource functions to benefit from technological advances that they are unable to adopt in their own systems, consumers could face detriment, if firms do not have sufficient oversight of outsourced functions or an understanding of how outsourced technologies interact with existing systems.

Investment businesses that use third party administrators to handle and record the firms' client money need to be aware that their responsibilities are not discharged merely through a rigorous selection process and the receipt of reports on breaches of rules and service levels. The regulated firms retain responsibility for ensuring that the outsourced functions are compliant and should carry out active monitoring to discharge that responsibility.

Some investment businesses may need to make significant changes to their businesses processes and systems and as a result of changes to the client asset rules which will be published in 2014. They will need to work closely with third party administrators to ensure that these changes are implemented effectively and on time.

Where firms are using unregulated third party tools, for example, risk profiling tools, that have been developed by unregulated entities, they must ensure they have the appropriate knowledge and expertise to use these tools to ensure good outcomes for consumers. In addition, regulated firms have the responsibility to ensure the way in which risk profiling tools are used, and the way they use information, meets their requirements as regulated bodies.

Consumer behaviour using digital platforms

As the scope and use of digital platforms as a source for information and to access financial products increases, firms and consumers may not be aware of or understand the risks associated. Firms may not take into account the financial capability of consumers using these platforms and manage the risks appropriately.

Risk to consumer protection (including financial crime risks) could arise:

- Where firms using digital platforms to interact with consumers (providing services, information and product access) do not have the controls in place to ensure consumers are adequately protected or aware of their options if something goes wrong

- Where a firm's strategy for product services and distribution is primarily driven through digital platforms, consumers who are not technologically savvy may be forced to engage with platforms which they are unable to use properly. In some cases consumers may fail to adequately monitor activity on digital platforms. For example consumers may be unaware of unauthorised transactions or changes in their holdings if firms move away from paper statements to online only, which for some consumers with limitied online access, could create barriers to their ability to make timely decisions.

- Consumers may increasingly use digital or online platforms to seek information or purchase increasingly complicated products. Through increased ease of access to products some may use execution only rather than more appropriate channels which seek advice. Firms using online platforms to build advice models may not be clearly defining whether consumers are receiving advice or non-advice – which could lead them with less protection if they use the wrong product.

- With an increase in the use of digital platforms, consumer may be at greater risk of financial crime (such as breach or theft of personal information, fraud or scams).

Resilience issues
From the linking of legacy systems and 'new' technology that firms adopt to improve consumer access to online and mobile technologies, resilience issues might arise. Firms may not consider the risks posed by adopting technologies and may not appropriately adapt their systems, processes and control frameworks to reflect these risks. Therefore they may not ensure adequate protection for consumers. In addition, existing firms may focus on 'getting ahead' by investing in digital interfaces which add little value to consumers (to compete with new entrants) rather than investing in improving existing systems to improve consumer experiences.

Poor culture and controls continue to threaten market integrity

Protecting consumers, market integrity

Poor culture and controls continue to threaten the soundness, stability and resilience of financial markets and transparency of the price formation process. While wholesale market participants may be able, to a greater or lesser extent, to protect their own interests and those of their immediate clients at a transactional level, poor conduct in these markets can feed through in the retail market and the aggregate impact of poor conduct can undermine the integrity of markets.

The flaws exposed in benchmark rate setting have demonstrated that market confidence can quickly be eroded by poor wholesale conduct, and that the impact of poor conduct, in and outside our regulatory perimeter, is far-reaching. It is in the interests of market participants and firms to maintain the integrity of UK financial markets.

As with other conduct risks, the culture of firms is the crucial driver of poor outcomes in wholesale markets and can lead to the transmission of detriment to less sophisticated consumers further down the transaction chain. Culture is fundamental to whether firms are able to embed conduct risk controls across the full range of their services and activities, regardless of the sophistication of their clients or whether a given activity is close to the regulatory perimeter.

Manipulation of benchmarks, as a base for financial instruments' price formation, has revealed the wide range of poor outcomes that can result from the failure of firms to adopt a holistic approach to identifying and mitigating the conduct risk arising from their activities. It has exposed how quickly trust and confidence in the integrity of markets and in the price formation process can be undermined. The culture of firms, underpinned by the incentive structures they employ, continues to determine whether these risks are adequately addressed or whether poor conduct is able to flourish where, for example, it is not expressly prohibited.

Our work will continue to focus on areas where we are not seeing the level of change we would expect, given the examples of poor conduct we have seen in recent cases. This includes a wide range of activities, business models and market structures that have the potential to damage trust in the integrity of our markets and potentially cause harm to consumers with a range of sophistication. In particular more work needs to be done to design sustainable, resilient solutions for setting financial benchmarks and continuity in existing benchmarks. As we have seen in LIBOR, firms failing to manage the risks and conflicts inherent in activities, will potentially have an impact on market confidence or distort price formation.[27]

We continue to be concerned about markets where there is a strong indication of signalling between participants and the market moving in concert, unless there was a good reason for this.

Market participants should ensure there are arrangements in place to manage these risks. Our work in this area will focus on:

- Business models that rely on information flows for cross selling purposes and trading activities (and balance sheet usage) often have deeply embedded conflicts of interest, are vulnerable to poor market conduct, or rely on the abuse of proprietary information acquired through agency relationships.
- Firms acting in different capacities providing multiple services to clients, not acting in clients' best interests or their obligations to manage conflicts of interest fairly and transparency to clients of payment mechanisms for secondary services, such as their research.
- The quality of execution services provided to professional and retail clients in different markets, including challenge of remuneration structures which are vulnerable to conflicts of interest or risk damaging market integrity due to a lack of transparency.
- Market abuse and poor conduct by both firms and individuals, using increasingly sophisticated IT analytical tools and primary market integrity by

27 Work is being undertaken by the Financial Stability Board to review foreign exchange benchmarks.

ensuring the disclosure and transparency of price sensitive information to market participants.

Large back-books may lead firms to act against their existing customers' best interests

Protecting consumers, promoting effective competition

The scale of back-books and the inertia of back-book consumers can allow firms to adopt strategies that may not in the best interest of existing consumers. A number of retail markets can be characterised by providers having large back-books (stock of existing customers). These exist where consumers may have not switched their providers for many years, including savings, current accounts, mortgages and many insurance markets.

Large back-books can benefit consumers by enabling firms to diversify risk and reduce costs for some consumers. However, firms may rely on extracting value from their back-book customers to support profitability.

Strategies may include cross-selling products to existing consumers, targeting inertia by offering existing customers worse terms than new customers and by making it more difficult for existing customers to switch to better deals. Such strategies can result in existing consumers facing higher charges, being offered worse terms (particularly increases in interest rates for existing borrowers or reductions in interest rates for existing savers) and buying (through cross-selling or on-selling) or retaining unwanted products.

Furthermore, extracting value from back-books may give existing firms a competitive advantage by allowing them to offer better rates to new consumers and thus allowing them to entrench market share against new entrants.

Specific risks include:

- Firms extracting value from their existing consumers, particularly consumers holding legacy products, by targeting consumer inertia resulting in poor outcomes. They can do this by keeping them in high charging, poor performing products or funds, offering poor rates or not informing consumers when better product alternatives or additional benefits are available within the firm. Another might be where SVRs on existing mortgage products are adjusted upwards to subsidise competitive new mortgage products. Lastly, where firms targeting consumer inertia or capabilities, do not do enough for consumers at the point of renewal or paying claims, for example, by offering insufficient or over-complex information or not mentioning alternatives.

- Firms' use of Big Data to identify changes in consumers' underlying risk profile for existing long-term products (where early repayment charges (ERCs) or fees apply), potentially looking at factors that may not have been considered in the initial decision. Firms may apply new information to re-pricing the product or altering the terms and conditions post-sale to offset changes in the consumer's risk profile.

Retirement income products and -distribution may deliver poor consumer outcomes

Protecting consumers; promoting effective competition

The decumulation phase of retirement income can cause risks to consumer outcomes over the long term. Currently decumulation products require consumers and firms, developing products, to consider risks such as expected longevity, inflation, interest rates, guaranteed periods, and volatility of assets/investments available for drawdown. This can create challenges for firms and consumers alike judging the suitability of different decumulation options, leading to consumers buying, or being sold, unsuitable products at prices that are not affordable or that do not serve their needs throughout retirement (meaning detriment may not be measurable for some time post-sale). Even basic savings products are an increase in complexity from traditional accounts which can make understanding their features a step change for consumers. While recent proposals for pension reform plan to allow consumers to access any amount of their pension pot at age 55, the need for consumers to understand the options available to them at retirement is still paramount. Any future innovation in decumulation products will compound these risks.

Behavioural biases can play a role in these decisions. For example, consumers may have insufficient knowledge to be able to make a decision in their long-term interest, on how to use their pension savings; if they do make the decision to purchase an annuity, consumers often fail to shop around for their annuity provider and inertia can lead them to opt for their existing provider when another may better serve their needs. In this market, consumer biases and information problems could be facilitating competition not working well for consumers.

Although we have not seen much innovation in decumulation products to date, recent and proposed legislative reforms in the pension market, longevity trends, social policy changes and concentrations of wealth could encourage innovation in some decumulation products in the future, to meet changing consumer needs. Many products available in the current market tend to be targeted towards more wealthy consumers, leaving the needs of many un-serviced by the financial sector.

As firm and consumer balance sheets remain under pressure from external conditions the disparity between what firms can viably offer consumers and what consumers need from decumulation products may increase. To minimise the consequences of these disparities, increasing conflicts may materialise in product complexity and the accessibility of product terms and conditions. Risks that look to be on the rise in this area include the design and distribution of pension products and in the design and development of products that capitalise on other stores of wealth (predominantly property, e.g. equity release).

Specific risks include:

Firms design complex, opaque and overpriced products

Firms may develop products that are not in the long-term interests of consumers and are difficult to compare due to hidden costs and fees. For example, in response to equity rich, cash poor households, firms may develop alternative 'equity release' products (which allow consumers new ways to tap into their housing wealth to make up shortfalls, in current or future retirement income). While such products might be suitable for some consumers there is a risk that firms may develop products that are not in the long-term interests of consumers and are difficult to compare due to hidden costs and fees.

With many interest-only borrowers facing debt burdens later on in their life cycle, firms may offer consumers the opportunity to de-cumulate these assets by offering hybrid life-time mortgages (where consumers can re-mortgage, carry on making interest only payments with the option of rolling up interest payments in the future). These are specialist product, which could be costly if mis-sold to consumers who could have alternative options available with their current lender (for example taking pre-emptive action now to prepare for maturity).

Increased innovation of products that cater to long-term spending needs may not offer the best value to consumers. For example consumers could seek income drawdown where the annuity is insufficient to pay for care costs.

Disclosure

Product complexity may be compounded by marketing material or product labelling that highlights unique product features. This may make it difficult for consumers to compare different products or diverts their attention away from considering other factors such as risk, costs and limitations.

In addition, the volume of information provided to consumers, and their willingness to engage with that information may impact on the extent to which they obtain the best products appropriate to their needs at retirement.

Barriers-to-exiting

Where products are purchased for the long-term but with an option for consumers to exit (e.g. with-profit investment funds) there may still be obstacles to consumers actually being able to exit a product or service if the product becomes unsuitable or unaffordable as their needs or the environment changes, for example through terms and conditions or excessive exit fees.

Focus on prices

Firms may act on consumers' focus on headline price or other near-term features and benefits by marketing (framing) products and services in a misleading way, or may take advantage of consumer inertia and other biases, which could lead them to make decisions without weighing up the long-term suitability or other costs, risks or exclusions. Through the design and pricing of these products, firms face potential conflicts between servicing consumer needs in a fair and transparent way, and creating sufficient margin to make the long-term costs on these products viable.

Appropriateness of distribution channels for decumulation products

Firms may design products for the non-advised market that may be too complex for consumers to fully understand and purchase without advice.

In addition, as consumers needs change over time, some financial advisers may develop more complex retirement solutions with a view to serving those changing needs. However, there is also a risk that these could result in increasingly complex products or a mix of products that require ongoing servicing and potentially higher costs.

Also, it may be challenging for people with different degrees of wealth at retirement to find products that suit their needs. Those with the smaller funds will always have fewer options (as there will be fewer players willing to service their needs) but it is important that consumers are not disadvantaged by this lack of choice.

The growth of consumer credit may lead to unaffordable debt

Protecting consumers, market integrity, promoting effective competition

Rapid growth of consumer credit could lead to unsustainable debts as households face an on-going squeeze on their spending power. Although there have been some recent positive economic signs (e.g. falling unemployment, a decrease in inflation, stronger growth), significant pressures remain on households' spending power. Post-crisis economic and policy conditions continue to squeeze lower-income households. Those struggling to meet living costs – particularly in light of welfare reforms such as the roll out of Universal Credit – could turn to additional consumer credit to manage. This also raises the risk of increased demand for, and uptake of, less mainstream, higher cost forms of credit among these groups and a more widespread need for debt advice and management services.

As economic conditions improve, growing consumer and lender optimism is likely to increase borrowing by consumers more generally. However, as household debt remains relatively high and is growing, there is increased risk that this further consumer credit borrowing will be unsustainable for some, particularly for households with already high levels of debt.

These risks in consumer credit markets are also in part driven by consumers not having sufficient information or sufficient understanding of consumer credit products, from being prone to behavioural biases in the products that they choose and use, and from firms not treating consumers fairly, by exploiting these weaknesses.

In consumer credit, our focus on affordability-related risks of detriment will be where:

- Mainstream, large-volume, credit products lead some households to struggle with debt.

- Vulnerable consumers are put at particular risk of detriment (e.g. with high cost short term credit, poor debt management services).

- Consumers in financial difficulty are at risk of being treated unfairly by firms.

- Consumers have insufficient access to suitable debt advice and solutions, or are paying too much for this advice.

Specifically, we have concerns that:

- Revolving credit products, such as credit cards and overdrafts, though not a problem for many consumers, could prove a risky source of additional credit for already highly indebted households. Given the large number of consumers using these products, even a small increase in the proportion of borrowers borrowing unsustainably would represent a significant increase in consumer detriment.

- The complexity of certain products (e.g. the incurring unexpected charges from credit cards and overdrafts) makes it harder for consumers to choose and use these products well, leading to poor value for consumers and making it more difficult for them to manage credit use. Related to this, competition in these markets may not be focused on product features that bring value to consumers.

- In more expensive, shorter term forms of credit (e.g. payday loans, logbook loans) some business models have evolved to shield lenders from the consequences of lending irresponsibly (e.g. excessive interest/fees more than cover credit-risk related costs, methods evolved to secure repayments even when consumers cannot afford to repay). The resulting weak incentives on lenders to act responsibly could lead to poor underwriting standards for loans to vulnerable consumers. Consumers experiencing difficulty making repayments in these markets may not be treated fairly by some lenders.

- In debt management, there is evidence that services are not always provided to a suitable standard, leading to poor outcomes for consumers, for example, in high fees and unsuitable debt solutions. Growing consumer credit borrowing and indebtedness further increases the risk of detriment through unsuitable debt management services.

Terms and conditions may be excessively complex

Protecting consumers, promoting effective competition

Firms across financial markets may proliferate excessively complex product terms and conditions. As firm and consumer balance sheets remain under pressure from external conditions, the disparity between what firms can viably offer consumers and what consumers need from financial products may increase. Consumers' misunderstanding of these terms and conditions may come to light under changing circumstances, which could be driven by changes in the environmental conditions.

One of the ways in which these increasing conflicts may materialise is in complexity and accessibility of product terms and conditions. Risks we will be monitoring in this area include:

- Consumers may misunderstand the degree of protection they have and can do little about changes in terms and conditions (e.g. flood risk or subsidence cover) – particularly where they are trapped with a provider, or have limited choice due to their circumstances.

- Consumers may encounter obstacles to exit a product or service as a result of terms and conditions that are unclear to the consumer at the point of sale (e.g. mortgages and with-profit investment funds). This can leave consumers with a product which has become unsuitable or unaffordable for their needs or the environment they face, and they could encounter surprises when they look to exit and find they are unable to without penalty.

- Complex terms and conditions make it difficult for consumers to compare different products or other costs, risks or exclusions. Terms and conditions of complex products, which could be based on broad indicators (e.g. index-based/-linked products), may not reflect the true complexity of the product and may understate the real risks.

- There may be a tension between explaining complex terms and conditions clearly in plain language and the extra length this gives documents (for example, in insurance contracts, often legalistic wording is a lot shorter as terms do not need definition in the contract as they are already defined in law).

Where complex products and services are offered by a group of related companies, consumers may be confused as to which legal entity, or entities, they are contracting with. Further, in relation to some investment activities, there is a risk that responsibility for client money or custody assets may not be consistently treated as between the published terms and conditions, the firms' record-keeping systems and the consumers' expectations based on communications from the group. Clarity of the obligations of each regulated firm is of particular importance under the CASS rules when a pooling event occurs since the distribution rules apply to individual legal entities.

House price growth that is substantial and rapid may give rise to conduct issues

Protecting consumers, market integrity

Substantial and rapid increases in house prices may lead to conduct issues in the period of growth (where underlying risks are overlooked) and in the period of contraction that could follow (where issues that have built up are mismanaged). Environmental changes over the last year and the improved outlook for the economy combined with government policy initiatives, are creating conditions for growth in housing market activity and price inflation. UK housing activity appears to be gaining some momentum (particularly in London) and risks to our objectives may grow if stronger activity is accompanied by further substantial and rapid increases in house prices, a further build-up in household indebtedness that is already elevated for some households, or weaker underwriting standards as seen in previous house price cycles.

As demand for housing rises, and in the absence of sustainable housing supply, house prices could rise further relative to incomes and rents.[28] In a period of house price growth, present-bias and over-extrapolation in the belief that prices will keep rising, consumers could take on additional levels of debt to extract equity, or buy homes. As the economy improves and house prices increase interest rates are likely to rise, which could lead to an increase in the cost of loans.

The Mortgage Market Review (MMR) will strengthen firms' own mortgage controls and will go some way to limit unaffordable lending practices for new mortgage loans in the future. The effectiveness of the MMR rules in a period of rapid housing market growth is untested, and standards have been left flexible under the new regulations to allow lender discretion. Improvements in the economy are likely to see interest rates start to rise – this could lead to a rise in the carry cost of forborne loans and a move by firms towards exit strategies from current forbearance practices.

- In the period of rapid growth in house prices and market activity, risks we will monitor include:

Weakening underwriting standards

In a rapidly growing market, over overconfidence in future price growth could lead firms to gradually loosen underwriting standards to maintain a share of the growing market. In addition to the increased term extensions observed through current lending, lenders could start to reduce the cost of living data, or accept a higher proportion of bonus payments, commission or income from second jobs to stretch affordability assessments.

Consumer and investor expectations of future house prices could be fuelled during a period of rapid growth and lead to over-optimism about future wealth and the accumulation of unaffordable levels of secured and unsecured debts based on expectations of potentially unsustainable price growth. It could also lead lenders to increasingly look outside 'vanilla' groups of consumers and lend to higher-risk households – relying, as seen in the previous house price cycles, on their ability to access equity withdrawal.

Impact on affordability of interest rate rises

As discussed earlier, house price gains are likely to be reflected in more sustained recovery which will over

28 The FPC has recently announced its extensive tool kit that it could deploy in response to evolving housing market risks, should that become necessary to protect financial stability.

time lead to gradual rises in interest rates. Households with high debts may benefit from house price (equity) gains, but could face substantial increases in debt servicing costs from relatively small rate rises. This could lead to rising defaults or repossession if households are unable to support rising mortgage costs through budgeting higher incomes or access to credit.

Mis-treatment of consumers exiting from forbearance

Rising house prices (coupled with interest rate rises) could see lenders taking a much tougher line with consumers who are in default or forbearance as the carry cost becomes too great. This could lead to poor treatment of more vulnerable consumer groups by lenders if they are unable to cure their arrears. Improved environmental conditions, higher prices and normalised rates could crystalize the costs of forbearance and, in some cases, could highlight where it has been disproportionate.

Firms must ensure that decisions around forbearance or repossession are suitable given the specific personal and financial circumstances of borrowers, dealing sensitively with borrowers who have particular vulnerabilities. Decisions should take account of a borrower's broader debt portfolio and likely long-term ability to cure their arrears and rehabilitate their account.[29]

- Unsustainable house price growth could lead to further risks during the period of contraction, including:

Further prudential pressure on firms due to falling prices and household distress

Financial pressure driven by higher interest rates and debt levels could create a challenging cycle for firms of balancing prudential and conduct responsibilities. Adoption of short-term strategies to manage prudential risks arising from future falling house prices and the rise in defaults (due to the higher interest rate environment) may not be in consumers' best interests – for example in relation to financial distress and treatment of arrears (MMR rules around arrears handling should help offset this risk but we are still seeing poor practices in some firms).

Increased demand for non-mainstream credit

The accumulation of debts could grow if falling prices lead to a fall in mortgage lending. Consumers who do not have access to mortgage credit or who have poor credit histories (arising from default) may be exposed to potentially poorer underwriting standards, poor arrears handling (by non-mainstream lenders) and unaffordable debts.

Treatment of consumers in negative equity

Consumers in negative equity who are unable to switch lenders could find themselves vulnerable to higher rates as firms look at alternative ways to make these consumers profitable. Borrowers facing negative equity could be targeted by products, which may sit outside the regulatory perimeter, that offer to help consumers move but may be costly or do not benefit them in the longer term.

Withdrawal from products

Falls in prices could lead to firms withdrawing some products from the market, such as shared equity or lifetime mortgages, as they are unwilling to expose themselves to potential losses (once downside risks have crystallised), or are unable to offer these products at a price that is fair and affordable to borrowers. This could leave consumers forced towards unregulated substitutes that may not be their best interests.

29 The findings of recent work by the FCA can be found in Thematic Review Mortgage lenders' arrears management and forbearance, February 2014.

Links to the Business Plan and Conclusion

5.

Links to the Business Plan

Due to their nature, our ability to resolve the seven Forward-looking areas of focus set out in Chapter 4 in the short term may be limited. Some of the underlying drivers of risk and issues discussed in Part A of the document will take years to address and in some cases they may be impossible to resolve. In some cases we can only seek to reduce the role that these factors have in driving risks to our objectives.

We will continue to monitor and prioritise these risks and our actions by undertaking further research, supervisory thematic work or market studies to better understand the responses of firms and consumers to market developments and dynamics.

Our work to resolve the more developed and crystallized risks identified through our ongoing regulatory oversight of firms and markets is set out in our 2014/15 Business Plan. We will continue to balance our forward-looking work load with resolving crystallised and known problems in firms and markets.

Resolving root causes and drivers of risk

The 2014/15 Business Plan sets out a number of areas where we are planning work to address some of the underlying drivers of risk set out in the Risk Outlook.

This includes work around:

- **Culture and incentives:** The **suitability and structure of incentive structures**, for example, in debt management firms and lead generators where we believe these structures to be a strong driver of risk to consumer protection. Following our work on financial incentives we will look at how firms **manage the performance of their sales staff** and whether pressure put on staff (through, for example, sales targets) increases the risk of mis-selling. We will continue our ongoing assessment of firms' and how effectively firms are embedding this into their business, for example assessing the **fair treatment of long standing consumers** in life insurance and the **treatment of consumers in forbearance**. This will include work focusing on the structures and control firms put in place to manage risks for example, the role of **due diligence in affecting suitable investment selection and governance structures** in with-profit insurers. We will continue to **monitor the gateway** to gain a thorough understanding of firms' internal culture, their business models and the way they treat their customers. Changes to our **approved persons** regime will also put us in a stronger position to ensure individual in positions of responsibility in a firm are fit and proper and take full accountability for their roles and responsibilities.
- **Conflicts of interest:** We will look at the **effectiveness of controls around conflicts of interest** in investment banks and how wealth managers and private banks effectively control the conflicts of interest that arise when client assets are invested in in-house investment. Work will also cover the **controls in place over the flows of information** in investment banks, to ensure information is not being used in an abusive way.
- **Market structures:** We will seek to test whether **fair consumer outcomes are being consistently delivered through distribution chains** in wholesale markets. We will be completing our market studies into cash savings and income **products at retirement** to identify where competition is not working effectively in these markets. In 2014 we will be conducting market studies into **wholesale markets and parts of the consumer credit market** including credit cards.
- **Economic and market environment:** Our regulatory approach will continue to **monitor the impact that environmental changes have on firm and consumer behaviour** and will work closely with firms to ensure their practices and strategies in the period of sustained economic recovery (including the **impact of rising interest**

rates) do not pose undue risks to our objectives. Through our supervisory work we will continue to review firms' business models and strategies and their effectiveness under current and future conditions to assess potential risks to our objectives.

- **Technological developments:** Over the next year, we will focus on **resilience of legacy systems, cyber-attacks and the visibility of these** risks to firms' Boards. We will work closely with HM Treasury, the PRA and the Bank of England to assess and test the Financial Services Critical National Infrastructure's resilience to cyber-attacks.

- **Policy and regulatory environment:** We will continue to monitor the impact of policy and regulatory changes on firms and consumers. Our continued **engagement in international and European policy debates** will focus on the impact these initiates could have on our objectives to ensure rule changes drive the right outcomes for consumer. Our work **embedding Alternative Investment Fund Managers Directive (AIFMD) and implementing the second Markets in Financial Instruments Directive (MiFID 2)** will focus on the appropriateness of firms and market responses to these regulatory changes and ensure they achieve the intended outcomes – minimising unintended consequences during the period of transition. **Our post-implementation reviews of the MMR and RDR** will assess the responses of firms in their implementation of affordability rules and suitability of advice – we will also review the impact these changes have had on the market, and how firms may be finding ways to avoid the rules, and the role that we have had in shaping the outcome. We will also consider whether the understanding of our rules around non-advised and advised sales encourages internet-based sales and whether disclosures can be made simpler and work better for consumers. We will work with the Prudential Regulation Authority (PRA) to **implement the recommendations set out in the Financial Services (Banking Reform) Act 2013** which respond to recommendations from the Parliamentary Commission on Banking Standards, such as the **Senior Managers and Certified Persons Regimes.** With the PRA we will review the impact of changes set out in our 2013 review of requirements for firms entering into, or expanding, in the banking sector to **assess their impact on lowering barriers-to-entry and expansion in banking**

We will seek to undertake further research to support our work in these areas of focus to help inform a proportionate response or guide early intervention where appropriate. Our work will also focus on better understanding the responses of firms and consumers to the market developments and dynamics set out in this document and the adjust our priorities to respond to new and emerging risks throughout the year. Where possible we have highlighted where planned work is being undertaken to respond to aspects of these issues as set out through our 2014/15 Business Plan.

Poor culture and controls continue to threaten market integrity

We will look at how firms effectively reduce the risk of traders manipulating prices and at how firms ensure trading activity is consistent with our expectations of market conduct. We will continue work to detect and minimise abusive behaviour in the markets we and aim to educate firms about acceptable market practices in a variety of ways, such as through our forums, our market watch newsletter, our participation in industry panels and external engagement by senior people. We will continue to pursue a strategy of **credible deterrence** by taking tough and meaningful action against firms and individuals who fail to play by the rules. We will deliver on our commitments to establish **a robust framework of supervision for Libor** and continue to contribute to international benchmark reform, focusing on the FSB reviews of interbank interest rate benchmarks and **FX benchmarks**.

Large back-books may lead firms to act against their existing customers' best interests

In 2014/15 we will look into whether life insurance firms are **operating historic products** (often termed 'legacy' or 'heritage') in a fair way and whether they have adopted strategies that exploit existing customers. We will also complete our **market study into cash savings accounts**, looking at which customers switch accounts, how often, why and whether the information available to new and existing customers allows them to make informed choices.

Retirement income products and -distribution may deliver poor consumer outcomes

In 2014/15, we will undertake a **competition market study** into retirement income products, looking at whether consumers shop around and are getting the most appropriate and best value product for their needs. As part of this market study, we will undertake supervisory work on **sales practices in the annuities market**, into a market study into retirement products.

The growth of consumer credit may lead to unaffordable debt

In 2014/15 we will review the **arrears management processes of firms in the high-cost short-term lending** market and how customers are treated when they are in financial difficulty, including forbearance products. We will also look at the suitability and/ or **incentive structures of debt management**

We continue to monitor and prioritise these risks and our actions by undertaking further research, supervisory thematic work, or market studies to better understand the responses of firms and consumers to market developments and dynamics.

firms, including the use of lead generators to help us understand how this affects consumers.

We will look into the consumer market and carry out in-depth studies into areas where we see potential harm to our objectives, such as with credit cards or overdrafts. In 2014/15 we will also consult on the introduction of price caps for the interest rates that payday lenders can charge.

In sectors such as log book lending where we have evidence of some very poor consumer outcomes we will apply a demanding authorisations approach to ensure only responsible firms remain in the market. This will be followed by appropriate event-driven supervision and enforcement to maintain standards.

Terms and conditions may be excessively complex

We will look at whether consumers have the amount of protection they believe they have and what they can do about changes in terms and conditions. We want to be sure that there are no obstacles to consumers being able to leave a product or service in a firm's terms and conditions that are not made clear to the consumer at the point of sale.

We will also look whether complex terms and conditions are **compounded by marketing material or product labelling** that makes it difficult for consumers to compare products or does not reflect the complexity of the product.

House price growth that is substantial and rapid may give rise to conduct issues

We will **review how firms are implementing MMR** – which include our new affordability rules and how they give advice to customers. We will also look at how firms may be finding ways to avoid the rules, such as increasingly using execution-only and buy-to-let mortgages.

6.

Conclusion

Analysing how root causes and drivers of risk develop over time and how these factors combine to create risks to consumer protection, market integrity and effective competition will help us set our regulatory approach, enforcement and supervisory priorities.

As a regulator we look at the way financial organisations treat consumers; the way they behave towards them and how firms manage their financial risks through systems, controls and financial resources they hold. Our regulatory approach aims to be flexible and effective in our response to the complex challenges we discuss in this document. At times issues may cut across our objectives and at times our objectives may be in conflict – under these circumstances careful judgments will need to be made over which objective to pursue. We will ensure we use our regulatory tools to intervene in different areas of the financial markets and at different stages of the regulatory life cycle where appropriate. Many of the issues discussed in this document will develop over time as the environment continues to evolve and consumers and firms respond to changing external (and internal) conditions. In particular, as we take on responsibility for regulating consumer credit markets, our understanding of the issues set out here and their impact on consumers will evolve. We will therefore undertake further research to ensure our interventions are proportionate and timely.

Figure 29. Our regulatory approach in dealing with forward-looking risks

Our intervention, not only on the *Forward-looking areas of focus* set out in Chapter 4, but also in dealing with the root causes of risk to our objectives will require a concerted effort from ourselves, firms, consumer bodies and consumers themselves. Figure 29 sets out how the regulatory approach will support a measured and proportionate response to both issues raised in this document but also through firm-specific risks to our objectives.

We will use our powers to improve outcomes for consumers, enhance market integrity and encourage effective competition. In a dynamic financial sector this will be challenging and may need to adapt over time. In some cases, the response of the FCA and the industry to deal with the issues and implications of environmental developments are still a work in progress and delivery of the response is still ongoing. We will monitor our role in shaping these responses and adapt our regulatory approach by applying judgment where necessary.

Key messages for firms and consumer bodies

Many firms have shown genuine commitment to ensure that their strategies and activities embed conduct considerations and in some cases have demonstrated improvement in their understanding of consumers they serve. We are keen for firms to continue this momentum and ensure adjustments that consumer protection, market integrity and effective competition become wide spread across all financial markets.

Consumer bodies are working hard to help consumers achieve better outcomes from financial services by providing valuable input into the work of the FCA and ongoing representation on consumer issues. In addition, they can support consumers through the process of complaints where products are not working well or are causing harm to consumers using them.

Key messages for firms

We expect firms to engage with the analysis and messages in this document and assess the relevance to their own business models and strategies – from the products they design and their distribution to the oversight and use of technology and funding strategies. Firms should reflect on how the wider environment will not only affect their growth in particular markets but may also affect existing strategies in place and perhaps alter the conduct risks for existing consumers.

Firms should look at their business models, strategies and structure to critically assess whether they are effectively identifying and managing the root causes and drivers of risk set out in this document. They should also identify the relevance of the risks set out here – including the seven areas of focus – and critically assess whether they apply to their own business and how they could play a role in resolving these in a way that is fair to consumers, enhances market integrity and promotes effective competition.

Firms need to ensure they are putting the consumer and the integrity of markets at the heart of their business models and strategies.

Key messages for consumer bodies

We will continue to work with consumer organisations to ensure they are aware of the work we are doing to deal with the issues in this publication and welcome their involvement. The content of the document should be used to inform consumers of the potential risks the financial sector faces to help support their understanding of how they can protect themselves. Where consumers better understand their needs and options available to them they are better able to match the most appropriate products and services with their need.

Glossary of terms

Acronyms

AIFMD: Alternative Investment Fund Managers Directive

AML: Anti-Money Laundering

CAPE: Cyclically adjusted Price to Earnings Ratio

CCPs: Central Counterparties

COREP: Common Reporting (within CRD IV)

CRD IV: Capital Requirements Directive IV

DDOS: Distributed Denial of Service Attacks

EMIR: European Market Infrastructure Regulation

FINREP: Financial Reporting (within CRD IV)

FLS: Funding for Lending Scheme

FSB: Financial Stability Board

HFT: High Frequency Trading

HTB: Help to Buy

IFAs: Independent Financial Advisors

LIBOR: London Interbank Offered Rate

LTI: Loan to Income

LTV: Loan to Value

MAS: Money Advice Service

MCOB: Mortgage Conduct of Business

MiFID (2): Markets in Financial Instruments Directive (2)

MMR: Mortgage Market Review

MTFs: Multi Trading Facilities

NMPI: Non Mainstream Pooled Investments

OBR: Office for Budget Responsibility

OFT: Office of Fair Trading

OTC: Over The Counter

OTFs: Organised Trading Facilities

PSR: Payment Services Regulator

RST: Reverse Stress Test

SIPPs: Self-Invested Personal Pensions

SME: Small and medium enterprises

TC4: Threshold Condition 4

UC: Universal Credit

UCIS: Unregulated Collective Investment Schemes

VAR: Value at Risk

Financial Conduct Authority

25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk