Financial Services User Group's (FSUG)

Making financial services work for financial users

Paper 1: New model financial regulation

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ABOUT THE FSUG

The Financial Services Users Group (FSUG) consists of 20 independent experts who represent the interests of consumers, retail investors or micro-enterprises in the EU policymaking process.

The group's remit is to:

- advise the European Commission in the preparation of legislation or policy initiatives which affect the users of financial services
- provide insight, opinion and advice concerning the practical implementation of such policies
- proactively seek to identify key financial services issues which affect users of financial services
- liaise with and provide information to financial services user representatives and representative bodies at the European Union and national level.

FSUG – Making financial services work for financial users
Paper 1: New model financial regulation

SUMMARY

Introduction

- Following repeated market failures, it is self-evident that the financial sector needs to be radically reformed so that it works in the interests of financial users and wider society. This cannot be achieved by regulatory reform on its own. As well as a new approach to financial regulation, we need improved standards of corporate governance and ethics within financial institutions, and market forces that align the interests of owners, managers/employees, and customers of financial services – this in turn requires effective competition that works for financial service users and the owners of financial institutions[1] acting more responsibly and taking a more active interest in the behaviours of the financial institutions they own.
- Currently, FSUG is focusing on regulation as it failed on too many occasions to deliver the appropriate degree of protection for financial users[2] or produce the fair, efficient and competitive financial markets society needs. FSUG is in a good position to 'speak truth to power' when regulation fails but, rather than just criticise, we have taken the initiative to produce a series of three papers setting out an alternative model for regulating the financial sector[3].
- This first paper argues for a profound change in regulatory philosophy and proposes a new regulatory model which we believe would be more effective at understanding why markets fail and identifying effective policy interventions to make markets work. This 'new model' regulation has general application for financial services but can also be tailored to specific sectors such as banking, consumer and business lending, asset management, pensions and insurance, and so on.
- This will be followed by a second report called *Financial Supervision and Sanctions* which focuses on the practical implementation of regulation including: designing regulation; supervision; robust enforcement; and the use of sanctions to change corporate behaviour and make markets work. The third report, *Financial regulation, innovation, and competition*, challenges the widely held view that regulation stifles financial innovation to the detriment of financial users. This paper also shows how regulation can be used to reward positive behaviours and promote competition as the ultimate goal of any reform should be to create a regulatory system that penalises detrimental market behaviours and rewards positive behaviours and socially useful innovations.
- This series of papers will be of interest to policymakers and regulators at EU and national level including relevant European Commission (EC) policymakers, the European Supervisory Authorities (ESAs)[4], and national regulators[5]. Clearly, the primary concern for EU policymakers is an effective

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1 Proprietary or mutual.

2 Throughout the report when we refer to financial users we include a broad definition which includes consumers, depositors, borrowers, investors, pension scheme members and trustees, policyholders, small and micro entities, and the 'real' economy.

3 Please note these papers do not deal with specific regulatory initiatives such as MiFID, or Solvency II etc. The papers propose a new model of regulation. However, where relevant and helpful, we illustrate our points with specific examples.

4 European Banking Authority (EBA), European Securities and Market Authority (ESMA), and European Insurance and Occupational Pensions Authority (EIOPA).

5 Whether reforming existing regulatory structures or establishing new regulatory structures.

single market. However, there is little evidence of significant positive cross-border activity – where financial users in Member States with 'inferior' financial services use the single market to actively seek products from 'superior' providers in a different Member State. Indeed, the fear is that regulatory arbitrage is occurring. A truly safe, fair, efficient, single market can only realistically happen if it is also made up of safe, fair, efficient and competitive national markets.

- The reports will also be of interest to stakeholders such as consumer and investor groups, civil society groups, think-tanks and academics who have a stake in making financial markets work.

The need for reform

- A modern economy and society needs an efficient, effective, accountable financial system and financial services industry – the importance of the sector cannot be overstated. Policymakers often speak of 'systemically important financial institutions'. But the nature of the services provided by financial markets and institutions means they are also 'socially important financial institutions'. These core financial services include: networks and systems for transmitting money around the economy; markets for allocating savings/investment capital to the real economy (theoretically, to the most productive uses); stock exchange functions; a means for intermediating savings/deposits to provide loans to consumers, industry, and government (the bond markets)[6]; insurance, reinsurance, and derivatives markets to allow economic actors and investors to protect against and manage risks; and, of course, financial products and services to meet the core needs of financial users[7].
- FSUG recognises that there is much good in EU financial markets and services. Many parts of the financial system continued to operate efficiently throughout the financial crisis, and many providers have performed well over the years. However, it must also be accepted that there have been too many episodes of failure in the financial sector. This ongoing financial crisis is the most obvious, high profile example of large scale market failure. Far from managing risk more effectively, certain activities and 'innovations' actually magnified risk in the financial system. Indeed, while lucrative rewards (often derived from illusory gains) were privatised, the risks (and massive losses) were socialised. We are now in the third phase of the financial crisis: a crisis in arcane financial markets quickly turned into an economic crisis which has now resulted in a social crisis with EU citizens paying the price for the behaviours of largely unaccountable financial markets. The fundamental purpose of financial services – to meet the needs of financial users, economy and society – seems to have been subordinated to the short term interests of powerful financial markets and institutions. The credibility and legitimacy of our financial system has been called into question.

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6 Credit intermediation, financial flows and other financial activities increasingly occurred outside the mainstream financial system in the 'shadow banking' system.

7 Transactional banking, savings, mortgages and loans (consumers and SMES), pensions, investment funds, insurance, and financial advice/information services provided and distributed by a complex, diverse evolving ecology of producers and distributors – shareholder owned/mutual, multi-national/mutual, community institutions. This financial ecology continues to evolve with numerous product and business model 'innovations' emerging – although these innovations have not always been beneficial or productive for financial users.

- Less obvious, but equally important for financial users, are the chronic market failures within the single market and at national level that have been overshadowed by the systemic financial crisis. These failures include: embedded inefficiencies and high costs; the growth in extractive rather than productive business models[8]; misallocation of capital and resources; value destruction of savings, pension and investment portfolios; weak or misdirected competition that benefits dominant providers, intermediaries and distributors not the end-user; price gouging; the growth in financial innovations of little or no social utility (or toxicity); poor financial advice, misselling and aggressive behaviours; reckless lending and overconsumption of credit[9]; poor quality service; and chronic financial exclusion. Market failure has been widespread and not limited to one particular sector or Member State[10] – although it does seem to be more prevalent in certain sectors or Member States[11]. The failings in national markets have seriously hindered the establishment of a truly effective single market in financial services.

- What is striking is how badly much of the financial services industry has performed even during comparatively 'good times' in the run up to the financial crisis. As the Commission's own Consumer Markets Scoreboard shows, the financial sector is one of the consistently worst performing consumer sectors[12]. But we face a new, difficult financial and economic reality defined by a range of macro and micro socio-economic events which put sustained pressure on household incomes and assets, expose poor value and inefficiencies in the financial services supply chain and threaten the commercial viability of dominant, legacy business models. This makes the challenge of making markets work all the more difficult and necessary. This new economic reality requires a new economic paradigm to understand the role and efficiency of markets and a new regulatory model to make markets work in the interests of society[13].

Prioritising making markets work

- We must hope that one day we will emerge from the current economic and financial crisis but we must not return to 'business as usual' in the way the financial sector treats financial users especially given that policymakers seem to expect citizens to make greater use of financial markets in the future to meet pension and social insurance needs – even though the current state of markets calls into question the wisdom of this course of action.

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8 Examples include the growth in 'payday' and other subprime loans, and fee charging 'debt management' firms in certain Member States or the emergence of layers of investment intermediaries and funds in the investment industry that have the effect of increasing costs without enhancing net investment returns available to the end-user.

9 Now of course we have the opposite with many households and businesses facing real problems getting access to loans.

10 See FSUG's Financial Risk Outlook for examples of detriment in various Member States http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/risk_outlook-2012_06_en.pdf.

11 For example, the UK has seen a litany of misselling scandals over the previous three decades involving pensions, mortgage endowments, payment protection insurance (PPI), and complex interest rate swaps products missold to SMEs. But, it is not clear whether behaviours in the UK financial sector are actually comparatively so much worse than in other Member States or UK campaigners (and regulators) are better resourced and able to investigate and uncover more detriment. However, we do know that the root causes of so much detriment in the UK (aggressive behaviours, conflicts of interest caused by commission-based sales, etc.) are also evident in other Member States. Regulators in other Member States would be unwise to assume that their markets are cleaner and better behaved than the UK.

12 http://ec.europa.eu/consumers/consumer_research/editions/docs/6th_edition_scoreboard_en.pdf

13 In addition to the challenges set out in this paper, interventions are required to ensure that, following the massive bailouts provided by EU citizens, banks fulfil their fundamental role of lending to the real economy.

- Fundamental flaws have been exposed in the approach to financial regulation hitherto followed by policymakers at EU and national level – whether promoting financial stability or systemic risk management[14]; ensuring financial institutions are sound and prudently run[15]; or making financial markets work for financial users and society. Therefore, three clear regulatory challenges emerge: i) creating financial stability; ii) enhancing prudential regulation; and iii) making markets work. We focus on the third challenge in this series of papers.
- So far, systemic risk management and prudential regulation have dominated the policy agenda. Huge intellectual effort and regulatory resources have been devoted to promoting financial stability and improving prudential regulation. We fully appreciate the need to promote financial stability and resilience, and ensure that financial institutions are sound and prudently run. But the challenge of making markets work has not been given anywhere near the same priority. Policymakers must recognise that ensuring financial markets work in the interests of financial users is just as important to the citizens' welfare as financial stability and prudential regulation.
- It is important to note that better regulation on its own will not be enough to reform markets. Corporate governance also needs to be significantly enhanced. Moreover, many of the problems in our financial system can be explained by the structure of our financial system – in particular the banking model which combines speculative activities, investment banking, and 'utility' banking, and the emergence of the shadow banking system. This series of papers focuses on regulatory reform rather than structural reform which is covered by separate initiatives.

Why has regulation failed?

- We attribute the failure of regulation to four main causes: i) a flawed economic paradigm and regulatory philosophy that wrongly assumed a degree of market effectiveness not borne out by objective analysis; ii) a flawed regulatory model that failed to understand the real root causes of market failure and failed to keep pace with evolving, unnecessary complexity and risk taking in financial markets and, consequently, failed to intervene effectively; iii) an approach to regulation adopted by under-resourced regulators that was too slow and unresponsive to emerging risks and market failure; and iv) inconsistent, weak implementation, supervision and enforcement of policy.
- The failure in the regulatory approach, in our view, can in turn be partly attributed to the undue influence of the powerful, well-resourced industry lobbies on the policymaking process. The perspective of experienced, independent user representatives has been largely missing from financial market reforms – this is partly due to the absence of enough mechanisms for representation and engagement and the very limited resources available to user representatives[16]. This is unfortunate as it means that policymakers and regulators unwittingly acquire insular, or worse, industry biased views on the purpose and design of regulation and miss the opportunity to incorporate the knowledge and views of experienced user advocates. This limits opportunities to challenge conventional wisdom on how markets function and leaves

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[14] Known as macro-prudential regulation.

[15] Known as micro-prudential regulation.

[16] See for example FSUG's analysis of the lack of user representation in the ESA system contained in our letter to President Barroso, http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/opinions/letter_barroso-fin_user_representation-2011_08_04.pdf.

policymakers and regulators vulnerable to 'group-think'. Compared to the huge resources available to the industry (in terms of marketing and advertising), the lack of resources available to regulators to implement and enforce regulation is also a contributory factor.

- The 'art and science' of financial regulation that focuses on making markets work is very underdeveloped. To be fair, there has been some work published on consumer protection – for example, by the OECD[17] and Financial Stability Board (FSB)[18]. But, as well as largely ignoring the behaviours in wholesale and institutional markets[19] the established approach to regulating 'retail' financial services is outmoded and has until now relied far too much on classical economic models. Policymakers have too often assumed that, given the right market conditions, the animating spirits of competitive markets will automatically lead to positive outcomes for financial users. But, just because there are hundreds of providers and thousands of financial products on the market, this does not guarantee the right outcomes for financial users (see below). In other words, the illusion of competitive activity has been confused with effective markets.

- Regulatory theory often assumes 'rational' economic behaviours and focuses on information asymmetries and competition theory to explain market failure. Consequently, regulators often favour interventions such as information disclosure and financial education to indirectly change market behaviour by enhancing consumer influence (the demand side). Information asymmetry theory is based on the premise that consumers face information disadvantages – and that this disadvantage can be addressed by information disclosure. The expectation is that the right market outcomes will then result from the interaction between more equal and opposite forces in a transaction[20]. However, while interesting in theory, this model has limited application in the real world of financial services. Firstly, market participants do not behave with the degree of rationality assumed by conventional economic models – and probably never will. Secondly, information asymmetry only partially accounts for market failure which means that information solutions have limited impact. Demand side cognitive limitations[21] and the potential for providers to exploit these biases casts doubt on the effectiveness of this policy tool. There are a range of deep-rooted demand side, network/interface, supply side causes of market failure[22] which must be addressed if complex, risky financial markets are to work.

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[17] *Consumer Policy Toolkit*, OECD.

[18] *Consumer Finance Protection*, FSB, 2011.

[19] Assuming, quite wrongly, that the markets are populated by sophisticated participants who do not require intervention, and inherent efficiencies and effective competition.

[20] Financial users on one side and providers/intermediaries on the other side of the transaction.

[21] 'Cognitive' – also called 'behavioural' – limitations locates the failures in the mental processes of individuals. For instance: lack of contractual schemas or knowledge structures; inaccurate default assumptions of how contractual provisions are likely to be structured and if the contract is negotiable; narrow decision framing or narrow choice bracketing, optimism bias in future financial planning and the tendency to replace full attentive information gathering strategies with heuristics in case of stress and pressure, as well as biases causing selective reading, perception and memory. See Garcia, C. & Van Boom, W. Information disclosure in the EU Consumer Credit Directive: opportunities and limitations, in: *Consumer Credit, Debt and Investment in Europe*, 2012, edited by Devenney, J. and Kenny, M., Cambridge University Press.

[22] As well as information asymmetries, financial markets are characterised by behaviours and traits such as product proliferation, overcomplexity, conflicts of interest, high pressured and aggressive sales practices, which can overwhelm the potential benefits of disclosure in certain markets.

- Note that FSUG fully supports initiatives to improve disclosure to consumers and enhance financial capability but these are not enough to make markets work – in other words, these are necessary, but not sufficient. There is a clear rationale for robust regulatory interventions and the need to consider other consumer policy approaches that target the causes and consequences of market failure[23] alongside a strategy of information provision. Moreover, as FSUG has stressed before, there is a risk that information disclosure is used as an excuse to shift responsibility from firms to financial users[24].

- Furthermore, a 'permissive' approach to consumer protection has been the preferred option until now. That is, as long as providers meet fairly basic authorisation/licensing conditions and conform to basic 'conduct of business' rules, regulators did not intervene in markets unless there was compelling evidence of large scale detriment they could not ignore[25]. This is also known as ex-post regulation and by its nature is slow to respond to emerging scandals.

- Moreover, regulators focused too much on consumer protection at the expense of other market failures such as market inefficiency[26]. Protecting consumers from unfair market practices is, of course, a priority. But fair financial markets are just one of the outcomes financial users need. We also need efficient markets that produce real value (especially now that many households face a painful squeeze in incomes) and socially useful products not complex, expensive financial innovations that just benefit the business models of financial institutions and intermediaries.

- Another important point to make is that it is not enough to correct market failure in 'retail' financial services[27]. Market failure is evident in each of the major parts of the financial system that affect the economy and welfare of financial users – for example, wholesale and capital markets, investment banking, institutional markets, fund management, and of course 'retail' financial services. The root cause of much of the financial detriment experienced by the 'end-user'[28] is often found further up the 'supply chain' in the wholesale and institutional markets and then transmitted back down the supply chain to damage the financial wellbeing of ordinary financial users. This has not been fully appreciated by policymakers and regulators and must be addressed if financial markets are to work for the 'end-user'.

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23 For instance, bans, development of risk guidelines to increase the awareness of risk related to financial products or services, co-regulation strategies which allows consumer/user involvement and monitoring, performance problems and operational redress, behavioural engineering approach ideally complemented with independent advice.

24 See FSUG response to consultation on OECD draft high-level principles on financial consumer protection, 31.8.2011, http://ec.europa.eu/internal_market/finservices-retail/fsug/opinions_en.htm.

25 Note that part of the problem is that policymakers and regulators may not even be aware of detriment due to the lack of comprehensive information systems – see above.

26 Policymakers and regulators lack a clear consensus on the role of regulation in financial markets. Some focus on 'safety', others on the consumer protection role in retail financial services, others on a narrow structural competition role. However, if financial markets are to work for users, the financial regulatory system must deliver the full range of market outcomes.

27 Where banks, insurance companies, investment firms, intermediaries, etc. engage directly with financial users.

28 Inefficiencies, high charges, value destruction, misselling of complex financial products.

Introducing a new regulatory philosophy and effective regulatory model

- Making financial markets work requires a profound change in the philosophy, culture, and approach to regulation. Financial users should be at the heart of market reform and the primacy of financial users re-established – that is, markets exist to serve the interests of users and society, not the other way around. This requires a more robust, sceptical, early interventionist, and precautionary approach to regulation.
- It is not enough for regulators to create the conditions for markets to work, they must act as agents of society and actively and directly intervene to change market behaviour. Individual financial users have very limited influence on market behaviour in key financial sectors. Therefore, where consumer power is weak, regulators should take on the role of 'super-consumers' to counteract the power and influence of markets to create the right outcomes for users[29]. This 'super-consumer' role is even more critical to protect the interests of vulnerable users in the market. It is also critical when markets are expected to take over the role of meeting core financial needs such as retirement provision, social insurance, or funding healthcare costs from the state. A different organising principle and much higher standards of behaviour and efficiency are needed when such public goods are involved.
- A more precautionary, early intervention approach is appropriate for complex, high risk markets such as financial services – this means a greater emphasis on ex-ante regulation. As we will go on to explain in the third paper in the series, good regulation does not stifle genuine innovation and choice – indeed, good regulation promotes socially useful innovation and choices.
- Furthermore, as explained above, policymakers need to understand the root causes of market failure and apply this new approach to the entire supply chain. The activities and behaviours of the institutions and intermediaries[30] at each part of the supply chain must be aligned to the interests of financial users. Making the supply chain more efficient also benefits the real economy and improves the chances of a genuine single market emerging from the wreckage.
- However, if a new regulatory philosophy is to have any impact on market behaviour, it has to be put into practice. This requires a new regulatory model (summarised below) that is more effective at helping regulators understand market realities and intervene effectively.

Report contents

- The report is in five sections. Following *Section 1: Introduction and Background*, *Section 2: Time for a change* reminds readers of the compelling case for financial market and regulatory reform.
- *Section 3: Creating a new culture and approach to financial regulation* proposes a set of clear regulatory objectives, along with guiding principles to provide regulators with a new purpose and direction, promote a more user focused regulatory culture and philosophy, and more effective, responsive

[29] Of course, regulators are not the only agents who can take on this super-consumer role – consumer groups and other trusted intermediaries have a very important role to play.

[30] Intermediaries includes those involved in the distribution, selling of and advising on products and services and professional intermediaries such as credit rating agencies, analysts, actuaries and consultants.

regulation. The key principles and duties include: a primary duty to act in the interests of all financial users[31]; truly balanced representation between financial users and providers; judgment and courage; independence, accountability, and transparency; objectivity and market neutrality; a precautionary approach to regulation; and consistent and robust implementation and enforcement. Policymakers need to manage the potential conflicts of interest between the imperatives of systemic risk/prudential regulation and consumer/investor protection/market reform (which must be given the same priority).

- Changing regulatory culture and philosophy requires clear regulatory objectives. For example, a single overarching strategic objective might be expressed as: *The primary objective of the regulator is to promote fair, inclusive, efficient, and transparent financial markets that operate in the interests of all financial users (or society). This can be underpinned by supporting objectives such as: in pursuit of its primary objective, the regulator shall: ensure financial institutions are prudently and soundly managed; ensure an appropriate degree of user protection; ensure regulated markets and firms operate with integrity (or have a fiduciary duty of care to financial users); promote competitive, efficient financial markets; ensure financial users have access to the necessary standardised, customised[32], targeted information to make appropriate decisions; promote financial capability; act in the interests of all financial users[33]; ensure access to appropriate redress; promote corporate accountability and responsibility in financial markets.*

- Cultural change is important but regulators also need the means to make markets work. In *Section 4: New model regulation* we provide a blueprint for a new systematic, regulatory model which allows policymakers to: define market success; identify detriment and market failure; undertake root cause analysis; identify effective interventions and remedies; and prioritise issues. Note that this model (suitably revised) can be applied further up the supply chain to institutional markets (such as pension funds) and, not just to 'retail' financial services.

    i) <u>Defining what efficient, successful markets look like:</u> it is very important that regulators have a clear understanding of what a successful market (from the user perspective) looks like. We have formulated a set of clearly defined user outcomes and market success measures (see below) which allow stakeholders (and regulators) to: judge whether markets are really working for users; undertake proper impact assessments; measure progress; and judge whether regulators are effective and hold them to account. A major concern for FSUG is the lack of comprehensive, independent data on financial market performance[34]. A priority for the Commission and regulators should be to establish publicly available databases built around the consumer outcomes and market success measures. Comprehensive data is not just a 'nice to have', it is absolutely necessary to allow society to judge

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[31] Of course, regulators should have regard to the interests of providers but only with respect to the impact on users. Moreover, regulators should be careful to act in the interests of all users not just 'middle-class' or wealthy consumers.

[32] Embedding information in users' and existing decision making routines based on: a) information's perceived value in achieving users' goals b) its compatibility with users' decision-making routines, and c) its comprehensibility.

[33] This is to ensure that regulators are required to consider the interest of all consumers not just 'middle class' consumers. It also forces regulators to consider whether certain groups of consumers are facing discrimination or restricted access to markets.

[34] *The Consumer Markets Scoreboard* is an important document but even this only covers a small number of the outcomes and success measures we need to judge the real effectiveness of markets.

how well markets are really performing. Moreover, it would improve the efficiency and responsiveness of regulation[35].

ii) Identifying and measuring detriment and market failure: there are two main methods of identifying existing and potential detriment – i) systematic monitoring and ii) risk assessment. Establishing clear outcomes allows policymakers and regulators to systematically monitor markets for detriment. By definition, detriment/market failure occurs when markets fail to produce the right outcomes for users. Potential risks to the outcomes can be evaluated by modelling the impact of external factors[36] and by looking for evidence of behaviours and practices that we know from experience cause detriment – see Root cause analysis, below. The impact of existing and potential risks on different groups of financial users – especially financially vulnerable households – should also be evaluated. Detriment should be measured on different dimensions – firm/institution specific, sector wide, market wide, supply chain based. This is critical for the prioritisation process.

iii) Root cause analysis: to be effective, regulatory interventions and remedies must target the root causes of detriment and market failure. The paper sets out a range of demand side, network/interface, supply side, and external factors, practices and behaviours that, in our experience, cause detriment in financial services. In addition to misleading/poor quality information, other factors include: conflicts of interest/agency problems caused by lack of transparency and remuneration practices; poor financial capability, cognitive limitations; inherent product complexity, unfair contracts, product design; anti-competitive practices/barriers to switching; diseconomies of scale, oversupply, overintermediation or, conversely, overconcentration[37]; unsustainable business models; aggressive market behaviours and corporate cultures; distribution/acquisition strategies; weak corporate governance, poor risk management or due diligence; inefficient gatekeepers; poorly designed regulation; and external socio-economic conditions. Financial markets are not homogenous and these root causes will be different in various sectors. The key here is that regulators should systematically investigate markets to explain detriment or identify adverse practices and behaviours for pre-emptive action.

iv) Identifying effective interventions and remedies: once detriment is evident (or potential risks identified), the appropriate intervention must be applied using a precautionary, early-intervention approach. Possible interventions include: changes to market entry requirements (authorisation/licensing)[38]; information disclosure and financial education; specific market rules on minimum standards of behaviour; product intervention including product banning; controlling commission

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35 Currently, whenever the Commission or EU/national regulators are considering a major policy initiative they often have to create the relevant information and databases 'from scratch' each time. Properly maintained market databases allow market reviews to be undertaken more efficiently.

36 For example, social, economic, commercial and technological factors – see *FSUG Risk Outlook* for our analysis of how external events can impact on financial users.

37 It is important to note that anti-competitive practices and poor consumer outcomes can result from too few providers dominating a market (overconcentration) and too many providers (oversupply). The key here is to understand the actual root cause of detriment relevant for the market under consideration. Critically, regulators must not assume that because there are numerous providers in a market, that market is producing the right outcomes for financial users.

38 This may include either toughening requirements if entry is too easy and resulting in oversupply or relaxing entry requirements if the problem is overconcentration.

payments and other aggressive remuneration practices; tough sanctions to deter repeat behaviours; introducing a legal duty of care; effective redress and mass consumer actions; compensation/guarantee schemes; structural reforms; competition referrals; and development of alternative products and providers. The scale of market failure may require a portfolio of interventions. Selecting the appropriate mix and balance of interventions requires skilled and confident regulators. It is also important to recognise potential trade-offs between the consumer outcomes[39]. Policies may be implemented using statutory legislation, regulation and rules or self-regulation. While self-regulation can sometimes work, as the paper highlights it seems to have limited success in financial services[40]. In some cases, it may well be that even under optimum conditions the market solution cannot meet the needs of certain groups effectively and alternative solutions are needed or provision mandated[41].

v) Prioritisation: finite resources mean that issues and interventions must be prioritised based on detriment and impact on financial users (with emphasis on vulnerable users); potential effectiveness of chosen intervention(s) – to establish the 'Return on intervention'; and available resources.

- *Section 5: Defining market success* describes the consumer outcomes in more detail including suggestions on market success measures. The success or failure of financial markets (or specific sub-sectors – banking, lending, savings, pensions, insurance, etc.) can be judged according to whether the following critical primary outcomes are met – *1. Access and usage:* users should have access to appropriate products and services[42]; *2. Safety and security:* financial institutions should be safe and prudently run, the financial system resilient, products and services should be safe and legally secure, and financial institutions and individuals authorised to high standards; *3. Fairness and integrity:* users should be treated fairly, markets and individuals operate with integrity; *4. Performance and efficiency:* markets should be efficient, sustainable and produce value for money, quality, functional, socially useful products and services that meet the core financial needs of users; *5. Decisions and choices:* users should have the necessary information, advice and financial capability to make the right financial decisions and choices; *6.Redress and accountability:* users should have access to well-resourced redress and guarantee schemes, wrongdoers held to account for detrimental behaviours; and *7. Confidence and trust:* users should have justified confidence in markets and institutions that deserve their trust. It is straightforward to develop market success measures to judge whether these primary outcomes are met. Clearly, outcomes and success measures must be tailored for specific financial sectors and different parts of the financial supply chain. As we explain above, the root cause of detriment and market failure experienced by end-users can often be found further the financial supply

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39 For example, in theory, a greater number of providers in the market should lead to greater market 'resilience' – in the sense that the prudential failure of one provider will have a lower impact on the total market. But, as we see from experience, oversupply of providers and overintermediation can result in diseconomies of scale, market inefficiencies, and increased costs – not effective competition and effective choices. However, in practice, efficiency and effective choice, and resilience can be achieved through the use of guarantee schemes.

40 We will deal with statutory and self-regulation in more detail in the next report.

41 For example, certain groups may not ever be commercially viable for even the most efficient provider and alternative solutions may be needed to meet the needs of consumers – for example, developing collective pension provision, mandating legal access to a bank account, developing alternative funding/lending mechanisms for SMEs.

42 An important factor when considering financial exclusion.

chain. Therefore, regulators need to assess the 'contribution' of each part of the supply chain to these primary outcomes. *The annex* contains a summary of the consumer outcomes, consumer detriment metrics, and root causes of detriment.

- Even the most effective regulatory approach cannot prevent all detriment or market failure so any system of regulation should also incorporate effective redress mechanisms to protect financial users in the event of such failures. One of the most important judgments or philosophical decisions policymakers and regulators have to make is where to strike the balance between deploying resources and focusing activities on prevention and redress – between ex-ante and ex-post regulation. We do not deal with redress/protection schemes in any great detail in this paper as FSUG covers this issue in other opinions and this has already been the subject of much debate by user representatives and policymakers.

- As mentioned, this paper will be followed by two further papers on practical aspects of regulation and innovation. We hope that this series of papers will provide some helpful ideas and start a much needed debate about the culture and effectiveness of regulation. We would welcome the opportunity to discuss these issues with interested stakeholders.

1 INTRODUCTION AND BACKGROUND

This is the first of three major papers from the FSUG on regulating the financial services industry so that it works in the interests of financial users and society. This is something of a departure for FSUG. Our opinions tend to relate to specific financial services issues[43]. However, the sheer scale of repeated market failure and value destruction in financial services demonstrates that there is something fundamentally flawed in the overall approach to regulation followed up to now by policymakers and regulators at EU and national level. Unprecedented, radical and sustained financial market reforms are needed and this requires a very different more robust, interventionist, precautionary approach to regulating financial services. But instead of just criticising previous approaches to regulation, FSUG also felt it also has a duty to propose such an alternative approach. Therefore, we took the initiative to propose a new regulatory model which we believe will be more effective than previous failed attempts.

This first report sets out the case for a new philosophy and approach to regulating financial services, describes a new model of regulation, and the principles underpinning this new regulatory model. This will be followed by a second report called *Financial Supervision and Sanctions* which focuses on the practical aspects of regulation including how to design regulation, how to supervise markets, enforcement, and the use of sanctions to change corporate behaviour and make markets work. The third and final report in the series, *Financial Innovation, effective competition and regulation*, challenges the widely held view that regulation stifles financial innovation to the detriment of financial users. It also looks at how regulation can be used to reward positive behaviours and promote competition. If we want financial markets work for society, the ultimate goal of any reform should be to create a system of regulation that penalises market failure and rewards positive market behaviours.

The reports are particularly relevant for policymakers and regulators at EU and national level. Clearly, the primary concern for EU policymakers is an effective single market. However, there is little evidence of significant positive cross-border activity - where financial users in Member States with ‘inferior’ financial services use the single market to actively and knowingly seek products from ‘superior’ providers in a different Member State. Indeed, the fear is that regulatory arbitrage is occurring. A truly safe, fair, efficient, and competitive single market that works for users can only realistically happen if it is also made up of safe, fair, efficient and competitive national markets.

The reports will also be of interest to stakeholders such as consumer and investor groups, civil society groups, think-tanks and academics who have a stake in making financial markets work. We hope that these papers will provide some helpful ideas and start a much needed debate about the culture of regulation. We would welcome the opportunity to discuss these issues with interested stakeholders.

[43] Such as MiFID, the IMD, or collective redress. For a list of opinions produced, see http://ec.europa.eu/internal_market/finservices-retail/fsug/opinions_en.htm.

Structure of report

The report is divided into five parts. Following this Introduction and background section, Section 2: Time for a change: this reminds readers of the overwhelming case for financial market reform and why it is time to change the approach to regulation. Section 3: Creating a new culture and approach to financial regulation, provides a set of guiding principles which, if adopted, would provide regulators with a sense of purpose and direction, promote a more consumer focused regulatory culture and philosophy, and a more effective and responsive approach to regulation.

Cultural change is important but regulators also need the means to make markets work. In Section 4: New model regulation, we describe a regulatory model which allows policymakers to formulate consumer outcomes, identify and measure market failure, undertake risk assessments, and identify effective interventions. Policymakers must be clear about the market outcomes they are trying to achieve and make the market deliver those outcomes – they can no longer rely on the right outcomes to 'emerge' naturally from market forces and light touch regulation.

Throughout the series of papers, when we discuss a new model for regulation this includes regulation, supervision, and enforcement: regulation is the formulation and making of policy; supervision is the monitoring of compliance with policy; enforcement is enforcing against breaches of policy including the application of sanctions. This first report deals with the formulation and making of policy.

Section 5: Defining market success, describes the consumer and market outcomes in more detail including suggestions on how these outcomes can be measured.

The annex contains a summary of the consumer outcomes, the metrics for measuring consumer detriment, and root causes of detriment (which allows regulators to spot emerging risks).

Any effective regulatory system should also incorporate effective redress mechanisms to protect financial users in the event of regulators failing to prevent consumer detriment and market failure. One of the most important judgments or philosophical decisions policymakers and regulators have to make is where to strike the balance between deploying resources and focusing activities on prevention and redress – between ex-ante and ex-post regulation. We do not deal with redress/protection schemes in any great detail in this paper as FSUG covers this issue in other opinions and this has already been the subject of much debate by user representatives and policymakers.

Three major regulatory challenges

What is clear is that large scale market failure is evident in each of the major parts of the financial system that affect the economy and welfare of financial users[44] – wholesale and capital markets, institutional markets, and of course 'retail' financial services.

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[44] Throughout the report, when we refer to financial users, we include a broad definition which includes consumers, depositors, borrowers, investors, pension scheme members and trustees, policyholders, and small and micro entities.

FSUG – Making financial services work for financial users
Paper 1: New model financial regulation

As we know, the ongoing financial crisis continues to threaten the stability of EU financial markets and economies. It has seriously undermined consumer confidence in, and legitimacy of, our key financial markets. The crisis exposed systemic flaws in the financial system. Far from reducing risk, many activities and behaviours in the financial services industry magnified systemic risk in our financial system.

But the focus on systemic failures has diverted attention away from other chronic failures in financial services. There is much to commend in financial services but there is a growing sense that the fundamental purpose of financial services – to meet the needs of financial users, economy and society – has been subordinated to the short term interests of powerful financial markets and institutions. Financial services and markets have failed ordinary financial users and wider society far too often.

Policymakers need to recognise that, when thinking about how to make markets work for financial users, it is no longer enough to focus on market failure in 'retail' financial services. The performance of the wholesale and institutional financial markets can have a major detrimental impact on the financial well-being of ordinary financial users. The root cause of much of the financial detriment experienced by the 'end-user'[45] is often found further up the 'supply chain' in the capital, wholesale, and institutional markets – and then transmitted back down the supply chain to damage the financial wellbeing of financial users. Therefore, to make financial markets for financial users, policymakers need to apply a more robust, interventionist, precautionary approach to the entire supply chain including the intermediaries that operate at each link of the supply chain.

What is striking is that how badly much of the financial services industry has performed even during the comparative good times. But we face a new financial and economic paradigm defined by a range of macro and micro socio-economic events including: a period of financial repression and fiscal retrenchment; transition from a liberal to more restrictive lending regime; low economic growth; high debt (public and private); sustained pressures on household finances; low interest rates, margin and revenue pressures on core retail banking products; reduced real investment returns and a paradigm shift in risk/reward ratios; a more uncertain political and regulatory climate; more 'repressive' regulation; a shift in shareholder attitudes; technological developments; and changing consumer attitudes towards and levels of confidence in financial services. Regulatory interventions will also have unintended consequences. Therefore, the challenge of making markets work will become even harder.

In this environment, three clear regulatory challenges can be identified:

- Rescue and stabilisation: as the ongoing crisis shows, we not 'out of the woods' yet, with huge financial risks remaining and renewed threats of recession in the EU. Huge costs are being transferred to citizens including future generations;
- Financial market reform and crisis prevention measures: this includes improved financial stability and systemic risk management (macro-prudential) and better regulation of systemically important financial institutions (micro-prudential regulation); and
- Making markets work for citizens, the wider economy and society: financial markets need to be reformed so that they are more efficient and operate in the interests of financial users and the real economy and more accountable to

[45] Inefficiencies, high charges, value destruction, misselling of complex financial products.

society. Policymakers must recognise that ensuring financial markets work in the interests of financial users is just as important to the welfare of EU citizens as financial stability and prudential regulation. Making the financial services 'supply chain' more efficient will deliver benefits for the real economy as well as the ordinary financial users at the end of the supply chain and improve the chances of a genuine single market emerging from the wreckage.

So far, in the response to the financial crisis, systemic risk management and prudential regulation has dominated the agenda at the expense of consumer/investor protection and market reform. Huge intellectual effort and regulatory resources have been devoted to the challenges of promoting financial stability and improving prudential regulation. Policymakers and regulators are developing sophisticated models to allow them to analyse whether financial markets are working and regulation is effective in prudential terms – for example, capital requirements, liquidity ratios, solvency ratios, and so on.

FSUG appreciates that rescuing our economies and financial systems must be a priority. Moreover, we recognise that prudential regulation is important and that making markets work for consumers can be a rather abstract issue if financial institutions collapse.

But, the challenge of making markets work for ordinary financial users has not been given anywhere near the same priority as financial stability and prudential regulation. The 'art and science' of financial regulation that focuses on the interests of financial users is very underdeveloped. To be fair, there has been some work published on consumer protection – for example, by the OECD[46] and Financial Stability Board (FSB)[47]. However, this is outmoded and relies far too much on classical economic models which have limited application in complex markets – for example, the focus on information asymmetries and dynamics of choice or interventions such as financial education which have limited impact in changing provider behaviour and may take a generation to have a real impact on consumer behaviour.

Policymakers have until now followed what might be called a 'permissive' approach to regulation. That is, as long as providers meet authorisation/licensing conditions and conform to basic 'conduct of business' rules, regulators do not intervene in markets unless there is compelling evidence of large scale detriment they cannot ignore.

A more precautionary systematic approach is appropriate for complex, high risk markets such as financial services. That is, where regulators scrutinise more closely product design and business models before allowing products loose on market.

Moreover, it is critical to recognise that consumer protection is not the same as making markets work. Protecting consumers from unfair market practices is, of course, very important. But fair financial markets are just one of the outcomes financial users need. We also need efficient markets that deliver real value (especially now that many households face a painful squeeze in incomes) and markets that produce socially useful products that meet the core needs of users not complex, expensive financial innovations that benefit the business models of financial institutions and intermediaries.

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46 *Consumer Policy Toolkit*, OECD.
47 *Consumer Finance Protection*, FSB, 2011.

Policymakers have too often assumed that, given the right market conditions, the animating spirits of financial markets will automatically lead to positive outcomes for financial users. But, just because there are hundreds of providers and thousands of financial products on the market does not guarantee the right outcomes for financial users. In other words, the illusion of competitive activity has been confused with effective markets.

The failure of regulation in our view can be partly explained by the fact that the perspective of experienced consumer advocates has been largely missing from financial market reforms. This is unfortunate as it means that policymakers and regulators unwittingly acquire insular, or worse, industry biased views on the purpose and design of regulation and miss the opportunity to incorporate the knowledge and views of experienced consumer advocates. Hopefully, this series of papers will go some way to redress that imbalance.

2 TIME FOR A CHANGE: THE COMPELLING CASE FOR REGULATORY REFORM

Before we go onto to describe a new model of regulation, we should remind ourselves just how important financial services are to the financial and social welfare of citizens and the extent of market failure that justifies a radical new approach to regulating financial markets and providers is necessary.

The critical role of financial markets

When discussing financial stability, policymakers and regulators often speak about systemically important financial institutions. However, the nature of the goods and services provided by financial services providers means they are also 'socially important financial institutions'. Socially important financial institutions should be regulated to much higher standards than other consumer goods especially if they are expected to take on the important welfare role of the state.

Financial markets and providers provide a range of core functions which are critical to the functioning of our economies and society including:

- Networks and systems for transmitting and circulating money around the financial system and economy;
- Financial markets for allocating savings/investment capital to the real economy, stock exchange functions;
- Financial markets for intermediating savings/deposits to provide access to credit (short/long term, secured/unsecured) for consumers, industry, and government (the bond markets);
- Insurance, reinsurance, and derivatives markets to allow economic actors and investors to protect against and manage risks; and
- Financial products and services to meet the core financial needs of financial users.

In this report, we focus on meeting the needs of financial users. However, as we point out, the financial wellbeing of financial users is seriously affected by adverse behaviours and inefficiencies in the wholesale and institutional markets. Policymakers can no longer assume that the wholesale and institutional financial markets are efficient. The impact is not contained within the wholesale and institutional markets. It is important to recognise that if markets are to meet the needs of financial users, wholesale and institutional markets need to be reformed along with 'retail' financial services.

Citizens have a range of core financial services related needs increasingly being met by private sector financial providers including:

- Access to a transactional bank account to meet everyday financial needs.
- Liquid assets or short term savings in the event of an emergency need.
- Long term savings or investments for future events.
- The means to provide a decent income in retirement.

- Insurance against the risk of losing income and/or health.
- Insurance against loss of or damage to physical assets.
- Affordable housing provided either by renting or access to mortgage funding to purchase a property.
- A source of affordable credit in the event of needing to smooth out income flows or as a short term source of emergency funds.
- Objective financial advice and information to help them make effective choices and decisions.

The financial industry also has a critical role to play in 'intermediating' the savings and investments of one group of financial services users into mortgages and loans of another group of users.

Moreover, the products and services provided to financial users are a critical source of capital and long term investment for the real economy.

Core financial products and services are not discretionary consumer lifestyle goods – they are now necessities in a modern economy. In the EU, these core financial needs are met by a mixed economy of provision to varying degrees. Retirement incomes and social or welfare insurance tends to met by a combination of state and private provision (with the balance between state and private provision varying between Member States). In other areas, provision is predominantly provided by the private sector financial services industry with the state regulating the behaviours of the industry – in some cases, access to financial services is regulated.

FSUG is neutral about the way these core financial needs are met. However, policymakers in many states are actively pursuing a strategy of using financial services to increasingly take on the important welfare role of the state (funding retirement incomes and social care, insurance against loss of health and income). Therefore, policymakers have a duty to ensure (on an ex-ante basis) that financial markets are fit to meet the needs of citizens and that any transfer of risk and responsibility can be achieved fairly, efficiently, sustainably, safely and responsibly.

The sales and marketing of core financial products sold by socially important financial institutions and the behaviours of financial intermediaries and distributors should be regulated to higher standards than other consumer goods[48]. Similarly, financial users have a right to expect high levels of professionalism from those working in the financial services sector given that poor quality financial advice can have devastating effects on household finances and retirement incomes.

Moreover, whilst it may be desirable to allow firms in consumer sectors to fail in the interests of competition and innovation, if a financial institution fails it can have much wider consequences. Financial institutions need to be governed by much more robust prudential regulation and auditing standards to prevent failure in the first place and compensation schemes to minimise consumer losses in the event of a failure.

Therefore, a different approach and much higher regulatory standards and consumer protection must be applied to financial markets. However, when determining the role financial markets should play in the lives of citizens, it is not just a question of consumer protection and financial regulation. We need to consider the pre-eminent

[48] Please note that this refers to sales and marketing, not safety. We recognise that the safety of 'physical' consumer goods and products is paramount as faulty products can result in serious injury or even fatalities.

status markets are acquiring as an organising mechanism for society and the effect this has on vulnerable or disadvantaged citizens. There is a core set of rights the protection of which transcends the rhetoric of economic efficiency.

The responsibility of policymakers and regulators does not end at regulating markets to ensure market efficiency. Even markets that operate at optimum efficiency cannot meet the needs of all citizens. Markets are amoral (not immoral). The 'invisible hand' of the market allocates value based on economic power not needs or rights. Therefore, in certain cases, policymakers need to enforce rights in markets to ensure the right outcomes for citizens or where markets cannot deliver, provide alternatives to the market.

Clearly, there is clearly a much wider public policy debate needed to determine the relationship between citizens and financial markets. This paper focuses on the regulatory challenges.

Market failure in financial services

The FSUG makes the following observations to illustrate the scale of the challenge facing policymakers and regulators if they want to create a single financial market that works for EU citizens:

- A 'democratic deficit' exists in the EU system of financial governance. Financial providers were allowed to become largely unaccountable and ungovernable. Nation states, with few exceptions, now seem to be in thrall to the financial markets (or, to be more precise, a small number of powerful market actors), that exercise huge power and control over democratic nation states, not just the financial well-being of individual consumers. Moreover, the financial services industry exerts far too much influence over the policymaking process.
- The rewards for financial speculation and market manipulation were privatised, while the risks and costs were socialised with the result that EU citizens are being forced to pay a terrible price for the crisis. The cost of bailing out the financial system means that economic growth has been seriously affected with massive public deficits resulting.
- Financial services and markets, despite their much heralded and self-appointed role as enforcers of economic discipline and economic efficiency, have huge in built inefficiencies of their own wasting EUROS billions of savers and investors capital in the form of opaque, high charges.
- Savers and investors capital has been diverted away from economically productive or socially useful activities in the real economy to speculative activities and financial products of questionable social or economic value.
- Poor standards of corporate social responsibility allowed financial and legal engineering to be used by bankers and banking lawyers to systematically circumvent regulations such as tax, capital adequacy, disclosure rules in takeovers and trade embargoes, to get round regulatory control and the rule of law and involving regulators in a cat and mouse game[49].

[49] McBarnet, D. (2010) *Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and Banking Crisis*; MacNeill (ed.), *The Future of Financial Regulation*, Oxford: Hart; see also McBarmet (2006) *AfterEnron: will whiter that white collar crime still wash?*, British Journal of Criminology 46, issue 6; Huertas. T. (2008), Banking Sector FSA (2008) *Hybrid Capital*, speech at City and Financial Bank Capital Seminar.

- Financial institutions and financial intermediaries should have an important role to play in helping citizens make effective decisions and encouraging citizens to provide for the future (consumer inertia is a significant problem). However, aggressive institutional behaviours have resulted in a litany of misselling scandals that have left a legacy of mistrust and undermined consumer confidence in markets.
- There are now many layers of financial intermediaries between investors and capital markets extracting high fees and destroying investor value.
- The security of consumers' savings has been compromised and sub-optimal asset allocation decisions by supposedly expert investors has resulted in major value destruction in the pensions and long term investment sector (much of which is only now coming to light)[50]. This has further undermined confidence in markets at a time when citizens are expected to provide for the future. As a result, more citizens will be required to fall back on the state.
- Consolidation in the banking sector means that competition and choice may be significantly reduced, while the need for financial institutions to rebuild profits and a more risk adverse attitude in future means that institutions are likely to increasingly focus on higher profit/lower risk financial users which will cause even greater financial exclusion.
- Reckless lending in the run up to the financial crisis in certain Member States resulted in overindebtedness and distorted, overinflated property markets has now reversed with the result that many households find it impossible to get access to fair and affordable credit and are forced into the hands of predatory lenders. One of the most fundamental roles of financial institutions – to intermediate deposits into sustainable loans for other consumers and industry – has been undermined by speculation.
- As the Commission's own Consumer Markets Scoreboard [51] shows, FSUG representatives are right to be very concerned about the failure of financial services to work effectively for financial users. The Consumer Markets Scoreboard is a very powerful tool as it evaluates markets from the user perspective – not from the industry perspective. Despite the claims of industry lobbies, the research shows quite clearly that financial services continues to be amongst the very worst performing markets in the EU[52]. Previous attempts to make markets EU financial markets work by focusing on demand side interventions (such as information provision and/or financial capability) have had limited impact on their own.

What concerns FSUG is that the performance of the financial services industry has been poor even during comparatively 'good times' in the run up to the financial crisis. However, as we demonstrate in the FSUG Risk Outlook we face new, difficult economic reality which makes it even more important that the EU financial services industry is efficient and structured to meet the needs of financial users. Unless policymakers and regulators adopt the right policies, we fear that the level of detriment in the market will be even greater in the post-financial crisis era.

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50 For example, see the OECD's Pensions Outlook which shows how pension funds in many EU countries suffered negative returns over the short-medium term and barely kept pace with inflation over the medium-long term. Yet the OECD argues that there should be an expansion in the use of private pensions. See http://www.oecd.org/dataoecd/23/9/50560110.pdf.

51 http://ec.europa.eu/consumers/consumer_research/editions/docs/6th_edition_scoreboard_en.pdf

52 The investment, pensions and securities sector is one of the worst performers.

Of course, self-regulation has its place and designed properly can work in certain cases but it does not have a very good track record in financial services. For example, in February 2012, DG Health and Consumers published the results of a mystery shopping carried out to assess the implementation of a code of conduct adopted by the banking sector at EU level: it shows that more than two thirds of mystery shoppers were not able to switch their bank account successfully[53].

Therefore, given the legacy of previous failures and the scale of the challenges ahead, we hope there is a consensus amongst policymakers and regulators on the need for a different, more robust approach to regulating financial services. Tough supply side interventions and a new approach to financial regulation is needed to change the behaviours and improve the efficiency of the EU financial markets and promote a real single market that works in the interests of financial users and citizens.

However, a new approach to financial regulation requires independent regulators in each Member State with the necessary powers, sanctions, and resources to do an effective job. An effective, stable, safe single market needs to be built on a platform of effective markets in Member States. Similarly, markets at EU and Member State level cannot work to good effect without well-resourced, independent representative organisations to challenge powerful industry lobbies and ensure that the voice of the ordinary financial user is heard within decision making circles.

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[53] http://ec.europa.eu/consumers/rights/docs/switching_bank_accounts_report_en.pdf

3 CREATING A NEW REGULATORY PHILOSOPHY AND CULTURE

There are many complex theories about financial regulation but it is actually quite simple to define and summarise what financial users expect from markets and therefore what the objectives and outcomes of effective regulation should be.

Financial users expect:

- Access to socially useful, value for money, safe, products and services that meet their needs from efficient, competitive providers that treat them fairly and who deserve their trust;
- Sufficient information and fair, unbiased advice to make the right choices; and
- Adequate redress if things go wrong and wrongdoers held to account.

Unfortunately, as we explain above, far too often, the financial services industry in the EU has failed to deliver these outcomes for consumers.

Protecting financial users in this new, more challenging era, means that regulators must become more proactive and responsive to threats to consumer welfare. Regulators should work on the principle that prevention is better than the cure. It is more effective to pre-empt and prevent detriment from occurring in the first place rather than respond after the event. Making financial markets more efficient and responsive to the needs of financial users requires a radical change in attitude towards markets – regulators can no longer assume that markets know best.

But making this change happen and creating the right outcomes for financial users requires a profound change in the philosophy and culture of regulation.

Principles, objectives and duties

Creating a new regulatory philosophy and culture is not easy. Therefore, we have developed a set of operating principles, strategic objectives, and duties which, if adopted, should embed the interest of financial users into the regulatory process, create a more consumer-focused culture, and a more responsive and effective approach to regulation.

It is more effective if the strategic objectives and duties are enshrined in legislation to provide real accountability. The principles, objectives, and duties are:

- Primary duty to financial users: regulators should have a primary duty to financial users. Too often in the past, powerful industry lobbies have undermined regulation. Of course, regulators should 'have regard' to the impact of policies on the industry but regulators should be focused on making financial markets work in the interests of consumers and wider society, not financial markets or specific industry sectors. Regulators should not assume that what is good for markets and firms is automatically good for financial users.
- Act in the interest of all financial users: regulators should act in the interest of all financial users, not just 'middle-classes' or wealthy financial users. Particular attention should be paid to the most vulnerable financial users. The

definition of financial user is important[54]. Financial users should be defined as those who have used, are using, or may use financial services. This ensures that the interests of non-users who may be excluded from financial services are considered. Regulators should develop indicators and typologies of consumer vulnerability in financial services and identify areas where stricter standards of consumer protection are needed[55].

- Managing conflicts of interest[56]: regulators need to address the potential conflicts of interest between the objectives of prudential regulation and consumer/investor protection. As we outline above, consumer/investor protection has been the 'poor relation' in the regulatory system. Policymakers should ensure that making markets work for financial users and consumer/investor protection is given the same priority as prudential/systemic risk management.

- Judgment and courage: amongst the most important qualities that regulators should have are sound judgment and the courage and confidence to act on that judgment. History shows that regulators have been too timid in the past to act to prevent detriment. The failure to intervene or to intervene robustly enough has allowed detriment and market failure to continue long after the point at which it should have been stopped.

- Independence: regulators must be independent, and be seen to be independent, from the industry they regulate. They must be accountable to society (see below) as decisions taken by regulators can have wider public policy consequences (for example, decisions to raise capital levels can impact on availability of affordable credit, or have major consequences for the housing market in many Member States). It must be remembered that regulators (and policymakers for that matter) derive their ultimate authority from citizens.

- Openness, transparency, and freedom of information: openness and transparency should be the default setting for regulators. Disclosure of information in the public interest should take precedence over commercial interests. There are very few circumstances where withholding information on market behaviours is justified on the grounds of protecting commercial interests. Transparency is critical if regulators are to be held accountable to consumers and society (see below). Transparency also improves the effectiveness of regulation by allowing user representatives to scrutinise performance of the financial services industry and hold industry to account for failures. Unfortunately, there are many provisions in EU and national legislation which protect commercial interests to the detriment of the public interest. This, in turn, undermines the effectiveness of regulation. A wide ranging review of legislative provisions which prevent information from being disclosed is a priority.

- Accountability and representation: regulators must be properly accountable to consumers and wider society. This means ensuring the consumer interest is properly represented at the highest level. Suitable, well-resourced user representation at the highest level of the policymaking process is critical for a

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[54] With regards to vulnerable consumers, the descriptive analysis of consumers are far richer than the legal concept, which in broadly assumes consumers are anybody acting outside their normal business. Nevertheless, the legal concept, for understandable reasons, fails to analyse the extent of consumer vulnerability.

[55] See FSUG opinion paper on OECD draft high-level principles on financial consumer protection, 31.8.2011, http://ec.europa.eu/internal_market/finservices-retail/fsug/opinions_en.htm.

[56] Regulators also need to manage the conflicts of interest in the financial services supply chain which are the root cause of much detriment and market inefficiency in financial service – see Interventions below.

number of reasons: it enhances regulatory governance and accountability by balancing the influence of powerful industry interests; it significantly improves the capacity of user representatives to represent the interests of users and provides users with more direct involvement in the policymaking process; it ensures policymakers abide by the principles of good consultation thereby improving the consultation process; and most importantly, it improves the policymaking process by enabling policymakers to better understand the needs of users and avoid 'group-think'. This is particularly important given the emphasis placed on prudential/systemic risk management at the expense of consumer/investor protection.

- Objectivity: policymakers and regulators should be objective and understand that markets are a 'means to an end'. There may be examples where market solutions are not the optimal way to meet consumers' needs and alternatives are needed. A good example of this is the provision of pensions, social or welfare insurance, funding healthcare, or funding long term care in old age where collectively provided solutions are often more efficient, sustainable, and equitable than individual market based solutions where millions of consumers are expected to engage with thousands of providers and products. Similarly, policymakers may have to develop alternative products and providers to meet the needs of financial users who are not viable for 'mainstream' financial services.

- Market neutrality: regulators should be neutral towards particular sectors or business models. Regulators should not develop regulatory policy to protect particular business models unless it is of proven benefit to consumers (for example, there is a strong prima facie case for protecting mutuals to ensure diversity and competition).

- Understand financial users: regulators should make sure they understand how financial users think and behave in real life. Users are not homogenous and there is a wide variation in the level of sophistication and financial capability shown by users. Most 'ordinary' financial users do not usually conform to the classical economic models of rationality. The management and staff of regulators usually are very knowledgeable and experienced in financial services compared to the 'average' user. This may make it difficult for regulators to understand how financial users will respond in real life to interventions and to avoid imposing one-size fits all solutions. Understanding financial behaviours is important for regulators if they are to prevent financial service providers exploiting consumer's cognitive biases to enhance profits which creates further rationales for regulation.

- Target root cause of market failure: regulators should target the root cause of market failure. In many cases the cause of market failure or consumer detriment can be found not at the point of sale, but further upstream in the behaviours of institutional or wholesale financial markets or during the product 'manufacturing' stage. Evidence is important to inform judgments. However, judgment is equally important.

- Adopt a precautionary, not permissive approach to regulation: a more precautionary systematic approach is appropriate for complex, high risk markets such as financial services. That is, where regulators scrutinise more closely product design and business models before allowing products loose on market. Prevention is better than the 'cure'.

- Intervene proactively and decisively: financial regulators must become more responsive and flexible. Early interventions limit the scale of detriment and are more effective at protecting consumers (and more cost-effective) than clearing up after the event. Effective interventions include: market alerts, product interventions (such as banning toxic financial products or at least banning toxic advertising campaigns), addressing potential conflicts of interest. Interventions should target the root cause of detriment and market failure, not the symptoms.
- Implement and enforce regulation consistently and robustly: developing regulatory policy is important. But it is equally important to enforce policy robustly and consistently. If regulatory policy is not implemented and enforced properly it negates the purpose of regulation. Moreover, inconsistent implementation and enforcement distorts the single market and encourages regulatory arbitrage. Regulators should avoid regulating in 'silos' – that is, developing completely separate legislation and regulation for products and services that have similar purposes. In the past, this silo approach resulted in divergence in consumer protection standards and encourages regulatory arbitrage[57].
- Collaboration and 'co-production': financial regulators should proactively collaborate and cooperate with NGOs and representatives of financial users. NGOs, especially consumer and investor organisations that watch markets from their specific viewpoint are an invaluable source of evidence for regulators. Financial user representatives should also be closely involved in the 'design' of regulation to ensure regulation is designed around the needs of financial users.
- Adopt effective deterrence and sanctions: tough sanctions are an effective regulatory intervention and are important for a number of reasons. Sanctions have to be effective, proportionate with the gravity of the breach in the law and dissuasive, in order to prevent future law violations. Tough sanctions ensure that financial institutions, shareholders, and individuals in positions of authority understand that there is a price to pay for mistreating consumers so act as a deterrent to repeat or 'copy-cat' behaviours. Sanctions also create a level playing field for 'good' market providers by ensuring that providers who act unfairly or irresponsibly do not gain a market advantage. Sanctions can also provide a further market disciplining effect – shareholders and analysts will put pressure on financial institutions to clean up their acts if they recognise that negative behaviours will affect the bottom line (revenues and profits). However, if sanctions are to be effective, they must be tough and have a clear impact on the financial position of financial institutions. Low value sanctions are seen by the industry as a marginal cost of doing business. Regulators should use the 'polluter pays' principle. Regulators should set a clear tariff for sanctions – based on the extent of detriment caused and underlying cause of detriment (see Interventions, below). Clearly, sanctions have to be applied intelligently and proportionately to avoid unintended

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[57] A good example, is the market for long-term savings and investments. We currently have a range of regulations covering this important market including: MiFiD, IMD, AIFMD, PRIPS and so on. The products covered by these directives fulfil the same core financial needs – they provide access to capital markets to provide returns for savers/investors. There is no reason to have separate regimes covering the sales and marketing, distribution, and design of these substitutable products. Moreover, the current system of European Supervisory Authorities (ESAs) risks 'institutionalising' this silo approach with different supervisory authorities each having responsibility for different financial sectors and products. We recommend that the Commission and ESAs establish an independent consumer expert panel to advise the ESAs on consumer protection and market issues. For example, this panel could help ESAs identify risks, identify interventions such as product banning, and help coordinate activities.

consequences that could harm the interests of financial users in the long term (for example, closing down a firm and reducing choice and competition in markets that already have high degrees of concentration).

- Regulators should be well-resourced and independently funded: legislators and policymakers should ensure that regulators have sufficient resources to do an effective job. Cost cutting on regulation is a false economy as the costs of failure are ultimately transferred to society anyway in the form of externalities. The funding mechanism for regulators should ensure that regulators are protected from undue industry influence. This can be done by using public funds or statutory levies on the industry.
- Be efficient and cost-effective: while sufficient resources are important, regulators also have a duty to be efficient and cost-effective. The cost of poor regulation is ultimately passed onto society. Wasteful regulation also provides industry with a stick with which to beat regulators and to argue for deregulation.
- Ultimately, the responsibility for ensuring regulators comply with these duties will fall to elected representatives and policymakers such as finance ministries and/or central banks. Therefore, for the greatest effect, some of these duties and principles should be included in the necessary legislative frameworks and expressed in the form of clear statutory objectives[58]

[58] For example, regulators could be given an overarching statutory objective to: promote fair, efficient, and transparent financial markets that operate in the interests of financial users. This overarching objective can be supported by duties and operating objectives.

4 NEW MODEL FINANCIAL REGULATION

Changing the culture of regulation and philosophy that governs the approach to regulation is obviously critical. But any new philosophy must be put into practice if it is to have any impact on the market. Drawing on our knowledge of financial markets and experience as user advocates, we are now proposing a new, more systematic approach to regulation which in our view more likely to make markets work.

There are four key stages in the financial policymaking and regulatory process. These are:

- The formulation of strategic consumer and markets policy;
- Policy making – ie. implementation of detailed policy measures including making legislation and rules, undertaking detailed impact assessments;
- Supervision and monitoring of established policies; and
- Enforcement of breaches of policy including application of sanctions.

This paper focuses on the first stage. The other stages will be dealt with in subsequent papers.

Strategic policy formulation

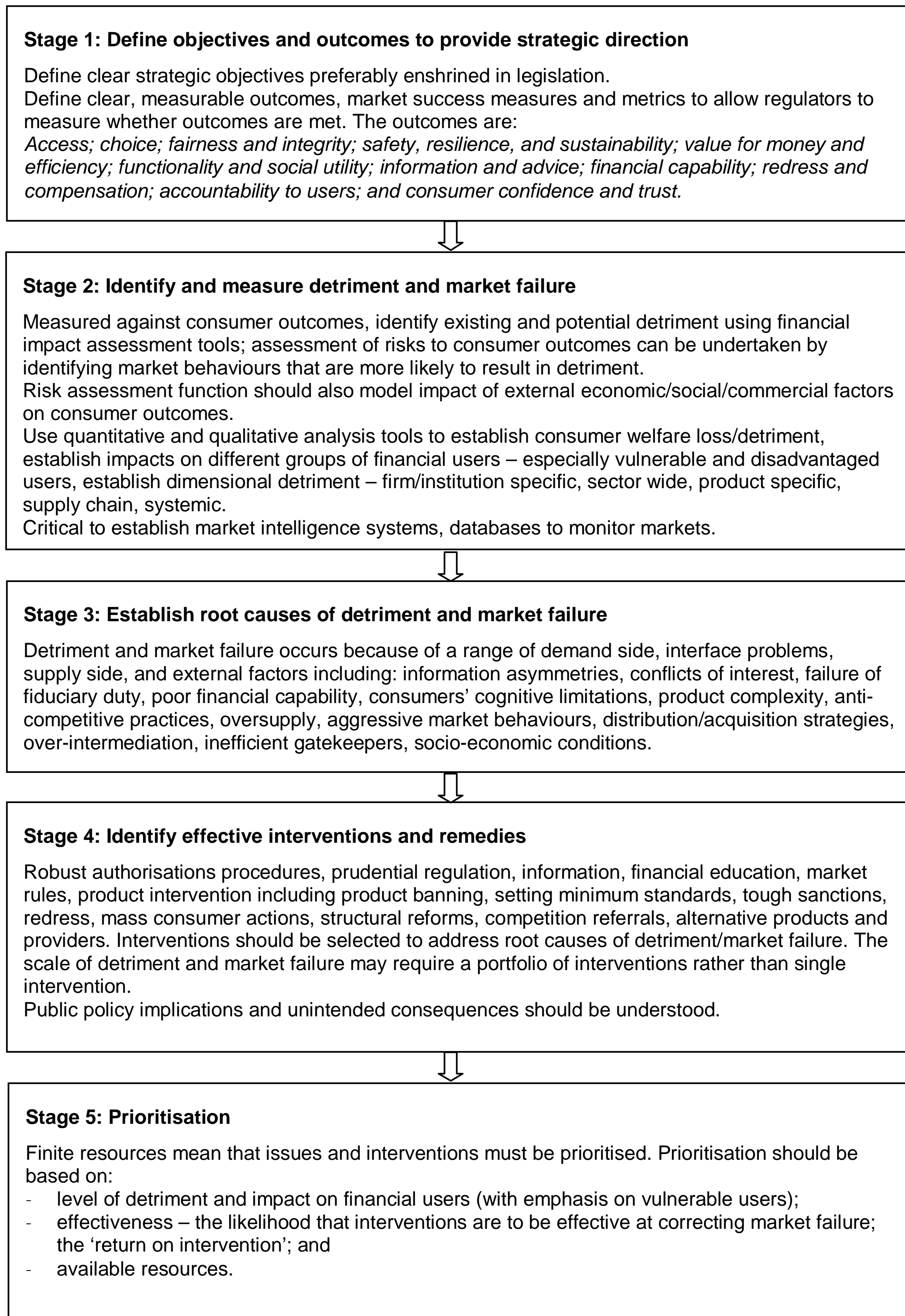
The strategy policy process consists of:

- the setting of consumer and market outcomes;
- identifying and measuring existing consumer detriment/market failure and risk analysis;
- understanding why markets fail (root cause analysis);
- identifying policy interventions and remedies; and
- prioritisation.

This is underpinned by a regulatory philosophy that governs the approach to regulation and exercise of judgments outlined in the previous section.

The flowchart below, Chart 1, summarises the strategic policy making process.

Chart 1: The strategic policy formulation process



We now look in more detail at the five separate stages of the policy formulation process.

Stage 1: Define clear regulatory objectives and outcomes to provide strategic direction

The first stage for legislators or policymakers is to formulate a strategic policy objective or objectives for regulators. Properly formulated objective(s) along with the principles described above are necessary to provide regulators with a sense of purpose and sense of direction. Objectives remind regulators that they are public servants, there to serve the interests of financial users and wider interests of society. Well formulated objectives and outcomes are also critical for democratic accountability and allow elected representatives and civil society representatives to hold regulators and the financial services industry to account.

As we explain above, objectives should be based on financial users' expectations. When financial users engage with markets, they want the following outcomes:

- Access to socially useful, value for money, safe, products and services that meet their needs from efficient, competitive providers that treat them fairly and who deserve their trust;
- Information and advice to make the right decisions; and
- Redress if things go wrong and wrongdoers held to account.

These expectations can be translated into a single overarching statutory objective and/or a set of explicit operational objectives.

It is critical that regulators recognise that these objectives should be applied to all parts of the financial system not just 'retail' financial services – much of the detriment and market failure that damages the financial wellbeing of users (consumers, investors, the 'real' economy) occurs 'upstream' in the wholesale or institutional financial markets.

A single overarching strategic objective might be expressed as: *The primary objective of the regulator is to promote fair, inclusive, efficient, and transparent financial markets that operate in the interests of financial users (or society).*

Alternatively, the regulator can be given a number of objectives which map on to the consumer outcomes described below. For example, these could be expressed as:

In pursuit of its primary objective, the regulator shall:

- *Ensure financial institutions are prudently and soundly managed;*
- *Ensure an appropriate degree of consumer protection;*
- *Ensure regulated markets and firms operate with integrity (or have a fiduciary duty of care to financial users) and social responsibility;*
- *Promote competitive and efficient financial markets;*
- *Ensure financial users have access to the necessary standardised, customised*[59]*, targeted information to make appropriate decisions;*
- *Promote financial capability;*

[59] Embedding information in users' and existing decision making routines based on: a) information's perceived value in achieving users' goals b) its compatibility with users' decision-making routines, and c) its comprehensibility.

- *Act in the interests of all financial users – existing and potential*[60]*;*
- *Ensure financial users have access to appropriate redress;*
- *Promote corporate accountability in financial markets.*

The strategic objective(s) provide a sense of purpose and direction. But regulators need to know if they are successful in meeting those objective(s).

For example, if regulators have a strategic objective to promote fair and efficient markets, then they need to understand what 'fairness' means in practice, or what efficient markets look like from the perspective of financial users.

Therefore, the strategic objective (s) has to be translated into practical outcomes. The consumer outcomes (access, choice, fairness and integrity, quality, efficiency and value for money and so on), described in the next section, allows regulators to interpret the strategic objectives and evaluate if those objectives are being met.

The consumer outcomes are based on the established consumer principles. The consumer principles have stood the test of time and remain the best template for regulators to define what effective markets look like from a user perspective.

When developing and refining the appropriate outcomes for financial services, policymakers should draw on the experiences of regulators in other consumer markets. Policymakers and regulators should also involve user representatives and actual financial service users when developing outcomes.

Stage 2: Identifying and measuring detriment and market failure (existing and potential)

The next stage is to identify and measure detriment and market failure using the consumer outcomes. By definition, detriment and market failure occurs when these consumer outcomes are not being met[61].

Regulators need to identify and quantify:

- existing detriment and market failure that is currently happening in the market; and
- potential detriment and market failure – detriment that has not yet occurred but may result from: i) external factors such as macro-economic, socio-economic, technological; ii) market developments; iii) certain commercial practices or behaviours that are more likely to cause detriment; or indeed iv) as a consequence (unintended or otherwise) of regulatory interventions. This is critical if regulators are to pre-empt and prevent detriment and implement successful ex-ante regulation.

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60 This is to ensure that regulators are required to consider the interest of all consumers not just 'middle class' consumers. It also forces regulators to consider whether certain groups of consumers are facing discrimination or restricted access to markets.

61 It is important to note that consumer expectations evolve and market conditions change. What is considered 'fair' today, may be considered unfair in future or what is considered value for money in current conditions may be exposed as being poor value in the future.

Identifying and quantifying existing detriment

There are two effective approaches for identifying and quantifying existing detriment and market failure:

- evidence gathering and market analysis: using the consumer outcomes as a template to systematically gather evidence on detriment; and
- risk-based approach: identifying market behaviours and product characteristics that increase the risk of consumer detriment occurring.

The two approaches complement each other and should be used in conjunction to improve the likelihood that detriment and failure is identified.

Evidence gathering

The outcomes based approach and developing market success measures allows regulators to gather evidence on the scale of existing consumer detriment and undertake risk assessments to anticipate potential detriment (for example, as a result of external economic or market factors). The metrics that allow regulators to investigate whether each of the outcomes are being met are fairly straightforward. For example:

- the access outcome can be assessed by considering the number of suitable products available to consumers, analysing take up of products, the number of consumers who are financially excluded or forced into sub-prime markets;
- the fairness and integrity outcome can be assessed by gathering evidence on the scale of misselling (through reviews and mystery shopping), the number of unfair contracts or pricing structures in the market, reviewing information and marketing material, (for equity and bond markets the measure might be quality of trades, price formation);
- the decisions and choices outcome can be assessed by: monitoring levels of consumption of different products (for example, overindebtedness or undersaving/underinsuring) and testing whether consumers understand information provided, consider information misleading or confusing, or by reviewing product literature;
- financial capability can be assessed using baseline financial literacy tests along with regular monitoring;
- the performance and efficiency outcome can be assessed by analysing unit costs, pricing structures and margins comparing with benchmarks from other sectors or using international comparisons;
- social utility and functionality can be assessed by analysing whether a particular financial product (or feature) or financial instrument actually adds or destroys value for financial users. Social utility can be benchmarked against state provision (in the example of pension provision);
- the redress outcome can be assessed by comparing estimates of detriment with amount of redress obtained by financial users.

The outcomes and metrics are explained in more detail below in Section 4.

It is important that policymakers and regulators understand the impact on different groups of consumers. The consumer outcomes framework allows policy analysts to

objectively and systematically measure how well the market serves different groups of consumers and recognise when interventions are needed. For example, certain pricing structures may work for medium income consumers but have an adverse impact on consumers with lower incomes or with uncertain patterns of earnings. Assuming they can access markets in the first place, financially vulnerable consumers are more likely to be ripped off and any loss has a greater monetary impact. They are less likely to know and exercise their consumer rights. Following the theory of proportionate regulation, these consumers should attract stronger consumer protection than more economically powerful consumers.

Moreover, policy strategists should take care to understand the level of sophistication of financial users. For example, a common mistake is to assume that pension scheme trustees are sophisticated investors. This is not always the case. They may be just as vulnerable to conflicts of interest and poor quality advice as 'ordinary' retail investors. Indeed the level of potential detriment involving pension scheme trustees can be greater given the large value of scheme member's assets under the control of trustees and the conflicts of interest inherent in the investment supply chain.

Once the metrics have been agreed, there are a range of quantitative and qualitative methods for gathering evidence on consumer detriment and market failure including:

- Business and market analysis to identify market trends;
- Consumer research and consumer profiling, household-level data to reveal cross-sectional variation in financial decision making;
- Quantitative and economic analysis such as price comparisons, margin analysis, benchmark analysis, substitute product comparisons;
- Mystery shopping to test quality of advice or market behaviours;
- Complaints data and root cause analysis of the complaints;
- Intelligence gathering from stakeholders and user representatives;
- Other evidence gathering such as product and literature reviews.

This can be undertaken at market, sectoral, and product level. Market analysis and evidence gathering needs to be undertaken on a systematic basis to identify the emergence of new risks, accumulate evidence and to measure progress against outcomes.

Regular, continuous, systematic analysis also makes regulators more responsive to emerging crises and scandals as they do not have to re-create market data from scratch each time a crisis occurs.

Risk-based approach

As part of the more precautionary approach to regulation, regulators should not wait until detriment has occurred before intervening. A risk-based approach identifies types of producer and consumer behaviours that are more likely to result in detriment (see below, causes of detriment).

For example, a guiding principle for regulators should be to 'follow the money'. Products or firms that are attracting huge inflows of money or rapidly gaining market share are often good indicators that aggressive sales practices or acquisition strategies are taking place. Detriment is more likely to occur under these conditions.

Similarly, consumers are more vulnerable to detriment whenever complex products are involved or when sales staff and distributors are rewarded using remuneration strategies that are based on volumes of sales.

A less obvious, but critical, root cause is weak corporate governance at senior level within financial firms that focuses on financial returns (shareholder and personal financial gain) and encourages or ignores aggressive selling practices, unfair treatment of consumers, or poor quality service.

A particular sector or market may be dominated by an aggressive corporate and business culture that competes for market share through high commissions which means that competition is for distribution not for financial users.

Detriment can be displaced from one sector or product area to another. The risk based approach allows policy strategists to track when behaviours and practices that cause detriment in one sector are being exported to another sector.

Following a risk assessment, consumer outcomes and market success measures can then be used to gather evidence on whether these risk factors are actually leading to detriment and determine the appropriate response.

Anticipating and identifying potential detriment

Financial markets and economies are not static. The macro and micro environments for the industry and households is constantly changing.

We face a new economic and financial reality defined by a range of macro and micro socio-economic events including: a period of financial repression and fiscal retrenchment; transition from a liberal to more restrictive lending regime; low economic growth; high debt (public and private); sustained pressures on household finances; low interest rates, margin and revenue pressures on core retail banking products; reduced real investment returns and a paradigm shift in risk/reward ratios; a more uncertain political and regulatory climate; more 'repressive' regulation; a shift in shareholder attitudes; technological developments; and changing consumer attitudes towards and levels of confidence in financial services. Regulatory interventions also have unintended consequences.

In a changing environment such as this, an effective risk assessment function is critical. The consumer outcome framework allows strategists to analyse how the different external factors described above might result in detriment and affect how well the market can meet the needs of financial users.

For example, strategists can estimate how changes to capital requirements as a result of prudential regulation initiatives might impact on access to and price of credit for consumers or SMEs.

Similarly, strategists can analyse the impact of pricing structures on the real investment returns investors can expect in a low financial return environment and the judge the impact this may have on investor and adviser behaviour (consumers may be more susceptible to being persuaded to invest in products supposedly offering a higher investment return but with a higher risk attached).

Squeezed margins on core lending products may encourage lenders to missell more expensive ancillary products such as loan payment insurance which offer poor or no value to consumers.

Technological developments or financial innovations such as risk-based/differential pricing may benefit certain groups of consumers while excluding other groups of consumers.

It is critical as part of the precautionary approach that policy strategists model the impact of macro-/micro-economic and market factors on the consumer outcomes to allow for prioritisation of interventions. Regulators should not wait until things go wrong before intervening.

Identifying and measuring dimensional detriment

It is also critical that regulators do not make the mistake of analysing and regulate markets in 'silos'. They need to ensure there are systems in place to identify and measure detriment occurring on different market dimensions. .

Consumer detriment can occur and be measured at the following levels:

- within a single firm/financial institution;
- within a particular product area – for example, personal pensions, current accounts, personal loans, payday loans, etc.;
- at sectoral level – affecting a number of retail banks, insurance companies, asset management companies, etc.;
- supply chain – at an early stage of the supply chain for a product/service and transmitted back down to impact on the 'end-user';
- horizontal – occurring at an early stage of the supply chain but across a number of products or sectors; or
- vertical – occurring at every part of the supply chain for a product/service.

Analysis might establish that similar 'types' of detriment or risk are evident in a number of sectors and that these can be traced to the same root causes of detriment. Identifying and dealing with large numbers of individual firm specific detriments is ineffective and inefficient from the perspective of financial users and regulators.

It may be that a targeted, 'horizontal' intervention is effective at correcting targeting a number of detriments. A good example is misselling of personal pensions, structured investment products, and payment protection insurance (PPI). The cause of misselling in these three different product areas can be traced to the same root cause – conflicts of interest caused by aggressive remuneration/incentive schemes. It is inefficient to intervene separately in each of these product areas when a single, horizontal intervention could be applied.

Stage 3: Root cause analysis, understanding why consumer detriment occurs

Once detriment has been identified and measured, the next step is to understand why the detriment occurs. Policy interventions cannot be deployed to best effect unless they are targeted at the primary root causes of consumer detriment and market failure, not the symptoms of failure.

There are a number of root causes of consumer detriment and market failure in financial services. We classify these causes into four broad categories:

- Demand side factors: these relate to consumer behaviours, cognitive limitations, low financial capability (knowledge, attitude, and skills);
- Network or Interface problems: problems that occur at the point of interaction between financial users and financial providers and advisers/distributors;
- Supply side factors: these relate to structural problems in the industry and behaviours of financial institutions; and
- External factors: these are external problems which are outside the control of the industry – for example, low incomes, or socio-economic conditions.

Experience shows that once financial users engage with the market, the main root causes of market failure are more likely to be interface and supply side factors. Therefore, regulatory resources should be primarily directed towards tackling these causes.

However, it is important that the regulatory approach allows for the identification of external factors that cannot be addressed by regulation or improved market performance. For example, the root cause of financial exclusion is often low incomes or inherent diseconomies of scale which mean that many lower income households will never be commercially viable for ‘mainstream’ financial providers. Alternative provision will be necessary.

Demand side

Demand side factors that cause detriment include:

- Cognitive limitations[62] such as lack of contractual schemas or knowledge structures; inaccurate default assumptions of how contractual provisions are likely to be structured and if the contract is negotiable; narrow decision framing (which leads borrowers not to internalise the global cost, for instance, of payday loan) or narrow choice bracketing (which leads borrowers not to think enough about how fees associated with a given loan will add up through cycles of refinancing, encouraging overconfidence about their ability to repay a loan quickly). Also optimism bias in future financial planning and the tendency to replace full attentive information gathering strategies with heuristics in case of stress and pressure, as well as biases causing selective reading, perception and memory.
- Consumers tend to exhibit situational and transactional vulnerability which compromise their financial decision making capability
- Low levels of financial capability(knowledge, attitude, skills)
- Psychological barriers, consumer inertia and other negative consumer behaviours
- Low level switching activity/poor quality switching

[62] ‘Cognitive’ – also called ‘behavioural’ – limitations locates the failures in the mental processes of individuals. The possibility that financial service providers might exploit these biases to enhance profits creates further rationales for government intervention. See Garcia, C. & Van Boom, W. Information disclosure in the EU Consumer Credit Directive: opportunities and limitations, in: Consumer Credit, Debt and Investment in Europe (2012) Edited by Devenney, J. and Kenny, M., Cambridge University Press (forthcoming publication).

Network/interface factors

Various network/interface factors include:

- Aggressive or misleading marketing and promotion activities
- Misleading disclosure, information asymmetry problems[63]
- Barriers to switching
- Inadequate training and competence, unprofessional behaviours
- Misselling or poor quality advice and recommendations
- Conflicts of interest caused by commission payments and other remuneration strategies that reward volume of sales rather than quality of advice (note these conflicts occur at all parts of the supply chain – see below)

Supply side

These include:

- Insufficiently capitalised firms
- Market structure problems including overconcentration in markets
- Product and producer oversupply and diseconomies of scale[64]
- Conflicts of interest at each part of the financial supply chain between different actors in the market and financial users including: wholesale and institutional market operators, financial 'product' manufacturers[65] and distributors, providers/distributors and financial users, experts and advisers (see above)[66] – often caused by a reliance on remuneration policies which link financial rewards to volumes of sales rather than quality of sales (for example, commission or sales targets)
- Absence of clear fiduciary duty to financial users
- Product complexity
- Unfair contract terms and product pricing structures (such as front end loaded charges, penalty charges)

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[63] Information asymmetry is often the first thing regulators look for when trying to explain market failure and will tend to revert to information solutions as a remedy to the market failure. However, it is important that regulators recognise that the classical, theoretical information asymmetry model is of limited practical use for addressing market failure in complex markets such as financial services. It is, of course, correct that information asymmetry can partly explain market failure and in theory if ordinary financial users are able to utilise information effectively then, by definition, markets are likely to work better. However, in practice, the complexity of financial markets and products, the sheer proliferation of products on the market, conflicts of interest, aggressive market behaviours such as commission driven sales, and to some extent low levels of financial capability amongst ordinary financial users, means that information solutions have had limited effect on market behaviour. FSUG strongly supports the provision of standardised, clear information but we are concerned that the emphasis on information solutions means regulators do not properly address the underlying or root causes of market failure such as complexity, conflicts of interests. In other words, information is necessary, but not sufficient.

[64] Policymakers tend to focus on overconcentration (too few providers) in a market as a root cause of detriment and wrongly assume that extensive choice of providers and products is evidence of functioning markets. However, product proliferation and oversupply is as much if not more of a cause of detriment and market failure.

[65] Includes investment banks who manufacture sophisticated financial products and instruments.

[66] For example, investment consultants and actuaries advising pension schemes.

- Lack of consumer compensation if a provider voluntarily exits a market[67]
- Aggressive acquisition and distribution strategies
- Aggressive corporate cultures
- Weak corporate governance and due diligence
- Poor risk management and financial controls
- Legacy systems[68]

External factors

- Economic and market conditions which can encourage sub-optimal decisions by consumers and investors – for example, low interest rates which can encourage savers to take risks with capital in search of a higher return
- Economic conditions which make it more difficult for inefficient financial institutions to provide socially useful, value-for-money products and services to financial users – see New economic paradigm, above
- Low incomes – in this case, low incomes means that consumers are not commercially viable for retail financial services and either access has to be mandated or alternatives to market based provision are required
- Disability and other disadvantages – similarly, market based systems can automatically discriminate against vulnerable consumers and provision may have to be mandated
- Unintended consequences of regulation and interventions: regulators should also be mindful of the unintended consequences of regulation on consumer generally or specific groups of consumers. Examples can include: poorly calibrated prudential regulation pushing up cost of access/borrowing or interventions which reduce prices for one group of consumers leading to increases in for another group of consumers;

It is critical that regulators identify the root causes of detriment and inefficiency in the markets being investigated. We know from painful experience that primary root causes (including weak corporate governance, aggressive corporate cultures, conflicts of interests, distribution biases, and unnecessary product complexity) ensure that consumer power and influence is weak and competition is aimed at distributors and brokers, not the financial user. It is not surprising that information solutions such as disclosure (while necessary) are insufficient to protect consumers and change market behaviours.

The classical model of competition posits that greater choice and supply should lead to prices falling as competition works its 'magic'. But regulators should recognise that too much supply and choice can be as damaging to financial users interests as too little choice. A proliferation of providers and products makes it more difficult for financial users to make effective, confident decisions, pushes up search costs, and increases the need for expensive financial advice. It also embeds diseconomies of scale into the supply chain.

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[67] This relevant for insurance products where the contract is renewed annually but where the premium was fixed for a number of years (e.g. protection insurance) or covered ongoing medical conditions (e.g. PMI and pet insurance).

[68] For example, dominant entrenched providers such as big banks may have substantial cost bases which may limit their ability to develop competitive products and services. To maintain revenues and profit margins, banks may seek to exploit their dominant positions to sell high margin, poor value products.

The asset management sector provides a case in point. There are hundreds of providers and thousands of products, and barriers to entry into the market are low. As the number of products and providers in the market increased, the costs to the end user have actually risen in many cases. Cost increases might be justifiable if this led to an improvement in the 'quality' of the investment products sold by the industry (quality in this sense defined as improved risk adjusted investment returns) or some other social objective being met (for example, an improvement in the number of households building up a sufficient pool of pension assets for retirement). But there is little evidence that greater supply and intermediation has led to improved outcomes for financial users and society – indeed, the evidence is to the contrary as oversupply and intermediation extracts value from pension or investment contributions.

The same problem occurs in the consumer credit markets in some Member States where the activities of a vast number of consumer credit providers results in oversupply and overconsumption of unsustainable or high cost credit.

Therefore, it is critical that regulators do not assume that, just because there are large numbers of products and providers and evidence of activity, markets are actually working for financial users. This is why the consumer outcomes are necessary to objectively measure the effectiveness and efficiency of markets from the perspective of financial users.

This list of root causes can also be used by regulators to improve risk management techniques and proactively identify and pre-empt large scale market failure and detriment. Experience shows that consumer detriment and market failure are more likely to occur in markets where there is evidence of the factors described above (commission driven sales, product complexity, weak corporate governance and so on).

Root cause analysis can help policy strategists target market investigations and identify the appropriate interventions and remedies.

Policy strategists should consider whether the detriment and market inefficiency identified can be attributed to one or more of the root causes before selecting the appropriate interventions (or portfolio of interventions depending on the scale of the market failure).

Stage 4: Identify potential interventions

Once the type and scale of detriment and market failure has been established (or potential risks identified), and root causes identified, the next step is to evaluate which intervention(s) is likely to be the most effective at tackling the detriment and risks (or pre-empting and preventing potential detriment).

Policy strategists should be clear whether the interventions are to be deployed to deal with existing detriment or to pre-empt and prevent potential detriment from occurring.

Policy strategists have a range of interventions at their disposal. These include:

- Market entry requirements (authorisations/fit and proper requirements): the foundation of any consumer/investor protection regime is ensuring that financial users can trust that the financial intermediary/sales person they are doing business with is acting in good faith, is authorised to do business, and is fit and proper to act competently. Undertaking financial activities without

authorisation should be subject to the strictest sanctions. Calibrating market entry requirements is critical to effective markets. For example, it may be that in a specific market the root cause of detriment is oversupply and proliferation of poor quality providers. In this case, it may be necessary to toughen market entry requirements to protect users by improving supply and enhancing market efficiency. In other cases, it may be that market failure is due to overconcentration and abuse of dominant positions. In this case, it may well be that relaxing market entry requirements is necessary to encourage effective competition.

- Robust prudential regulation: although this paper is concerned primarily with consumer protection and conduct of business regulation, ensuring firms are well capitalised and prudently managed is critical. Consumer outcomes such as choice, fairness and integrity, value for money are rather abstract if firms do not survive. Of course, with regards to authorisations and prudential regulation it is important that these are carefully calibrated. Poorly calibrated regulations can be detrimental to the public interest if these act as unnecessary barriers to entry for new potentially more efficient providers who wish to compete with dominant providers. However, as outlined above, oversupply is often a major problem in certain markets. For example, in unsecured credit markets it can be too easy for entrants to gain a consumer credit licence and offer unsecured high cost credit to vulnerable consumers. So, in some cases, using tough authorisation and prudential regulation to actually restrict supply can be beneficial for society.
- Training and competence: similarly, intermediaries and sales staff should be suitably trained and qualified to meet the required standards of competence before advising or selling products. These standards should be continuously monitored.
- Consumer information solutions: information asymmetry is often the first cause regulators look for when trying to explain market failure. As a result, they tend to rely on information solutions as a remedy for the market failure. Financial user representatives understand the importance of and fully support the clear, effective disclosure of information. However, it is important that regulators recognise that the classical information asymmetry model is of limited practical use as a means of correcting market failure and consumer protection in complex markets such as financial services. Other more direct interventions are needed to make markets work. In other words, information is necessary but not sufficient.
- Behavioural finance: in response to the limitations of information theory, much work is underway on the application of lessons from behavioural finance to financial regulation. This is an important development but hopes should not be raised too much that insights from behavioural finance will improve the relevance of the information asymmetry model. Instead, behavioural finance insights are probably best used as a defensive mechanism by regulators to identify and restrict the use of subversive marketing and promotion techniques by the industry.
- Financial education: similarly, policymakers and regulators will often develop initiatives to improve the levels of financial capability amongst consumers with the intention of improving financial behaviours and, in turn, influencing the behaviour of firms. However, as with information above, there is very little compelling evidence that financial education on its own is effective in the short term at improving financial behaviours amongst consumers or, more importantly, the behaviour of the industry. Financial education or information

solutions work best if they are used to complement other more effective interventions. Financial education should be seen as a long term intervention which takes time to work.

- Market information interventions: while information solutions aimed at consumers have limited effect as a means of influencing corporate behaviour, regulators can influence behaviours using market information interventions such as market alerts and product warnings. These should be targeted at the senior management of financial institutions and other important actors such as shareholders and analysts – the aim is to alert institutions and shareholders that detrimental practices are likely to attract costly regulatory interventions.
- Product intervention: a more direct form of intervention is to regulate products and/or product development rather than leave it to market forces to create the products consumers need. Examples of product intervention can include price capping, regulating pricing structures, controlling variation terms, outlawing unfair or dangerous contract features, controlled distribution of products (for example, restricting sale of risky investment products to retail investors), setting the default option for products in the best interests of consumers, product classification or rating (risk rating of products), and pre-authorisation of business models, or ultimately banning products. An alternative to regulating product features is for regulators to set tough standards requiring firms to robustly test products before launching on the market to ensure products are suitable for the intended audience. This is closer to way pharmaceutical products and certain food products are regulated.
- Governance interventions: it may be that detriment such as poor product design or an aggressive corporate culture can be attributed to weak governance and internal risk management controls at senior management or board level within a firm (or sector). In this case, regulators can impose higher levels of responsibility at senior management or board level making it clear that individuals are personally responsible for detriment caused by employees of the firm and requiring the exercise of more effective due diligence.
- Regulating conflicts of interest/fiduciary duty of care: this is a priority for regulators. A significant amount of detriment can be attributed to conflicts of interest in the supply chain caused by remuneration policies that reward staff according to volumes of sales rather than quality of advice. This encourages misselling and undue risk taking. These conflicts can be tackled by imposing a fiduciary duty of care on financial institutions.
- Banning dangerous practices/root causes: one of the most widespread root causes of consumer detriment are commission driven sales and other aggressive remuneration practices that reward sales intermediaries and sales staff according to the volume of sales rather than quality of sales. Banning, or at least severely restricting the use of, these practices directly targets the cause of biased sales advice and pressurised selling.
- Tough sanctions and redress: a key intervention is the deterrent provided by tough sanctions that can be effectively enforced by regulators (known as credible deterrence). Market operators need to know that, even if there is a relatively small probability that they will visited or mystery shopped by supervisors, if they are caught breaching regulations they will face punitive sanctions. Sanctions can take the form of monetary sanctions (fines) or removal of authorisations to do business with financial users. The price to pay must be high enough to ensure that they know the chance is just not worth taking. This in turn should encourage shareholders and analysts discipline the

behaviour of financial institutions. Similarly, effective redress schemes protect financial users and act as a deterrent if financial institutions realise that they face significant financial penalties for detrimental practices and behaviours. The critical point is that the sanctions have to hit the bottom line. FSUG considers that sanctions should be set up based on the damage produced to the claiming consumers and/or on the size of additional gains produced by the violations and to the size of the firm involved (assets, turnover, etc). Fines should affect the level of profit and should be efficient. For example, fines should be set up as percentage to the asset base or the annual balance sheet turnover. Regulators should have the ability to fine up to 30% of annual turnover (as is the case with competition authorities in Member States). At the same time, fines for individuals should not refer only to the ban of the bonuses, but to their remuneration. Finally, fines should be recovered out of profits and not to be included in the costs of products and services[69]. Clearly, sanctions have to be applied intelligently and proportionately to avoid unintended consequences that could harm the interests of financial users in the long term (for example, if sanctions had the effect of closing down a firm and reducing choice and competition in markets that already have high degrees of concentration).

- Mass consumer actions/referral process: this includes a power for consumer bodies to make super-complaint referrals to the financial regulators regarding 'mass' consumer detriment issues.
- Corporate accountability: regulators should ensure that the industry is transparent about its operations and performance indicators. Firms should be required to disclose details of numbers of complaints. This is particularly important in relation to financial exclusion – for example, lenders should be required to disclose socio-economic profile of customers with bank accounts, loans and so on. Transparency should be the default option. There are very few circumstances in which commercial interests justify withholding information at the expense of the public interest.
- Structural reforms: in certain cases, an entire system or structural failure may be evident. When this happens, the scale and type of detriment and market failure is so great and the root causes of detriment so embedded in markets that superficial interventions will have limited impact on the performance of markets. Notable examples of system and structural failures include anti-competitive behaviours by dominant banks exploiting market share, or markets where competition and acquisition of market share is driven by commission and other aggressive remuneration practices. In these cases, the only option may be for policymakers to intervene to change the structure of a market on the grounds of competition or in the case of a system failure intervene to prevent market wide abuses caused by commission driven sales by banning commission or engineer a systemic change in market behaviour.
- Competition referrals: it may well be that the existence of anti-competitive behaviours can be attributed to overconcentration in the market. In cases such as this, the only option may be referral to competition authorities to require a break up of dominant providers.
- Alternative solutions: if objective evaluation shows that the market cannot enable access to fair, affordable, safe products for large parts of the consumer

[69] More on this topic could be read in FSUG opinion regarding Reinforcing sanctioning regimes in the financial services sector, http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/opinions/sanction_regimes-2011_02_19_en.pdf.

population on a voluntary basis, then policymakers have an obligation to ensure that fair market access is regulated or alternative provision is made available. Fair market access may include legal rights of access to bank accounts as part of universal service obligations (see below). Examples of alternative provision include community based lenders such as credit unions, collective pension schemes (for example, NEST the new national pension scheme in the UK), or special lending schemes for SMEs. It is important that regulators and policymakers include a stage in the policymaking process that allows them to identify when markets are unable to meet the needs of vulnerable users and ensure mandated or alternative provision is provided.

- Public interest regulation: in certain cases, the provision of certain financial services is so important to the financial well-being of consumers that terms of access and provision should be mandated by society. Access to a transactional bank account is a case in point. Transactional banking is a utility function and provision of services should not be left to the market to decide. Therefore, a powerful way of ensuring accountability to society is to impose public interest obligations on socially critical financial institutions who provide core financial services[70].
- Regulatory accountability: regulatory accountability should be regarded as an important intervention as it improves the overall effectiveness of regulation. There are a number of measures to ensure accountability including: significant consumer/investor representation on boards of regulators (particularly given the current dominance of industry representatives); transparency (see above); mechanisms for answering to democratic representatives; requirements to consult and consider the views of consumers; and requirements to report on activities. In practical terms, boards of regulators should hold public board meetings, publish minutes, and publish information on meetings with industry representatives. With regards to consultations, regulators should appoint consumer advocates to proactively seek the views of consumers during consultations – regulators must know that consumer representatives do not have the resources to respond in writing the same way to consultations as well-resourced industry representatives.

The ‘art and science’ of regulation

Deciding on the particular form of intervention(s) is a difficult task requiring significant judgment on the part of regulators. In some ways, selecting interventions to make markets work on behalf of financial users can be more difficult than micro-prudential regulation – where regulators can use sophisticated quantitative models to determine capital requirements and risk weightings and model how they expect financial institutions to respond.

But making markets work requires more qualitative assessments, and judgment based interventions. However, despite the challenges involved, a more disciplined, scientific approach is needed. The model we have described allows regulators to identify the dimensions and scale of detriment (existing and potential) and the root causes of that detriment. The list of potential interventions outlined above provides regulators with a ‘toolkit’ from which to choose the most effective intervention. The most effective intervention(s) needs to be judged on a case by case basis using

[70] Policymakers and regulators talk about systemically important financial institutions (SIFIs) with regards to financial stability and prudential regulation. Policymakers need to adopt a similar mindset for the provision of core financial services.

evidence gained from experience in similar financial markets (and similar consumer markets).

An important step is for regulators to create a repository of knowledge and evidence on which specific interventions have worked under certain conditions.

Means of regulation

Once policy strategists have identified an intervention (or portfolio of interventions), this has to be implemented in some way. This can be achieved using statutory regulation, guidance and recommendations, or self-regulation.

- Detailed rules and regulations: regulators can implement specific, detailed rules setting out how regulated firms and individuals have to behave in certain conditions. Examples include: detailed rules on the information firms or advisers must collect before making a financial recommendation; detailed client assets rules to segregate clients' assets from the firm's assets and so on.
- Principles and standards: alternatively, rather than issue detailed rules, regulators can use high level principles and guidance that set out expected standards of behaviour - but leave it to regulated firms and individuals to interpret how these principles and standards are implemented in practice.
- Self-regulation and codes of practice: an alternative to statutory regulation is self-regulation where the industry develops and monitors compliance with its own standards of behaviour. Self-regulation does not have a good track record in financial services. Experiences from many countries show that self-regulation has not worked properly as not all providers participate, the wording of what to do is very soft, there is limited monitoring of the effects of the code, there is often no consumer representation, insufficient transparency about the functioning and last but not least there are weak or no sanctions when firms misbehave. In Germany for example there has been a voluntary code of conduct in relation to the access to a bank account since 1995. In December 2011 German Government has stated in its report about its functioning that the code has been a complete failure and that now binding European rules are unavoidable .In February 2012, DG SANCO published the results of a mystery shopping carried out to assess the implementation of a code of conduct adopted by the banking sector at EU level: it shows that more than two thirds of mystery shoppers were not able to switch their bank account successfully[71]. In the UK, the FSA took over the regulation of retail banking from a self-regulatory body which lacked effective enforcement powers. An example for failure of self-regulation in Germany was the German Corporate Governance Code with respect to the issue of directors' pay. Only since the implementation of a new law, the so-called VorstAG, companies have started changing the remuneration systems for their management board member towards a more long-term approach. Another example for failure was the insider dealing code we had in Germany. This code needed to be replaced by a law on insider dealings in 1995 as it was not an effective means to stop insider trading in Germany because of a lack of enforceability.

[71] http://ec.europa.eu/consumers/rights/docs/switching_bank_accounts_report_en.pdf

Stage 5: Prioritisation

The final stage in the strategic policymaking process is to prioritise interventions. Regulators have finite resources at their disposal. Regulators face a critical operational and practical challenge – at what stage should they intervene to address market failure, to what degree should they intervene (and which tools should they use), and how much resource should they deploy on addressing a particular episode or episodes of consumer detriment/market failure.

Prioritisation should be based on:

- level of detriment and impact on financial users (with emphasis on vulnerable users);
- effectiveness – the likelihood that interventions are to be effective at correcting market failure; and
- available resources.

Regulators should attempt to establish what we call a 'return on intervention (ROI)'. This means that generally speaking regulators when prioritising should select the intervention or portfolio of interventions that remedy the greatest amount of existing detriment or pre-empt and manage potential detriment/risk.

As mentioned above, it is also critical that regulators do not make the mistake of analysing and regulate markets in 'silos'. Analysis might establish that similar 'types' of detriment or risk are evident in a number of sectors and that these can be traced to the same root causes of detriment. Therefore, it may be that a targeted, 'horizontal' intervention is effective at correcting targeting a number of detriments. A good example is misselling of personal pensions, structured investment products, and payment protection insurance (PPI). The cause of misselling in these three different product areas can be traced to the same root cause – conflicts of interest caused by aggressive reumuneration/incentive schemes. It is inefficient to intervene separately in each of these product areas when a single, horizontal intervention could be applied.

Clearly, the cost of any intervention needs to be understood. This requires cost-benefit analysis and impact assessments. There is a view that self-regulation and codes of practice are cheaper to implement than statutory regulation. However, while the direct regulatory costs may appear to be cheaper with self-regulation, it is important to set these costs against the effectiveness of an intervention and to measure the hidden costs of not regulating properly.

Supervision

If interventions are to be effective, compliance with interventions has to monitored. The effects on industry behaviour must also be monitored and supervised. At the risk of oversimplification, there are two basic approaches to supervision:

- Intensive supervision: this involves intensive supervision of large numbers of firms or large market/sector share to undertake detailed monitoring compliance with policies; and
- Risk-based, targeted supervision: rather than widespread supervision of a large numbers of firms, the alternative is to use risk management techniques to identify high-risk firms/sectors and stratified sampling techniques to select a

sample of firms for investigation and monitoring (for example, using mystery shopping to test compliance).

Intensive supervision by its nature requires greater resources – financial, human, and increasingly technological. However, if undertaken properly, this should be effective at picking up misconduct or regulatory breaches and acting as a deterrent.

Risk based supervision does not require as much direct resource so theoretically should be less expensive in regulatory terms. However, the risk of not picking up misconduct is likely to be greater than with intensive supervision. To counter this risk, greater investment is needed to ensure the risk management techniques are sophisticated and effective. Most importantly, if this approach to supervision is to work as a deterrent it needs to be accompanied by tough sanctions that can be effectively enforced by regulators (see above).

Regulatory specialists would classify this as a distinction between ex-ante and ex-post regulation. Ex-ante regulation focuses on anticipatory interventions to achieve the desired outcomes whereas ex-post regulation focuses on penalising or redressing misconduct or market failure either through sanctions applied to market participants or providing redress to users affected if outcomes are not met.

Of course, ex-post regulation can play an important role in effective ex-ante regulation. For example, effective redress schemes can have a disciplining effect on market behaviour if providers understand that misconduct or mistreatment of financial users comes at a heavy financial price.

Indeed, effective use of sanctions can persuade other market actors such as professional investors and market analysts to exercise proper due diligence and oversight over the behaviours of senior management and boards of financial institutions.

The practical aspects of supervision and enforcement are dealt with in more detail in the second report.

5 DEFINING MARKET SUCCESS

One of FSUG major concerns is that policymakers and regulators do not have the right models to analyse whether markets are working for financial users. In this section, we now explain how the consumer outcomes can be used to regulate financial markets more effectively.

It is not enough to assume that if there are numerous products and providers in the market and financial users have information that the dynamics of competition and choice will make markets work. Regulators need a more rigorous approach to evaluating financial services based on the expectations of financial users.

The success or failure of financial markets (or specific sub-sectors – banking, lending, savings, pensions, insurance etc) can be judged according to whether the following critical primary outcomes are met –

1. Access and usage: users should have access to and choice of appropriate products and services, and use those products[72;]

2. Safety and security: financial institutions should be safe and prudently run, the financial system resilient, products and services should be safe and legally secure, and financial institutions and individuals authorised to high standards;

3. Fairness and integrity: users should be treated fairly, markets and individuals operate with integrity;

4. Performance and efficiency: markets should be efficient, sustainable and produce value for money, quality, functional, socially useful products and services that meet the core financial needs of users;

5. Decisions and choices: financial users should have the necessary information, advice and financial capability to make the right financial decisions and choices;

6. Redress and accountability: users should have access to well-resourced redress and guarantee schemes and wrongdoers held to account for detrimental behaviours; and

7. Confidence and trust: users should have justified confidence in markets and institutions that deserve their trust.

These market outcomes are based on the tried and tested consumer principles. It is straightforward to develop market success measures and metrics to judge whether these primary outcomes are met. Clearly, outcomes and success measures must be tailored for specific financial sectors and different parts of the financial supply chain.

These primary outcomes can then be deconstructed into individual measurable outcomes and market success measures that regulators can use to analyse markets. The outcomes are: access; choice; fairness and integrity; safety/security; value for money and efficiency; functionality and social utility; information and advice; financial capability; redress; accountability to users; and confidence and trust.

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[72] An important factor when considering financial exclusion.

These outcomes define the expectations financial users have of financial services. Therefore, by definition, consumer detriment and market failure can be said to occur when markets do not produce these outcomes. The consumer outcomes approach allows regulators to develop metrics to systematically measure market performance to assess whether the needs of financial users and society are being met. This systematic approach allows regulators to expose detriment and prioritise interventions.

We now go onto explain what these outcomes mean in practice and the type of evidence regulators should look for when assessing markets.

When assessing markets for consumer detriment and market failure, regulators should be careful to measure the impact on different groups of financial users. Detriment and market failure has a disproportionate impact on lower income or disadvantaged consumers. Disadvantaged consumers are less likely to get access to a market in the first place, once in the market they are more likely to encounter detriment, detriment has a bigger financial impact on households with lower incomes, and they are less likely to be aware of their consumer rights or rights to redress, and less likely to get redress.

Access and availability

Consumers should have access to a choice of appropriate, value-for-money products and services.

Access is the primary consumer principle. If the market is to work, then suitable products and services must be available and consumers must have the opportunity to access those products and services. Unless this condition is met, then other outcomes such as choice, fairness, quality, and security do not come into play.

Access is particularly important when evaluating the degree of financial exclusion in a market or the consequences of forcing market solutions on consumers.

It is critical to differentiate between market barriers to access and other external barriers to access. Financially excluded consumers may face a number of barriers to access arising from inherent market behaviours including poor product design, unnecessary product complexity, sales and distribution practices. Technological developments can contribute to a growth in financial exclusion. Technology can be barrier to access. Technology enables more sophisticated risk based or differential pricing which can be detrimental to the interests of lower income or other disadvantaged financial users.

However, for many financially excluded consumers, the key barrier to access is that they may simply not be able to afford the product. This of course is not the fault of the market and policymakers will have to ensure alternative provision is available for consumers.

Similarly, it should be recognised that markets are amoral. Markets allocate value according to economic power not according to the principles of fairness or social justice. Free market providers will provide anything if the price is high enough and they can expect to make a return. A clear example of this can in the sub-prime lending market in certain Member States where there is effectively no limit on the amount lenders can charge borrowers. For example, in the UK APRs of more than 200 % are not uncommon – indeed, some lenders charge more than 1,000 %.

So, in this case, in theory, consumers have access to the consumer credit market. However, many people would argue that this access is provided on terms that are unfair or predatory in the sense that consumers with a real choice acting rationally would never use this form of credit. Therefore, consumers do not have access to markets on terms that meet the access definition, above.

Evidence of detriment

Measures of detriment include: availability of suitable, good products; low take up of products or restricted access – for example, number of households with mainstream bank account, savings, insurance, mainstream loans, access to free ATMs; growth in numbers excluded from mainstream sector and/or consumers using high cost/toxic products – for example, number of households using sub-prime loans, or commercial debt management firms; extent of discriminatory pricing.

Choice

Consumers should have a choice of appropriate, socially useful, functioning products and services that meet their needs and preferences.

Sufficient choice in a market is important to promote competition and innovation. However, choice per se is not an end in itself, it is a means to an end. Regulators should take care not to make the mistake of assuming that, just because there are vast numbers of products on the market supplied by numerous providers, effective competition for the consumer also exists.

The true measure of effective competition is whether the right outcomes are produced for consumers. This has been one of the main reasons why financial regulators failed in the past to make markets work for consumers. Regulators wrongly assumed that their role was to create the conditions to encourage the market and the dynamics of choice and competition would automatically ensure that consumers' needs are met.

However, the dynamics of choice and competition does not always lead to the right outcomes for consumers. A wide range of products and providers is not always necessary to produce the right outcomes for consumers[73].

Indeed, an unnecessary proliferation of choice of products and providers can be detrimental to good consumer outcomes. This can lead to over-complexity in markets, spurious product innovation to gain a leading edge with product distributors and advisers, higher search costs and distribution costs, and an increase in the need for expensive financial advice – these higher costs are passed onto the consumer with no corresponding improvement in value-added (see VFM and Functionality, below). So, in financial services the chaos and complexity resulting from oversupply of products and services can be as detrimental to the interests of consumers as abuse of dominant positions caused by overconcentration in the market (for example, oligopolistic behaviours in the banking sector).

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[73] NB! FSUG is ideologically neutral on how the necessary consumer outcomes are produced. We have no stated preferences for state or market solutions. In many cases, there is compelling evidence that centrally provided or collectively provided solutions are likely to be the most efficient, fair and equitable – for example, in the field of pensions or social insurance provision. In other cases, market based solutions are always likely to be more effective – for example, mortgages, motor insurance, and market exchange functions.

Economic theory holds that oversupply in a market should lead to prices reducing. Interestingly, in financial services we see evidence that oversupply actually results in prices rising for consumers and value being destroyed[74].

So, while regulators should assess markets to ensure there is sufficient choice to promote competition, they also consider the detrimental impact of too much choice and oversupply.

Evidence of detriment

Measures of detriment include: restricted choice of products and providers (for example, this can be measured using classical methods such as Herfindahl indices); limited numbers of products that meet certain pre-determined benchmarks or standards (we are interested in whether financial users have a choice of appropriate products, not a choice of products per se).

Fairness and integrity

Consumers have a right to be treated fairly and protected from unfair and illegal market practices

Markets should operate with integrity

Once consumers decide to engage with the market, they have the right to be treated fairly by providers and protected from unfair market practices. Examples of unfair practices that regulators should look for include: aggressive, high pressure selling or misselling; unfair contracts; unfair cross-subsidies; opaque product design; failure to disclose or misrepresent important terms and conditions and product features; attempts to move existing customers onto contracts with less favourable terms[75]; misleading advertisement including expressions such as ‘pre-approved’, ‘interest free’ or ‘bad credit no problem’; encouragement of a cycle of borrowing; roll-over loans; failure to check borrowers’ ability to repay; falsification of income data on application forms; equity lending; conditional sales; tying, bundled or combined products (e.g. consumer credit with payment protection insurances), terms and conditions of agreements (e.g. lending on security of the home rather than the ability of the individual to repay, the so called guarantee-clause ‘pactum de contrahendo’, or ‘pactum commisorium’, the non-admission of clauses excluding liability in case of fraudulent misrepresentation and so on.

Fairness should apply pre-sale (when consumers are considering buying a product, shopping around), at point of sale (during the sales process), and post-sale (for the length of time the consumer has a relationship with the provider and longer in cases where redress may be due).

Treating consumers fairly should be an integral part of the day to day good governance and corporate culture of financial service providers. The industry should undertake to be as transparent and open with consumers.

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[74] See, http://www.economist.com/node/13862505; http://www.ft.com/cms/s/0/63e96dd8-ef77-11e0-941e-00144feab49a.html#axzz1ojQuaf2V; *Time May Change Me, Mutual Funds Management Fees*, Ed Moisson, Lipper, October 2011; and *Profiting from Proliferation*, Lipper White Paper, 2009.

[75] In the UK, some mortgage lenders offered tracker mortgages which guaranteed to track at a set percentage below base rate. Such products are now very favourable for consumers and lenders have tried to find ways to move consumers onto other, less favourable products.

When assessing whether providers are acting fairly and with integrity, regulators should be objective about the level of financial sophistication of financial users. For example, pension fund trustees are treated as sophisticated investors in some Member States and receive a lower level of regulatory protection than retail financial users. However, in practice many trustees are ordinary employee representatives and who are vulnerable to inappropriate behaviours by financial advisers and market specialists advising pension schemes.

One of the defining features of financial services is the extent to which financial institutions look after other people's money. This means there is a special duty and responsibility for financial institutions to act with integrity and exercise a fiduciary duty of care when making decisions on behalf of financial users.

Financial consumers should be treated equitably, honestly and fairly at all stages all stages of their relationship with financial service providers. It is not just at the point of sale during the interaction between consumer and provider/distributor/intermediary where major detriment occurs. This happens further up the supply chain in the wholesale and institutional markets. Indeed, as with efficiency, the behaviours of wholesale/institutional markets can have a greater detrimental financial impact on the financial welfare of consumers than retail market operators who receive most attention from stakeholders.

Similarly, the integrity of the capital and stock markets are critical to the functioning of the real economy.

Evidence of detriment

Regulators should look for evidence of: exploitative pricing structures/contract lock-ins, detrimental behavioural pricing ((by using the price portioning technique, namely cutting up the price in the sales sequence e.g. basic price, options, surcharges, etc. and by framing a unit price in pennies-a day price is well-known in consumer credit that helps to frame the proposition favourably and to anchor the borrower's thinking rather than considering the total amount in interest he might focus on the periodic payments and their consistency with his budgetary constraints[76]), front end loaded charges, high unauthorised overdraft charges), unfair cross-subsidies, dual pricing, price discrimination, hidden unfair terms aggressive selling/misselling, short selling/stock-lending, acting contrary to client's interest, failure of price formation, insider trading.

Safety, resilience and sustainability

The financial system should be resilient to external shocks and sustainable in the long term

Banks and other financial institutions should be soundly and prudently managed

Consumers' assets should be legally secure and protected from fraudulent practices

Financial users should be able to trust that firms and individuals are subject to strict authorisation and 'fit and proper' tests by the regulator before being allowed to do business

[76] See Van Boom, W. (2011) *Price Intransparency, Consumer Decision Making and European Consumer Law*, Journal of Consumer Policy, Consumer Issues in Law, Economics and Behavioural Sciences. Electronic copy available at: http://ssrn.com/abstract=1895353.

Consumers should have legal certainty with regards to contracts

Investors should be protected from unknown or undue risks

Society places great emphasis on product safety in other consumer sectors. Financial users have a right to expect that the financial products they use are safe and secure and assets are protected.

Of course, risk management in the financial services sector is different to risk management in other industries such as the physical goods sector, transport, electricity sector, and so on. Risk management failures in financial services generally do not lead to fatalities or injuries. However, it can lead to serious damage to financial well-being.

At a time when consumer confidence has been damaged by the financial crisis and chronic misselling episodes, safety and security is increasingly important to consumers.

There are a number of elements to safety and resilience in financial services including:

- Financial resilience: ensuring that the system is robust enough to withstand external shocks or the failure of dominant institutions;
- Prudential soundness: ensuring banks, pension funds and insurance companies are prudentially managed to ensure there are sufficient assets to meet liabilities and assets/deposits are protected;
- Sustainability: markets and business models should be sustainable over the long term. Products and services should be sustainably priced, and prudently managed. Underpriced products create unforeseen risks;
- Market exit: Ensuring that firms which are imprudently run can exit the market in a way which does not damage consumers' interests;
- Legal security: ensuring that customer assets are legally secure and protected from fraudulent behaviours;
- Authorisations: the foundation of consumer/investor protection is ensuring that firms and individuals undergo robust authorisation procedures which are continuously updated;
- Contractual certainty: ensuring that consumers can enforce contract terms; and
- Investment risk: a particular aspect of investment based products is the risk associated with investment volatility. Risk and reward are linked and investors should understand that to get a higher return they are taking on a higher risk. However, investors should at least be aware of the risks involved.

Transparency and disclosure of these risks is paramount so that potential and existing consumers are able to understand the consequences of purchasing financial products. However, as mentioned elsewhere, disclosure and transparency is not sufficient to protect consumers. There should be a duty of care on providers and distributors/advisers to inform and explain all the risks involved.

Financial agent should exercise a duty of care and not take undue risks with clients' assets.

Regulators face a difficult challenge deciding whether to ensure safety/security on an ex-ante basis (effective prudential regulation) or ex-post basis (through good deposit/insurance protection schemes).

Evidence of detriment

Regulators should look for evidence of:

- Prudential regulatory failures – insufficient assets to meet liabilities, inappropriate risk management techniques;
- Legal risks – consumer assets misappropriated, client assets not segregated;
- Contractual risks – consumer unable to enforce contract terms;
- Investment risk – investors exposed to unknown, unforeseen, or unwanted risks (volatility) leading to capital losses.

Value for money (VFM) and efficiency

Consumers should have access to value-for-money, products and services from competitive and efficient markets.

It should be noted that, unlike other more efficient and competitive consumer sectors, in financial services there is often an inverse relationship between price and functionality. For example, mutual funds should be relatively simple, transparent products designed to provide investor access to capital markets to provide long term investment growth. However, there is no evidence that mutual funds that charge higher prices to investors deliver superior investor performance. In this case, the higher the price, the greater the value destruction that results.

Regulators should take care to understand that the source of inefficiency can often be found further up the supply chain – for example, inefficiencies or conflicts of interest in the wholesale capital markets, institutional markets – not at the point of sale where the interaction between market and consumer occurs.

Evidence of detriment

Regulators should look for evidence of the following:

- high or excessive charges;
- value destruction;
- layers of unnecessary intermediaries;
- excess margins;
- products and services that do not meet expectations (for example, investment funds that underperform benchmarks).

Value for money and efficiency can be established using international benchmarks or by comparing with substitute products.

Functionality and social utility

Consumers should have access to functional, good quality, innovative, socially useful products and services that meet their core financial needs and preferences.

Functionality, quality, and innovation are just as important in financial services as in other consumer sectors. Indeed, given the importance of financial services, financial users have the right to expect a higher level of social utility.

Financial services are not physical or tangible products like motor cars or electronic goods where measures such as reliability can be used by consumers to choose products. However, there are equivalent measures.

Functionality can be judged according to whether products and services really do meet the needs and preferences of consumers. In other words, products and services need to be designed to meet the needs of consumers not the commercial needs or business models of providers and/or distributors/advisers.

Products and services have to meet the purpose for which they are intended – for example, if pension products do not produce the appropriate risk adjusted investment returns then they do not fulfil their essential purpose. Similarly, is users buy insurance against a risk, they expect to be able to claim if that risk transpires.

True functionality can include easy accessibility (in the case of ATMs), product design features such as contract flexibility, and efficient levels of service (particularly important in the insurance market where efficient claims handling is paramount), and products designed to exploit positive behaviours including countering multiple potential biases in price perceptions, attention, preferences[77], extracting information to support financial decision-making(products for the assessment of default probabilities).

Policymakers and regulators need to have the intellectual confidence to challenge industry accusations that regulatory interventions stifle innovation or competition (see Regulatory principles). Care must be taken not to confuse product complexity for genuine innovation that produces the right outcomes for consumers and enhance societal wellbeing.

The social utility of many of the financial innovations in the past two decades is questionable. Indeed, some of the financial innovations have been very dangerous and detrimental to society's interests. The financial services industry is notorious for introducing 'innovative' products or product features that increase, not reduce, risk in the financial system and destroy, not create, value for financial users. A recent example is exchange traded funds (ETFs) – one of the fastest growing new products. The original concept of ETFs is not necessarily risky but recent 'innovations' involve complex financial products such as synthetic ETFs which can be difficult for financial users to understand.

Those innovations that have created real benefit have tended to be technological (ATMs) or legal/regulatory (for example, UCITS funds) or based on taxation (Individual Savings Accounts and offset mortgages). Indeed, it would appear that there are very few financial innovations that have created genuine value for consumers over the past two decades.

[77] Known as 'kitchen sink/behavioural engineering approach', ideally complemented with independent advice.

Evidence of detriment

Regulators should look for evidence of: 'innovations' that do not add value, complex features that offer no utility or improve consumer welfare.

Decisions and choices

Consumers should have access to the necessary information to allow them to make informed decisions and choices. Critical information should be disclosed pre-sale, point-of-sale, and post-sale.

Where required, consumers should have access to the necessary guidance and advice to help them reach appropriate decisions and choices, from appropriately trained and competent market practitioners.

Financial service providers and their authorised agents should provide consumers with key information that informs the consumer/investor of the fundamental benefits, risks, terms of the product and the remuneration and conflicts associated with the authorised agent through which the product is sold. In particular, information should be provided on material aspects of the financial product/investment.

Standardised pre-contractual disclosure practices should be promoted where applicable and possible to allow comparisons between products and services of the same nature. Specific disclosure mechanisms, including possible warnings, should be developed to provide information commensurate with complex and risky products and services. Critical information should be disclosed pre-sale, at point-of-sale, and post-sale.

However, it is also critical that regulators understand the limitations of information disclosure, partially due to its design defects[78] , as a means of making markets work and influencing consumer and provider behaviour. In addition, is important to stress that mandatory information disclosure should not be used to shift responsibility from firms to consumers.

It is important that consumers have the necessary financial capability to use information effectively.

Where required, consumers should have access to the necessary guidance and financial advice to help them reach the appropriate decision and choice. The provision of advice should be as objective as possible and should in general be based on the consumer's profile considering the complexity of the product, the risks associated with it as well as the customer's financial objectives, knowledge and experience.

Evidence of detriment

Evidence of detriment includes: unclear information, misleading information relating to charges, terms and conditions, investment risk; inconsistently disclosed information which prevents financial users making comparisons; insufficient and unintelligible pre-contractual information (complex language, important information hidden in small print, long pages of information provided only shortly before the signature of the contract), advisers failing to disclose important information; advisers

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[78] Design defects such as: information overload, flawed finance charge definitions, late timing, and lack of uniform presentation of key credit information, just to mention some.

making recommendations that suit commercial needs rather than the needs of financial users.

Information detriment can be tested through product literature reviews, consumer testing to assess whether consumers understand the information provided, and mystery shopping.

Financial capability

Financial users should have the necessary financial capability to make effective decisions.

In complex markets, it is important that financial users have the necessary levels of financial capability to engage with financial services, to be able to use information effectively and have the necessary confidence and skills to make effective decisions and choices.

Financial capability is not simply financial literacy. It encompasses understanding and knowledge of financial matters, the confidence and propensity to act on that knowledge. Successful financial capability interventions change the way financial users think, behave and act. As such these interventions should be oriented to at one hand building capacity by enhancing knowledge(explicit, heuristic, soft), expanding access to desirable financial products(with focus on the features and design of those products) and, considering that people need structures or pathways, in order to move from desire to action. This is also known as 'channel factors', situational forces that either facilitate or hinder a particular human behaviour. In practice this relates to anything from writing out a budget to visualising in advance how a financial decision will be handle. The demand for ´structures' is what had motivated the blossom of auto-enrolment retirement plans or the implementation telephone calls or texts reminders.

As with information above, there is very little compelling evidence that financial education is effective in the short term at improving financial behaviours amongst consumers or the industry. Policymakers and regulators should therefore recognise that financial capability initiatives need to support other more effective interventions – see below[79].

There is a wider dimension to effective decision making. That is, financial users should make optimal decisions about consumption of financial products. For example, overconsumption of credit is a bad outcome for users – whereas underconsumption of savings is also a bad outcome.

Evidence of detriment

Financial capability can be analysed using benchmark or baseline studies that measure financial literacy, understanding of financial products, levels of confidence, and evidence of positive financial behaviours (overindebtedness or undersaving/underinsuring).

[79] See FSUG opinion on ....

Redress and compensation schemes

Consumers should have access to effective redress mechanisms including: including individual redress, collective redress, and court actions.

Redress should put consumers back to the position they were in if detriment had not occurred.

Consumers should have access to well-funded compensation schemes.

Effective redress is critical for consumer protection and consumer confidence. Consumers should have the right to meaningful, accessible redress if they are victims of detrimental market practices and have suffered a financial loss. The basic principle of redress is that consumers should be restored to the position they would have been in if the original detriment had not occurred. They should also be entitled to compensation for distress and inconvenience involved.

Policymakers and regulators should ensure that different redress mechanisms are available to consumers and their representatives including individual redress, collective redress, and court actions.

Even if regulation is as effective as possible, it is not possible to prevent all market failure/consumer detriment. In other words, a zero-failure regime is not possible. The cost of preventing all detriment/market failure would be immense for consumers and wider society. The regulatory costs would be large.

Moreover, one way to prevent all detriment would be to ensure that industry and consumers do not take any risks. However, this could have serious cost implications for society – for example, it would severely impact on the ability of consumers to benefit from investment growth with serious consequences for pension provision.

Therefore, given that it not sensible to expect total ex-ante consumer protection, redress schemes can be a more efficient way of providing ex-post consumer protection.

Evidence of detriment

Evidence of detriment includes:

- absence of suitable and effective redress schemes
- number of consumers not obtaining redress they are entitled to;
- value of redress falling short of detriment/welfare loss identified.

Accountability (to users and society)

Market operators should be accountable to consumers and society and take responsibility for their actions.

Accountability has taken on more significance in light of the financial crisis and the sense that financial markets generally and many powerful financial institutions have become unaccountable and ungovernable.

Policymakers and regulators should therefore ensure that mechanisms are in place to enable users and society to hold powerful financial interests to account and

enforce corporate responsibility. This can be done through a number of mechanisms including:

- Effective redress (see above);
- Robust, effective financial and regulatory sanctions including fines, civil sanctions. The joint use of regulation and liability should be advanced by imposition of punitive damages and and confiscation of unlawful profits)[80], anti-fraud rules, deferred prosecution agreements[81];
- Transparency and disclosure: regulators should ensure that the industry is transparent about its operations and performance indicators. Firms should be required to disclose details of numbers of complaints. This is particularly important in relation to financial exclusion – for example, lenders should be required to disclose socio-economic profile of customers with bank accounts, loans and so on. Transparency should be the default option. There are very few circumstances in which commercial interests justify withholding information at the expense of the public interest.

Evidence of detriment

Evidence of weak corporate accountability includes:

- sanctions not having desired effect of disciplining provider behaviour;
- lack of transparency and disclosure, commercial interests protected in legislation.

Consumer confidence and trust

Consumers should have justified confidence in markets that deserve their trust.

It is self-evidently important that policymakers must restore and maintain confidence and trust in financial services. This is important for two reasons. Financial users need to have confidence and trust if they are expected to use financial services to meet their core financial needs. They also need to have confidence to engage with financial services and make effective choices.

Evidence of detriment

Consumer confidence and trust is relatively straightforward to monitor. This can be done by undertaking regular surveys pointing to low levels of consumer confidence, or consumer reluctance to purchase financial products.

Using the consumer outcomes

The outcomes approach can be applied at a macro-industry level, at sectoral level (asset management, banking, insurance), and product level (current accounts, credit,

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80 The main purpose to impose punitive damages has been assumed to give an incentive to those injurers who might strategically choose to breach the law to take a more appropriate level of care. Support to this initiative has been also stressed by the European Economic and Social Committee suggesting that proceeds should be paid into a 'support fund for collective action' to make it easier for consumers' associations to take collective action seeking compensation or redress. See OJ C 162, 25.6.2008, p. 1-19 and OJ C 175, 28.7.2009, p. 20-25.

81 Under deferred prosecution agreements firms are required to set up committees of senior executives (head of group or experienced designee) from all the disciplines in the firm in charge to review and approve transactions. These committees are required not just to ensure that the transactions did not technically break the law, but prohibit firms from engaging in any transaction intended to achieve a misleading earning, revenue or balance sheet effect.

life insurance – although it is important that regulators do not repeat the mistakes of the past by regulating in 'silos'[82]).

The outcomes approach can also be applied 'thematically', 'horizontally' or 'vertically'.

Market investigations may find that a particular consumer outcome (for example, fair treatment) is not being met across a number of sectors. For example, evidence of similar type of misselling or aggressive practices has been uncovered in insurance/investment/personal pension products in different distribution channels such as financial advisers and banks. The root cause of the detriment uncovered is often the same – for example, conflicts of interest caused by commission bias. It makes no sense to develop specific separate interventions for each product and distribution channel. Regulators in this case should intervene to stamp out practices and set consistent rules across these corporate sectors. This is the horizontal or thematic approach[83].

However, it may be the case that investigations find that a number of consumer outcomes within a particular sector or product area are not being met. For example, evidence may be uncovered that consumers in the current account market (or customers or a single bank) are subject to: unfair treatment; expensive, poor value products; restrictive or discriminatory practices that deny access to products; poorly functioning services; and anti-competitive practices. This is a clear example of a systematic failure within a sector or institution. There is unlikely to be a single root cause of systematic detriment. Experience tells us that, when a market fails to such a degree, root causes can be found along the entire supply chain – for example, barriers to entry at a sectoral level preventing new entrants coming into the market, poor governance at board level, poorly trained staff, reliance on aggressive sales practices to retain market share, poor product design, information problems, barriers to switching, and so on. Clearly, a single intervention focusing on, say, information solutions will have limited effect. This would require a concerted set of interventions tailored to this sector by policymakers and regulators. This is the 'vertical' approach.

Similarly, impact assessments and cost benefit analysis are a core part of regulatory policy. Regulators must be confident they understand the potential impacts of any decisions to regulate or deregulate on consumers and providers. The consumer outcomes provide a template to allow this ex ante evaluation to take place in a coherent, consistent way.

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[82] For example, at a EU level, policymakers developed major separate pieces of legislation on the design and selling of insurance products, investments products, complex products such as hedge funds (MiFID, IMD, PRIPS). These products may have different legal and corporate structures but they perform similar roles for consumers and investors and have a high degree of 'substitutability'. Moreover, the same type of consumer detriment was evident in each of these product sectors – aggressive sales practices, conflicts of interest, market inefficiencies and so on – which should have triggered a more coherent, consistent response from regulators. But this silo approach resulted in inconsistent and inefficient consumer and investor protection. This was a classic regulatory failure which resulted from policymakers and regulators failing to first understand the needs of ordinary investors.

[83] An example of this is the UK FSA's Retail Distribution Review which seeks to create better outcomes for retail investors by addressing commission bias across a range of distribution channels and products.

ANNEX: SUMMARY OF OUTCOMES, MARKET SUCCESS MEASURES, DETRIMENT, ROOT CAUSES OF DETRIMENT

Outcome	Types/evidence of detriment/market failure	Factors that cause detriment and market failure
Access *Consumers should have access to appropriate products that meet their needs from providers that treat them fairly and deserve their trust*	Low take up of products or restricted access – for example, number of households with mainstream bank account, savings, insurance, mainstream loans, access to free ATMs, growth in numbers excluded from mainstream sector and/or consumers using high cost/toxic products – for example, number of households using sub-prime, commercial debt management firms Consumers without access to core bank accounts	External socio-economic factors Income related and person-specific factors Demand-side factors (financial capability) Supply-side factors: network and distribution inefficiencies; ineffective competition; oversupply in the market and diseconomies of scale; complex products; inefficient regulation; basic economics of access Banks deliberately or inadvertently using regulations to deny access
Safety, resilience and sustainability *The financial system should be resilient to external shocks* *Banks and other financial institutions should be soundly and prudently managed* *Consumers assets should be legally secure and protected from fraudulent practices* *Consumers should trust that financial intermediaries are authorised to do business* *Consumers should have legal certainty with regards to contracts* *Investors should be protected from unknown or undue risks*	Absence of compensation schemes Prudential soundness: insufficient assets to meet liabilities Legal security: Consumer assets misappropriated, client assets not segregated Authorisation: Intermediaries trading illegally Contractual certainty: consumers unable to enforce contract terms Investment risk: investors exposed to unknown, unforeseen, or unwanted risks (volatility) leading to capital losses	External economic financial factors, asset/liabilities mismatch, poor risk assessment, lending practices, poor governance structures, deposit protection/insurance guarantee schemes Weak internal governance and processes Failure to separate client assets Low return environment, weak marketing and promotion controls, misselling, aggressive selling Weak regulatory and supervisory structure
Choice *Consumers should have a choice of appropriate products from efficient and competitive markets*	Limited numbers of suitable products and providers that meet conditions, below; inflexible, pricing models; socially useless financial innovations Financial users making sub-optimal choices	Weak or misdirected competition; homogenous product structures/prices; limited numbers of efficient market providers/products; weak regulation Poor quality advice/information; conflicts of interest; lack of duty of care to clients

Fairness and integrity *Consumers have a right to be treated fairly and protected from unfair and illegal market practices* *Markets should operate with integrity*	Exploitative pricing structures/contract lock-ins,[84] negative behavioural pricing front end loaded charges, high unauthorised overdraft charges), unfair cross-subsidies, negative dual pricing, price discrimination, aggressive selling/misselling, short selling/stock-lending acting contrary to client's interest, disproportionate impacts on financially vulnerable consumers, hidden unfair terms	Remuneration structures, conflicts of interest between producers/distributors and consumers/clients, prevailing business models Oversupply in market, competition for distribution, not consumer/client Corporate culture influences, weak governance structures Opaque pricing, misleading marketing, promotion and disclosure
Value for money/efficiency *Consumers should have access to value-for-money products and services from competitive and efficient markets*	High charges/costs (value for money and costs should be benchmarked against the appropriate comparators not within the market itself)[85] Supply chain inefficiencies – NB! it is critical that charges and costs should be measured along the whole supply chain Detrimental pricing structures (see front end loaded charges) Destruction of value and social utility caused by additional or unnecessary charges, layers of intermediaries Post sale inefficiencies, poor levels of service allowed at the expense of price competition (for example, poor claims handling in the insurance sector)	Competition for distribution not end-user, product complexity, remuneration and incentives Oversupply in the market, product proliferation increases search costs, while layers of intermediaries extract value from the supply chain Illusion of choice not the same as effective competition *(note: competition is a means to an end, not an end in itself)* At the other end of the scale, overconcentration and abuse by dominant providers can increase costs and stifle real innovation

[84] For example, by using the price portioning technique, namely cutting up the price in the sales sequence e.g. basic price, options, surcharges, etc. and by framing a unit price in pennies-a-day price is well-known in consumer credit and helps to frame the proposition favourably and to anchor the borrower's thinking rather than considering the total amount in interest he might focus on the periodic payments and their consistency with his budgetary constraints.

[85] For example, benchmarking private pension schemes or mutual funds against other similar or substitute products could create a false picture of market efficiency and value for money – this is because the broader asset management/fund management sector as a whole is inefficient. So, in this case, the appropriate benchmark would be state or collectively provided pension schemes.

Functionality and social utility *Consumers should have access to functional, good quality, innovative, socially useful products and services that meet their needs and preferences*	Products and services have to meet the purpose for which they are intended – for example, if pension products do not produce the appropriate risk adjusted investment returns then they do not fulfil their essential purpose. Similarly, is users buy insurance against a risk, they expect to be able to claim if that risk transpires. Functionality can be judged according to whether products and services really do meet the needs and preferences of consumers, not the commercial needs or business models of providers and/or distributors/advisers. 'Innovations' that do not add value, complex features that offer no utility or improve consumer welfare,	Competition for distribution not end-user, product complexity, poor product design, aggressive marketing and distribution, remuneration and incentives, product features added to provide differentiated marketing benefit for product manufacturers not for the end financial user
Decisions and choices *Consumers should have access to the necessary information to allow them to make informed decisions and choices. Critical information should be disclosed pre-sale, point-of-sale, and post-sale.* *Consumers have the necessary financial capability to use information effectively* *Where required, consumers should have access to the necessary guidance and advice to help them reach appropriate decisions and choices, from appropriately trained and competent market practitioners.*	Types of detriment include: unclear information, misleading information relating to charges, terms and conditions, investment risk, inconsistent information which prevents comparisons. Misleading advice, advice and recommendations which fail to understand consumers' needs, biased advice, poor communications Sub-optimal decisions on consumption of products – overindebtedness vs. undersaving/underinsuring	Remuneration structures, conflicts of interest between producers/distributors and consumers/clients, prevailing business models Corporate culture influences, weak governance structures Poor levels of training and competence amongst sales staff and intermediaries Consumers with low levels of financial capability

Redress *Consumers should have access to effective redress mechanisms including: including individual redress, collective redress, and court actions. Redress should put consumers back to the position they were in if detriment had not occurred*	Numbers of consumers not obtaining redress Redress schemes not available Consumers not obtaining redress they are entitled to Levels of redress falling short of detriment/welfare loss identified	Consumers not aware of redress mechanisms Low levels of financial literacy Specific issue with financially vulnerable consumers Firms blocking redress Ombudsmen/redress schemes under-resourced
Accountability *Market operators should be accountable to consumers and society and take responsibility for their actions*	Effective redress (see above) Sanctions not having desired effect, disciplining effect on provider behaviour Cost of sanctions not borne by shareholders Lack of transparency and disclosure	Sanctions not impacting on bottom line, too low Governance structures, regulation protecting commercial interests by allowing information to be withheld
Confidence and trust *Consumers should have justified confidence in markets that deserve their trust*	Detriment includes underprovision by consumers Confidence affecting propensity to save, insure, take out pension Affects consumer welfare and business sustainability Can be measured and tracked using baseline studies and continuous monitoring of consumer attitudes to financial services	Confidence is affected by a range of factors including: negative user experiences, financial scandals, trust in regulators