

Financial Services Strategy

A consultation document

April 2009

OFT1077con

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Scope of this consultation

Topic of this consultation	The Pre-Budget report in November 2008 committed the OFT to publishing a Financial Services Plan.
Scope of this consultation	The consultation is intended to give stakeholders the opportunity to provide views and comments on OFT's Financial Services Strategy, which will feed into a final plan. The aim of the plan will be to set out a coherent and co-ordinated approach to all OFT's work across the financial services sector reflecting the current economic climate and enabling OFT to respond flexibly to changing circumstances.
Geographical scope	There is no specific geographical dimension to this consultation.
Impact assessment	Not applicable

Basic information

To	Stakeholders within and of the financial services sector, including businesses, trade associations, consumer organisations, and other government departments
Duration	7 April to 12 June 2009
Enquiries	By telephone: Debbie Samosa (020 7211 8141) By email to: debbie.samosa@oft.gsi.gov.uk By post to: Debbie Samosa, 4C, Markets and Projects - Services, Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX

<p>How to respond</p>	<p>Respondents to this consultation are asked to supply a brief summary of the interests or organisations they represent, where appropriate. We ask that any suggested changes or comments on the documents be submitted in writing (by email, or alternatively by letter).</p> <p>Please send responses to Debbie Samosa using the contact details above, by 12 June 2009 at the latest. An earlier response would be appreciated.</p>
<p>Additional ways to become involved</p>	<p>We have contacted a number of key stakeholders to ask for their views. We would also welcome the opportunity to discuss views with stakeholders on a one to one basis and anticipate holding broader feedback session(s).</p>
<p>After the consultation</p>	<p>We will collate responses to the consultation and publish a formal summary of these within a final version of the Strategy in July 2009, taking into consideration comments made in response to the consultation. The document will be available on our website at www.oft.gov.uk.</p>
<p>Compliance with the <i>Code of Practice on Consultation</i></p>	<p>Given the significant changes which have taken and are still taking place in the sector, OFT would like to ensure that a plan is in place as soon as possible in order to deal with the immediate issues facing consumers arising from the current crises. This consultation of approximately 10 weeks, will therefore run for a shorter length of time than that set out in the Code of Practice on Consultation. The Chairman of the OFT has approved the reduction in length of this consultation, as per the requirements set out in the Code.</p>

Background

<p>Getting to this stage</p>	<p>OFT has carried out a review of historical and current work in order to identify key themes across the sector</p>
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**Previous
engagement**

Since January 2009, the OFT has had discussions as well as a roundtable with a number of key stakeholders, including other government departments and consumer organisations, during the development of the strategy, in particular on the key themes and issues to focus on over the coming year.

Feedback about this consultation

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

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A copy of the key criteria from the Better Regulation Executive's *Code of Practice on Consultation* can be found in Annexe D.

Data use statement for responses

Personal data received in the course of this consultation will be processed in accordance with the Data Protection Act 1998. All information received (including personal data) is subject to Part 9 of the Enterprise Act 2002. We may choose to refer to comments received in response to this consultation in future publications. In deciding whether to do so, we will have regard to, among other things, the need for excluding from publication, as far as that is practicable, any information relating to the private affairs of an individual or any commercial information relating to a business which, if published, would or might, in our opinion, significantly harm the individual's interests, or, as the case may be, the legitimate business interests of that business. If you consider that your response contains such information, that information should be marked 'confidential information' and an explanation given as to why you consider it is confidential. We cannot guarantee that information which you mark as confidential will not be disclosed by us in accordance with Part 9 of the Enterprise Act 2002.

Please note that information provided in response to this consultation, including personal information, may be the subject of requests from the public for information under the Freedom of Information Act 2000. In considering such requests for information we will take full account of any reasons provided by respondents in support of confidentiality, the Data Protection Act 1998 and our obligations under Part 9 of the Enterprise Act 2002.

If you are replying by email, these provisions override any standard confidentiality disclaimer that is generated by your organisation's IT system.

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1 EXECUTIVE SUMMARY

- 1.1 The OFT's mission is to make markets work well for consumers. The OFT has a dual competition and consumer mandate. We seek to use the virtuous circle of positive feedback between well-informed consumers and competitive markets.
- 1.2 The OFT has examined and taken action in many financial services markets to address issues of transparency, unfairness, lack of competition and low confidence in the market. Examples include the markets for personal current accounts, store cards, payment protection insurance, payments systems for credit and debit cards and banking services for SMEs. We have also reviewed a number of mergers in the sector. On the consumer protection side, the OFT has examined, among other things, debt collection issues, misleading advertising and unfair terms. In addition to strong direct intervention, we support self-regulation where it is demonstrated to be effective.
- 1.3 Over the last 18 months the financial services sector has been in crisis both in the UK and across the globe. Where and how the process of flux will end is not clear at this time. Although the causes will be debated for some time and is an area outside the OFT's expertise, we take the view that too much competition was unlikely to be the cause. What is clear is that the sector – in particular banks – has received an extensive commitment of public funds and will be subject to a new regulatory environment.
- 1.4 In his Pre Budget Report in November 2008, the Chancellor of the Exchequer, stated that the OFT would set out a specific financial services plan, detailing how we will build on our strong track record of tackling anti-competitive behaviour and consumer detriment.
- 1.5 Much of our work is already aligned with the needs of the current crisis but we intend to sharpen our financial services focus over the coming year. This will be based around two key themes:

- to **promote fairness and responsibility** in the relationship between the credit industry (including banks and debt businesses) and their customers, to deal with the immediate issues facing consumers
 - to play a strong role as an **advocate of choice and competition** in the UK and internationally, to ensure that as public decisions are made to deal with the current crisis, they do not harm competition over the long term and thus reduce the future growth of the UK economy.
- 1.6 We will, where they meet our prioritisation principles, also take action to tackle other issues, both competition and consumer protection but, for the short term at least, higher priority will be given to the areas set out above.
- 1.7 This consultation is intended to give stakeholders the opportunity to provide views and comments on the OFT's approach. This document sets out:
- the OFT's role and objectives in financial services
 - the impact on OFT's work of the current financial crisis
 - OFT's priorities and future work plans
- 1.8 The regulatory framework and the changing landscape of the financial services sector are explained in the annexes to this consultation document.
- 1.9 We are keen to hear from all those with an interest in our work in this sector. We will collate responses to the consultation and publish our final strategy in July 2009.

2 OFT'S ROLE AND OBJECTIVES IN FINANCIAL SERVICES

- 2.1 The OFT's mission is to make markets work well for consumers. Well functioning, competitive markets are a key driver in delivering optimal outcomes for consumers. Regardless of the type of market, effective competition, within a framework of transparency and fairness in advertising and contract, can provide greater choice and does drive efficiency, productivity and innovation.
- 2.2 The OFT has a dual competition and consumer mandate. It has gone further than most agencies by seeking to fuse these together to exploit the oft-cited synergies between consumer and competition policy. In particular, we seek to use the virtuous circle of positive feedback between well-informed consumers and competitive markets.
- 2.3 The OFT can apply our powers contained within the legislative frameworks on competition and consumer protection to the financial services sector. These powers include:
- licensing and regulation of businesses engaged in consumer credit activities to ensure that they meet required standards of competence and behaviour
 - investigating anti-competitive behaviour by firms (anti-competitive agreements and abuses of dominant positions) under the Competition Act 1998 (CA98) and Articles 81 and 82 of the EC Treaty
 - conducting market studies in all aspects of market failure (these can examine both competition and consumer issues). As well as looking at particular economic markets, the studies may also look at to practices across a range of goods and services. The term 'market studies' is therefore not limited to markets in the economic sense
 - obtaining and reviewing information relating to merger situations and referring them to the Competition Commission (CC) if the OFT believes there may be a substantial lessening of competition as set out under sections 22 and 33 of the Enterprise Act 2002 (EA02)

- making Market Investigation References to the CC under the Enterprise Act 2002. The OFT has the power to make a reference if we have reasonable grounds to suspect that competition within a market is restricted, distorted or prevented by any feature or combination of features of that market
- reviewing the regulatory provisions of the Financial Services Authority (FSA) under section 160 of the Financial Services and Markets Act 2000 (FSMA 00)
- investigating unfair terms in consumer contracts and misleading advertising under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCCRs) and the Consumer Protection from Unfair Trading Regulations 2008 / the Business Protection from Misleading Marketing Regulations 2008 respectively
- approving codes of practice under the EA 02.

2.4 The OFT carries out a range of these functions:

- assessing applications for recognition by exchanges and clearing houses (under sections 303 of FSMA 00)
- credit licensing and enforcement
- reviews of consumer codes under the consumer codes approval scheme (CCAS).

2.5 Broadly speaking, the OFT's work in the financial services sector to date can be captured under the following four, interlinking, objectives:

- **Competition:** ensuring that markets in the financial services sector work in ways which effectively promote fair, but vigorous, competition between suppliers (*for example, investigating allegations of anti-competitive agreements, reviewing the potential impact of proposed mergers on competition*).

- **Choice:** ensuring that consumers have the information needed to make effective choices and that there are no unnecessary barriers to switching between provider (*for example, promoting transparency of the costs of financial products and improving the switching process*).
- **Fairness:** ensuring that consumers are not being exploited by unfair terms in contracts or mis-sold products (*for example, ensuring that credit providers do not unfairly change the terms of credit provision to debtors*).
- **Responsibility:** ensuring that lenders act in a responsible manner, that risks are appropriately shared and that the recovery of debts is pursued in a reasonable and proportionate manner (*for example, licensing credit providers and investigating allegations of inappropriate behaviour relating to the recovery of debts*).

2.6 Specific concerns, such as transparency and market structures, are captured within these broad themes. The OFT does not have responsibility for financial stability, prudential regulation or the level of credit in the economy as a whole.

2.7 We have carried out a number of specific investigations in the financial services sector to improve the functioning of markets to the benefit of consumers. Recent examples include:

- a super-complaint about **payment protection insurance** which resulted in a market investigation reference to the CC
- a super-complaint about **personal current accounts in Northern Ireland** which resulted in a market investigation reference to the CC and subsequent Orders
- a super-complaint about the supply of **home credit** which resulted in a market investigation reference to the CC and subsequent Orders
- a review of the **supply of banking services to small and medium enterprises (SMEs)** which was completed on 23 August 2007. The CC supported the OFT's recommendations

- a fact finding review of the **supply of store cards** which resulted in a markets investigation reference to the CC and subsequent Order
- a market study on **sale and rent back**, which was published in October 2008 and recommended regulation of the sector
- a report on **the impact on competition of public support for Northern Rock** which was published on 10 March 2009
- a review of the operations of the **Payments Council** which was published on 25 March 2009

2.8 Current major projects include:

- our consultation on the results of our **market study into personal current accounts**, launched July 2008
- our ongoing work investigating **unarranged overdraft charges**
- the '**Save Xmas**' **campaign** promoting choice in saving methods
- our investigation into the respective **interchange fees** of the MasterCard and Visa networks
- consulting on the scope of our work on **irresponsible lending**
- contributing to the implementation of payment protection insurance remedies, working closely with the CC and FSA
- developing guidance for businesses engaged in **second charge lending**

2.9 More information about our current work in this area can be found in Chapter 4 and further details of all our work can be found on our website www.ofc.gov.uk.

2.10 More information about the regulatory framework can be found in Annexe A.

3 IMPACT OF THE CURRENT FINANCIAL CRISIS

3.1 Following a sustained period of economic growth and improving consumer confidence, the financial crisis has had an impact on every aspect of the UK economy, particularly the financial services sector. A more detail analysis on the challenges for consumers, the sector and the OFT can be found in Annexe B.

3.2 The immediate impact of the current crisis has been to restrict consumers' and businesses' access to credit, to increase levels of indebtedness and to reduce the range of financial products offered. It has also led to significant Government interventions in the sector.

3.3 The financial crisis and economic downturn impact on the work of the OFT in a number of different ways:

3.4 Consumer protection:

- consumers moving from prime to sub-prime lending as they find themselves in changed circumstances. This has knock-on effects on the availability and cost of credit
- repricing of products for existing customers
- increases in levels of arrears, defaults and their consequences such as accounts moving to debt collection, court action, and repossession
- pressure on collections departments to decrease forbearance levels and to recoup outstanding balances more quickly
- increases in practices designed to make money from over-indebtedness and distress, for example activities such as debt management, claims management, debt purchase and 'credit repair'.

3.5 Competition:

- a reduction in competition with firms going out of business, reducing supply, which in turn reduces the competitive pressures on those remaining
- conversely, there may be an increase in competitive pressures as demand falls and firms try to replace customers that they have lost. This may lead to fiercer competition or an increased risk of coordination between firms as they collectively try to maintain profitability
- a change in merger activity. On the one hand, we may observe an increase in the number of mergers as firms decide to consolidate their activities in order to deal with the economic downturn. On the other hand there may be difficulties in obtaining finance for mergers
- a change in the willingness or ability of firms to enter certain markets due to, among other things, lower profitability and more restricted funding (although falling interest rates may partially counteract this by making low return investments profitable which otherwise would not have been).

3.6 The OFT needs to address the issues of short-term consumer detriment, whilst ensuring that market dynamics remain competitive. The OFT will also need to work closely with those reframing the system of prudential regulation to ensure that the benefits of competition continue to be recognised and realised. For example, incumbents should not be protected from the threat of new entry to ensure that consumers benefit from more choice and lower prices through the entry of more efficient suppliers.

4 OFT'S PRIORITIES AND FUTURE WORK PLANS

- 4.1 The existence of strong and vigorous competition is a key element in making markets work well for consumers. Competition in any market provides incentives for firms to lower costs and deliver value for money to their customers. It is also the key driver of innovation and choice. Confident customers (both consumer and businesses) are critical in making the competitive process work.
- 4.2 Financial services markets are no exception. Effective competition is driven by confident consumers and hence consumer protection rules have a vital part to play, especially in a market characterised by products which are often complex and difficult to understand.
- 4.3 Where and how the process of flux in the financial services sector will end is not clear at this time. The OFT has to respond nimbly to changing circumstances and events. It seems sensible at the present time to look at our priorities with both a short term and a long term focus.
- 4.4 The OFT will continue to place a strong emphasis on working with partners, particularly the FSA, HM Treasury and the European Commission, to ensure that the UK competition and consumer regimes are as strong as necessary, over both the short and long term.

Our approach

- 4.5 Open competitive markets are characterised by:
- **Empowered consumers** – competition relies on customers (consumers and businesses) understanding the products on the market, and being able and prepared to switch to drive value for money and greater choice. Consumers need to have access to clear and transparent information that is not misleading, incomplete or excessive, thus allowing them to make informed choices about the products they purchase and to make responsible decisions about their own borrowings.

- **Effective and proportionate regulation** that establishes confidence in markets, and protects consumers, but also avoids placing undue burdens on business – since these are ultimately passed on to consumers in higher prices and / or less choice.
- **Fair and responsible practices** – customers must be able to purchase goods and services without being subject to unfair practices. Firms must behave responsibly towards their customers and not exploit their position. Regulation can support this by setting standards of professionalism and making sure these are rigorously enforced.

4.6 Our general approach involves:

- **Strong regulatory and enforcement action** when necessary (and proportionate) through the use of the OFT's powers under consumer protection and competition law.
- **Monitoring markets** and deepening our understanding of the drivers of financial markets.
- **Working in partnership** with other regulators, government departments and our wider stakeholders to ensure we achieve the intended outcomes. For example, the OFT and FSA, as set out in our Joint Action Plan¹, are committed to working together to ensure that regulation (including any new regulation resulting from the crisis) is efficient and effective. In addition, we are continuing to work closely with the FSA to ensure that the remedies proposed by the CC following the PPI market inquiry are effectively implemented.
- **Supporting self-regulation** where it is the most effective intervention.
- **Advocacy** for the long-term benefits of open markets and competition.

¹ Announced April 2006 and updated annually

Our financial services strategy

- 4.7 Given the scale of the crisis in the financial services sector, its impact on the wider economy and the measures taken by government to stabilise it, we are reviewing our approach to work in this sector.
- 4.8 The financial services industry covers not only financial intermediation (mainly banking) but also insurance and pensions. The focus of our work set out below is on banking, the granting of credit and leasing. This is because we believe the impact on consumers and SMEs of the current crisis will primarily be felt through what is happening to banks and other credit providers.
- 4.9 Much of our work is already aligned with the needs of the current crisis but we will sharpen our focus such that our priorities over the coming year will be based around two key and inter-related themes:
- to **promote fairness and responsibility** in the relationship between the credit industry (including banks and debt businesses) and their customers to deal with the immediate issues facing consumers
 - to play a strong role as an **advocate of choice and competition** in the UK and internationally, to ensure that as public decisions are necessarily made to deal with the current crisis, both around ownership and control and the future regulatory structure, they do not harm competition over the long term and thus reduce the future growth of the UK economy.

Fairness and responsibility

- 4.10 In the short term our priority will be to use the various powers at our disposal to ensure distressed consumers and businesses are treated in a fair and responsible way.
- 4.11 Where strong enforcement is necessary (and proportionate) to protect consumers or to act as a deterrent we will seek to act in a quick and

robust manner. Where a lighter touch, such as self-regulation, can work effectively we will seek pursue it.²

- 4.12 As outlined in chapter 3, the current crisis has had a huge impact on the credit markets which together with the rise in the number of distressed consumer make the credit sector and debt recovery issues clear priorities for us.

Credit sector

- 4.13 The market has changed significantly in the last year. We intend to launch a **review of the unsecured consumer credit sector** to examine its operation, including the offerings of suppliers, the role of intermediaries and the behaviour of and decisions made by consumers.
- 4.14 Ahead of this we will be writing to stakeholders to ask for their views and to engage with them to discuss the scope and focus of the review which will commence in summer 2009. We propose that the review should consider:
- consumer behaviour and decision-making
 - the degree of transparency in pricing
 - how risk-based pricing operates
 - whether the right incentives are in place for suppliers to provide consumers with the products that are right for them
 - whether there are significant concerns in relation to the information passed between lenders and credit reference agencies and its use as part of responsible lending decisions.
- 4.15 We will be discussing these issues with Government, consumer groups and the industry in the run-up to the launch in order to refine the scope

² See Statement of consumer protection enforcement principles, OFT 964, November 2007

of the review. We will be contacting key parties directly. Other interested parties can submit views to the credit review team at the OFT by 8 May 2009.³

- 4.16 We launched our **Irresponsible Lending project** in August 2008. The aim is to provide a clear OFT position on what constitutes 'irresponsible lending' within the meaning of section 25 of the Consumer Credit Act 1974 (CCA 74) (the fitness test). It will set down clearly the types of conduct that the OFT considers unfair so that licensed businesses know what is expected of them and consumers are made aware of business practices that they should not expect to experience when dealing with responsible businesses. The review is examining issues in advertising and marketing, selling techniques, product design, use of appropriate credit scoring techniques and handling of defaults and arrears as well as behaviour and practices around a borrower's ability to repay credit. Draft guidance on irresponsible lending is likely to be issued for consultation by summer 2009 and the project is expected to be completed by the end of 2009.
- 4.17 We published a consultation on draft **guidance for businesses engaged in second charge lending** on 13 February 2009. The consultation follows a government review of arrears and repossession policies and practices in the second charge sector. The draft guidance covers a range of issues such as customer care, advertising and selling techniques, contractual terms and conditions and practices around management of defaults. It sets out the standards of behaviour that the OFT expects from those businesses engaged in second charge lending. The consultation runs until 8 May 2009.⁴

³ Submissions on the proposed scope of the credit review should be sent to: Unsecured Consumer Credit Review, Fourth Floor, Office of Fair Trading, Fleetbank House, 2-6 Salisbury Square, London EC4Y 8JX. They can also be emailed to creditreview@oft.gsi.gov.uk

⁴ OFT 1057con, Second charge lending – OFT guidance for brokers and lenders, an OFT consultation, February 2009 at: www.oft.gov.uk/shared_oft/consultations/oft1057con.pdf

- 4.18 We are working together with stakeholders to ensure that if the FSA proposals for Banking Conduct of Business Rules are implemented in November 2009, we use this opportunity to work towards **wider and more effective self-regulation across the lending sector**.
- 4.19 We are looking for the banking industry to make **significant changes in connection with the provision of unarranged overdraft and returned items fees** (referred to as 'charging terms'). We made clear in our market study report into the personal current account market that we have significant concerns about banks' use of these charging terms and the impact they have on the market. Our concerns relate, amongst other things, to the limited degree of transparency, complexity in the way some charges are implemented and the lack of control that consumers have in incurring charges. We have also written to banks with our provisional view on the fairness of the charging terms setting out our concerns that they may be unfair under the Unfair Terms in Consumer Contracts Regulations 1999. We expect to reach a final decision on fairness later in 2009.
- 4.20 We will also take specific **enforcement action** as appropriate against firms who act unfairly or where the OFT is dissatisfied with their behaviour.

Debt recovery

- 4.21 Given the dramatic increase in the number of people facing serious financial difficulties as a result of rising unemployment and the rationing of credit, we will seek to use the existing consumer protection framework vigorously to ensure that consumers who fall into arrears or default are treated fairly and that lenders do not use inappropriate methods of debt enforcement.
- 4.22 We are particularly sensitive to the need to **protect consumers from the misleading promotion of products/services aimed at those in debt**. For example we have already taken the initiative to tackle debt management companies portraying themselves as if they were impartial and

independent advice agencies and certain issues in the sale and rent back market.

- 4.23 Attempts by unsecured creditors to seek inappropriately to secure their debts on properties are also a cause for concern. There has been a significant increase in the number of charging orders applied for and granted recently. We are **monitoring the use of 'charging orders'** as a method of enforcing judgment debts, where the debts originally arose under regulated consumer credit agreements. We have written to a number of creditors seeking further information as we have concerns about the appropriateness of their use in certain circumstances.
- 4.24 **Debt Collection** - we will continue to use our new enforcement tools to ensure that standards are raised across the debt collection and debt purchase industries.
- 4.25 We will undertake a full **review of compliance with OFT's Debt Management Guidance** which was first issued in 2001. The review is expected to start in mid 2009. We will take appropriate action to deal with issues of unlicensed trading by debt management and claims management companies.
- 4.26 **Claims Management** - we will work to ensure that standards are raised within claims management companies and contractual fairness exists for both creditor and debtor, with both 'can't pays' and 'won't pays' being dealt with in an appropriate manner.
- 4.27 We will take appropriate action to deal with **cold-calling for debt management services** and also with **misleading advertising** in the sector – especially with businesses not being clear about fees charged and effects of debt management plans on debtors' current and future standing.

Financial education

- 4.28 We work in partnership with a range of organisations to empower consumers to enable them to make informed decisions that are right for

them so that they can act as a positive stimulus to competition between businesses and obtain better outcomes from markets.

- 4.29 The FSA has the lead role in financial education, in particular through the information available in its Money Made Clear guidance. We have worked in partnership with the FSA, and will continue to do so, to ensure that information on money and credit on our Consumer Direct website is consistent with and links to FSA information.
- 4.30 We have one specific campaign – **Save Xmas** – which was launched in June 2007 and taken forward in collaboration with partners (principally Citizens Advice). It highlighted the advantages and disadvantages of different short-term savings options. The initial campaign was very successful. The campaign continues into 2009-10. Our focus this year will be on improving the quality of the information sessions offered through Citizens Advice. We will also re-position the campaign in the light of current economic circumstances. We intend to launch an online resource taking consumers through short term savings options, bringing the campaign to a wider audience.
- 4.31 We have also looked at how financial information should feature in our consumer education activity which is delivered through **Skilled to go**, the OFT's online consumer education toolkit. In summer 2009, we will publish guidance for teachers explaining how to help learners to develop a range of financial capability skills. Developed for teachers working with adult learners, Skilled to go uses everyday consumer situations, such as choosing a mobile phone, as contexts for learning literacy and numeracy.

Choice and competition

- 4.32 The stability and proper functioning of the UK financial services industry rests upon effective prudential regulation and a framework within which vigorous and fair competition between firms can take place. Extensive public support has proved necessary to stabilise financial markets not just in the UK but across the globe.

- 4.33 In the longer term however it is important that these various support measures do not distort incentives, create moral hazards and thereby weaken the competitiveness of UK markets to the detriment of consumers and business customers.
- 4.34 Therefore the financial services industry that emerges from this crisis should be characterised not only by effective prudential regulation protecting savers and the wider economy from the consequences of bank failures, but also one in which markets are open, competition is vigorous and consumers are not subject to unfair practices.
- 4.35 In the short term other policy objectives, in particular the stabilisation of the financial system, have had to take priority. We are aware of the danger that short term measures taken to stabilise markets can have an impact on competition in the long term if they are not revisited when markets have stabilised. The emerging market structures post-crisis will need to be assessed to ensure they are pro-competitive and deliver the best outcomes for consumers. Particular attention will need to be paid to how Government withdraws from the banking sector and ensuring that new entry can be a credible threat to existing players.

Regulatory reform and competition advocacy

- 4.36 A fundamental review of prudential regulation within the financial sector internationally is underway led by the G20. In the UK a key piece of work in this area is Lord Turner's review of the prudential framework and regulation of the banking system which was published on 18 March 2009.⁵ That review, alongside the associated FSA discussion paper,⁶ makes recommendations for reforming UK and international approaches to the prudential regulation of banks.

⁵ The Turner Review - A regulatory response to the global banking crisis

⁶ DP/02

- 4.37 The OFT and other competition authorities across Europe have an important advocacy role to ensure that the impact on competition is adequately taken into account by policy makers framing this new regulatory environment – as recognised by the Chancellor in his speech on 27 March 2009.

Re-structuring of the financial services industry

- 4.38 There has of course been a significant re-structuring of the UK financial services industry in the past year. We believe that the growth of a competitive fringe of challenger banks in the UK prior to this crisis had very positive effects both for SME customers and in delivering improvements in the value offered to personal current account customers.
- 4.39 When we reviewed the merger between Lloyds / TSB and HBOS we concluded that there was a realistic prospect that the anticipated merger would result in a substantial lessening of competition in relation to personal current accounts, banking services for small and medium sized enterprises and mortgages.
- 4.40 In the long term we will monitor the extent to which competition within the sector is prevented, restricted or distorted by market features or combinations thereof. Our existing merger rules and standards will continue to be applied to further mergers or acquisitions within this sector. We will also consider whether markets should be referred to the CC.

Re-capitalisation of banks

- 4.41 UK government schemes to stabilise the financial system, including a re-capitalisation scheme in which a number of major banking groups such as RBS and Lloyds were willing to participate, have been reviewed and approved by the European Commission. Part of this clearance process reviewed the impact of the scheme on competition within the sector. We share the view expressed by the European Commission that such public support should not in the future give undue advantages to poorer

performing banks compared to banks which are fundamentally sound and better performing.

- 4.42 In the longer term recapitalisation should pave the way towards the return of these banks to long term viability in the private sector. We will be concerned to ensure that the structure of the industry that emerges as the government withdraws from owning equity in banks is one which promotes open and vigorous competition.

Other work

- 4.43 Our market study into personal current accounts in the UK identified the need for improved transparency of costs and greater confidence in the switching process. These changes should help consumers to drive competition through more cost efficient use of their accounts, comparing the cost of accounts and switching where relevant. We are working with stakeholders to agree improvements and hope to conclude our work by the end of the summer.
- 4.44 Efficient payment systems are at the heart of the financial economy. We will continue our work to ensure that they are subject to the benefits of the competitive process and responsive to customer needs.

5 CONSULTATION QUESTIONS

5.1 We welcome views on our proposed approach and have identified some specific questions that would help inform our strategy and approach. We have also identified some questions where feedback would be most welcome in informing the policy position we may take on particular issues.

Overall strategy

Q1 Do you agree with the OFT's proposals to focus on the two key priorities of:

- fairness and responsibility, and
- advocacy for strong competition and open markets (within a context of appropriate prudential regulation)?

Fairness and responsibility

Q2 Do you agree that the OFT's focus should be particularly on credit markets and debt recovery?

Q3 Are there other markets or issues within financial services, other than those mentioned above, that you think we should monitor or pay particular attention to in the short term?

Q4 Are there any key aspects either in relation to consumers or business, that we are missing and that might be relevant to the work of the OFT?

Competition and open markets

Q5 Are there any areas of financial regulation that pose a particular risk in relation to their impact on competition? We are particularly interested in regulation that creates significant barriers to new entry.

Q6 We would welcome thoughts on some of the trade-offs the OFT will have to address in advocating the benefits of competition. For example, what, if any, are the trade-offs that need to be made between competition and financial stability?

General

Q7 Do you have any additional comments to make on the strategy?

ANNEXE(S)

A REGULATION OF THE FINANCIAL SERVICES SECTOR

Introduction

A.1 This chapter explains the definition the OFT uses for the financial services sector. It contains an overview of the regulatory framework that applies to financial services. The aims and objectives of the OFT are set out together with a short description of the other key players.

Definition of financial services

A.2 The definition used by the UK Office of National Statistics (ONS) when it measures the sector is listed as category J of its Standard Industrial Classification of Economic Activities (UK SIC(92)) codes. The ONS splits the sector into three areas of economic activity:

- Financial intermediation,⁷ except insurance and pension funding. This includes monetary intermediation (activities of banks and building societies) and other financial intermediation services such as financial leasing, factoring, the granting of credit and investment activities.
- Insurance and pension funding (not including State social security). This includes both life and non-life insurance.
- Activities auxiliary to financial intermediation. This includes activities such as brokerage and fund management.

Sector size

A.3 According to the Institute of Financial Services London, based on ONS data, the financial services sector's share of UK GDP reached 7.6 per cent in 2007.⁸ It employed over a million people (June 2008).⁹ The

⁷ A financial intermediary is any institution which mediates between two parties in a financial context such as a bank channelling funds between borrowers and savers.

⁸ IFSL Research, *Economic Contribution of UK Financial Services*, December 2008

financial services sector is not only a very large and important component of the UK economy in its own right but also underpins the performance of business more widely.

Regulatory framework

A.4 The financial services sector is subject to a number of legislative frameworks, including the FSMA regime, the competition framework and consumer legislation. The latter two are applicable to all sectors, whereas the first addresses the unique features of the financial services sector, including the inherent risks to consumers and to the proper functioning of financial markets.

Prudential regulation

A.5 All FSA authorised and regulated firms are subject to prudential regulation. The objective of prudential regulation is to maintain confidence in the financial system and to ensure the ability of FSA-authorised firms to meet the relevant 'threshold conditions' for authorisation¹⁰ and any other applicable requirements relating to their financial resources. These include the requirements of EU law.¹¹

A.6 There is a Memorandum of Understanding between HM Treasury, the Bank of England and the FSA (who collectively make up the 'Tripartite authorities').

A.7 The main role of the Tripartite Authorities is developing regulation and policies to safeguard financial stability. While the OFT does not have a

⁹ Ibid.

¹⁰ As set out in FSMA, Schedule 6

¹¹ In the case of banks, the [Banking Consolidation Directive](#) permits a host state [competent authority](#) to require a 'credit institution' within the scope of the Directive to meet certain standards relating to its liquidity.

direct role here, some of the measures taken by the Tripartite Authorities will have a bearing on its competition and consumer roles.

- A.8 In addition, the Financial Services Compensation Scheme (FSCS) plays an important part in supporting consumer confidence in the system. As a fund to guarantee deposits up to a certain amount it becomes particularly important in the event of a bank failure.

Competition

- A.9 The key organisations are the OFT, the European Commission and the CC. HM Treasury and BERR have roles as the sponsor of competition legislation within the UK.
- A.10 Anti-competitive behaviour is prohibited under Chapters I and II of the Competition Act 1998 and may also be prohibited under Articles 81 and 82 of the EC Treaty. Broadly, these laws prohibit anti-competitive agreements between businesses and the abuse of a dominant position. Since 1 May 2004 the OFT has had the power to apply and enforce Articles 81 and 82 of the EC Treaty in the UK.
- A.11 However, in the context of oligopolistic markets, the CA98 does not cover all types of competition concern and it may be more appropriate for the OFT to make a **market investigation reference** to the CC under the EA 02.¹² Under section 131 of the EA 02 the OFT has the power to refer markets to the CC for further investigation where it has reasonable grounds for suspecting that any feature or combination of features of a market is preventing, restricting or distorting competition. It is for the CC to decide whether competition is indeed prevented, restricted or distorted and what actions should be taken to remedy the situation.
- A.12 The EA 02 also contains provisions on merger control. The OFT has a function to obtain and review information relating to merger situations. If the OFT believes that it has jurisdiction and that it is or may be the case

¹² Other regulators may also make a market investigation reference to the CC under EA 02.

that a merger may be expected to result in a substantial lessening of competition, the OFT must refer the merger situation to the CC for further investigation.

- A.13 Under s42 of the EA02 the Secretary of State for Business, Enterprise & Regulatory Reform may intervene in a relevant merger where he believes that a public interest consideration specified in s 58 of the EA02 is or may be relevant to a consideration of a merger. Until recently there were two public interest considerations.¹³ However, in anticipation of a merger of Lloyds/HBOS, the EA 02 (Specification of Additional Section 58 Consideration Order) 2008 introduced a third consideration of maintaining the stability of the UK financial system. Where such an intervention is made the OFT must provide a report to the Secretary of State on the competition issues and summarise representations it has received on the public interest issues. The Secretary of State must then decide whether to refer the case to the CC, ask the OFT to seek undertakings in lieu of a reference or, as in the Lloyds/HBOS case, clear the merger.
- A.14 The CC investigates mergers referred to it by the OFT (and occasionally by the Secretary of State) to determine whether there is a relevant merger situation and if so, whether that merger situation has resulted, or may be expected to result, in a substantial lessening of competition. The CC determines the outcome of merger cases referred to it by the OFT and reports to the Secretary of State on those mergers referred to it by the Secretary of State under the public interest regime. It has no authority to investigate any merger unless it has been asked to do so by the OFT or the Secretary of State under the relevant statutory provisions.

Consumer protection

- A.15 Interventions by the OFT in relation to consumer protection are designed to support the development of competitive, efficient, innovative markets

¹³ National security and standards in the media

where standards of consumer care are high, consumers have choice and are empowered and confident about making choices, and where businesses are not disproportionately burdened by government regulations and are encouraged to offer benefits to consumers beyond the protection afforded by law. This can involve the use of several tools.

- A.16 Consumer protection responsibilities are shared between the OFT, the FSA and the Financial Ombudsman Service.
- A.17 The regulation of credit, that is, ensuring that those businesses advancing credit are run in a fit and proper way, is shared between the FSA and the OFT. Broadly speaking the FSA is responsible for first charge mortgages, whereas the OFT is responsible for licensing businesses engaged in Consumer Credit Act activities (such as credit cards, personal loans, hire purchase schemes, debt collection, debt advice and credit reference agencies).
- A.18 The Consumer Credit Act 2006 reviewed consumer credit regulation under the CCA 74 and since April 2008 the OFT has had substantially improved powers, enabling it to move from passive licensing of consumer credit businesses, to proactive regulation with a focus on high-risk activities in the licensed credit and debt markets.
- A.19 The OFT also uses legislation to protect consumers by challenging unfair practices, including misleading adverts, scams and aggressive sales (the Consumer Protection from Unfair Trading Regulations 2008), challenging unfair contracts (the Unfair Terms in Consumer Contracts Regulation 1999) and ensuring performance of contracts. The OFT uses its tools to target specific business practices and conducts. This can apply to particular methods of sales, such as distance selling, doorstep selling and electronic commerce or to particular sectors.

The OFT

- A.20 The OFT's powers are described at paragraph 2.3 of this consultation document. In addition:

- A.21 Under section 160 of FSMA 00, the OFT is responsible for keeping under review the regulating provisions and practices of the FSA and is required to report if the OFT considers that they create significantly adverse effects on competition.
- A.22 Under section 303 of the FSMA 00, the OFT is required to report on whether the regulatory provisions (or a combination of the regulatory provisions) of organisations which apply to the FSA for recognition as an exchange or clearing house have a significantly adverse effect on competition.
- A.23 Under section 304 of the FSMA, the OFT must keep under review the regulatory provisions and practices of recognised exchanges or clearing houses. The OFT must make a report if it considers that regulatory provisions and practices (or a combination thereof) have a significantly adverse effect on competition.
- A.24 Section 162 of the EA 02 (and section 88 of the Fair Trading Act 1973) require the OFT to review from time to time (as well as monitor and enforce) remedies put in place following inquiries by the Competition Commission and undertakings in lieu of a market investigation reference among other things. In a review, OFT must determine whether by reason of any change in circumstances a remedy is no longer appropriate and needs to be varied or revoked or one or more parties can be released. If there has been no change in circumstances, a remedy cannot be remedied or revoked.
- A.25 The OFT is not responsible for monetary policy or financial stability nor directly responsible for the overall availability of credit (unsecured or secured).

The Financial Services Authority

- A.26 The FSA is the UK's primary financial regulator. It aims to promote efficient, orderly and fair financial markets and to help retail consumers achieve a fair deal. The Financial Services and Markets Act 2000 (FSMA) gives the FSA four statutory objectives: maintaining market

confidence; promoting public understanding of the financial system; the protection of consumers; and reduction of financial crime.

- A.27 Within the scope of FSMA, the FSA is responsible for the authorisation and prudential supervision¹⁴ of financial services firms, including banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies.
- A.28 The FSA also issues a Conduct of Business sourcebook (part of its Handbook of Rules and Guidance) for all relevant firms that accept deposits (in certain respects), or carry out designated investment business or long-term insurance business, and associated activities.¹⁵

The European Commission

- A.29 The European Commission's Directorate General for Competition (DG COMP) has an important role when breaches of competition law affect trade more widely than just in the UK. It enforces Articles 81 and 82 of the EC Treaty which deal with anti-competitive agreements and abuses of a dominant position respectively.
- A.30 Through the European Competition Network (ECN), of which the OFT is a member, a consistent application of EC competition rules is ensured.
- A.31 Mergers with a Community dimension are examined at European level by the European Commission. This allows companies trading in different EU member states to obtain clearance for their mergers in one stop. If the annual turnover of the combined businesses exceeds specified thresholds in terms of global and European sales, the proposed merger

¹⁴ Prudential supervision here can be defined as the regulation of FSA-authorized firms so as to maintain confidence in the financial system and to ensure their ability to meet the relevant threshold conditions for authorisation and any other applicable requirements relating to their financial resources.

¹⁵ The FSA is currently considering responses to its consultation on extending its conduct of business rules to the retail deposits sector.

must be notified to the European Commission, which must examine it. Below these thresholds, the national competition authorities in the EU member states may have jurisdiction to review the merger.

- A.32 The merger control rules ensure that European and national mergers are assessed by the best placed competition authority.
- A.33 The European Commission also enforces European rules on state aid control. These are an essential component of the European competition policy framework. By creating a common framework for state subsidies, state aid rules ensure a level playing field for companies in the European single market.
- A.34 The OFT has no direct statutory role to play in the assessment of state subsidies. The European Commission is the central authority dealing with state aid in the European single market.
- A.35 In the context of wider financial instability, the OFT recently considered the impacts on competition of financial support from the UK Government for Northern Rock. The OFT has concluded that during the period of analysis, February 2008 to February 2009, public support for Northern Rock did not have a significantly adverse impact on competition.

The Competition Commission

- A.36 The CC's role is to conduct in-depth inquiries into mergers, markets and the regulation of the major regulated industries (including utilities, postal services, railways, airports, air traffic control) in the UK.
- A.37 All CC inquiries are undertaken following a reference made to the CC by another authority: most often the OFT (which refers mergers and markets) or one of the economic regulators (which refer their markets, or price controls, or, in the case of Ofgem, appeals in respect of modifications to the codes covering the energy industry). References can also be made by the Secretary of State for Business, Enterprise and Regulatory Reform (BERR).

- A.38 If CC investigations conclude that a merger or a feature of a market (or a combination thereof) raise competition concerns, the CC is required to remedy that situation.
- A.39 If CC investigations conclude that features of a market prevent, restrict or distort competition in the UK, the CC seeks to determine and implement appropriate remedies.
- A.40 Market investigation references are initiated following a concern raised by another UK authority when it appears that competition may be being prevented, distorted or restricted in a particular market. This is usually the OFT. The OFT typically investigates around 150 mergers a year, of which it refers around 10 per cent to the CC. The OFT and other authorities also typically refer one to three markets or other regulatory issues to the CC each year, though the actual number in a particular year can vary greatly.
- A.41 A wide range of remedies is available to the CC for both merger and market investigations.

B RECENT CHANGES AND THE FINANCIAL CRISIS

Introduction

- B.1 In the period 1996 to 2006, prior to the onset of the financial crisis, growth in the financial services sector in the UK outpaced all other business sectors, according to National Statistics Economic and Labour Market Review The output of the sector grew by 76.4 per cent over the decade, compared with 43.5 per cent for the services sector as a whole and 32 per cent for the UK economy.
- B.2 The system of regulation of the UK financial services industry was characterised as light-touch and risk-based. There was a high degree of confidence in the role of markets in disciplining and constraining the actions of economic agents and financial institutions.
- B.3 Since the summer of 2007, we have witnessed the near collapse of a number of major UK retail banks and their subsequent recapitalisation by Government. More widely, credit availability has shrunk causing widespread problems for both consumers and businesses – we have seen a number of high profile business closures in the real economy, that is, in the non-financial side of the economy - good, services, and resources.
- B.4 Within the financial services sector, the parameters of competition have altered and the existing business models have had to be reconsidered in light of new pressures. The prudential regulatory system is also being reconsidered after the financial crisis uncovered significant weakness and gaps, which need to be addressed in order to minimise the risks of future crises occurring.
- B.5 Taken together there has been a general loss of confidence in the system and increasing scepticism over the role of markets in delivering benefits to consumers and the economy as a whole.
- B.6 This Annexe provides a brief overview of the financial crisis and its potential impact on consumers, businesses, and the financial sector.

The financial crisis

- B.7 In its October 2008 Financial Stability Report, the Bank of England dates the beginning of the credit crunch to 5 March 2007, when HSBC announced one portfolio of purchased sub-prime mortgages was demonstrating much higher levels of delinquency than had been priced for.¹⁶
- B.8 Through the summer of 2007, it became more and more evident that sub-prime mortgage exposure affected a large number of financial institutions. Resulting uncertainty about the stability of institutions led to a severe rationing of funds in the money markets as lenders were reluctant to lend. The results were seen most dramatically in August 2007 when there was a run on Northern Rock, a bank that was particularly reliant on the wholesale money markets for funding, after it was forced to seek support from the Tripartite Authorities. This support culminated in the government taking complete ownership of the bank in February 2008.
- B.9 However, while the events at Northern Rock represented a 'watershed' moment when the potential impact of the credit crunch began to be more widely understood, it was only the beginning of a series of more fundamental shocks to the financial services sector, and later the wider economy.
- B.10 Throughout 2008, there were a series of major developments in the markets. Globally, the markets witnessed the demise of a major bank, Lehman Brothers, and the emergency acquisition of a number of others (such as acquisition of Merrill Lynch by Bank of America and of Wachovia by the Wells Fargo bank group). The crisis caused large scale interventions from public authorities, for example, the German authorities announced a package to save Hypo Real Estate, the Dutch authorities announced a major capital injection into ING and the Icelandic government had to step in to take control of a number of banks.

¹⁶ See Annexe, *Financial Stability Report*, Issue No. 24, October 2008, Bank of England.

Assistance to the distressed insurer AIG and the US motor industry, showed the turbulence was not limited to the banking sector.

B.11 In the UK, one of the most important changes to the financial landscape was the large-scale investment by the government in the Lloyds Banking Group and the Royal Bank of Scotland Group (RBSG). This followed the announcement of the anticipated merger between Lloyds TSB and Halifax Bank of Scotland. The government also nationalised the mortgage book of Bradford & Bingley following its collapse, its branch network and savings business were sold to Banco Santander. At the time of writing, Government owns significant shareholdings in the Lloyds Banking Group and RBSG, wholly owns Northern Rock and owns Bradford & Bingley's mortgage book.

B.12 Additional changes include:

- the acquisition of Alliance & Leicester by Banco Santander
- the acquisition of the Cheshire and Derbyshire building societies by Nationwide, and
- the Britannia building society anticipated to soon merge with Co-operative Financial Services.

B.13 The government has also provided sector- wide support to banks such as wholesale guarantees and insurance.¹⁷ This public support includes:

- a bank debt guarantee of £300 billion
- Bank of England loans worth £185 billion
- recapitalisation of banks totalling around £81 billion
- Bank of England corporate debt scheme of £50 billion

¹⁷ www.hm-treasury.gov.uk/press_05_09.htm

- Working Capital Fund for Small Businesses of £10 billion, and
- an Asset Protection Scheme for banks under which, in return for a fee, HM Treasury provides protection against credit losses incurred on one or more portfolios of defined assets. At the time of writing, two banks were participating in this scheme: RBS in respect of £325 billion worth of assets and the Lloyds Banking Group in respect of £260 billion worth of assets.

Wider impact

B.14 Despite the public support to the financial services sector, the impact of the crisis has spread through the economy, most importantly through a contraction in the availability of credit to businesses and consumers and a reduction in confidence. As a result, the financial crisis has turned into a wider recession as firms outside the financial services sector experience difficulties and, in some cases, go out of business.

Availability of credit

B.15 There has been a major change in the consumer credit market. In the UK, credit had previously been relatively easy to obtain - to the extent that concerns were raised about 'responsible lending'. This was particularly true in the case of the mortgages market where mortgages with a loan to value ratio of over 100 per cent were being widely offered by mortgage providers.

B.16 According to statistics from the Bank of England there has been a significant slowdown in lending to individuals compared with previous years. In December 2008 annual growth in secured lending was 3.4 per cent compared with an average of 9.5 per cent in the period between 1996 and 2007. Similarly, annual growth in consumer credit, both credit cards and unsecured lending was 5 per cent in 2008 compared with an average of 13.8 per cent between 1996 and 2007.

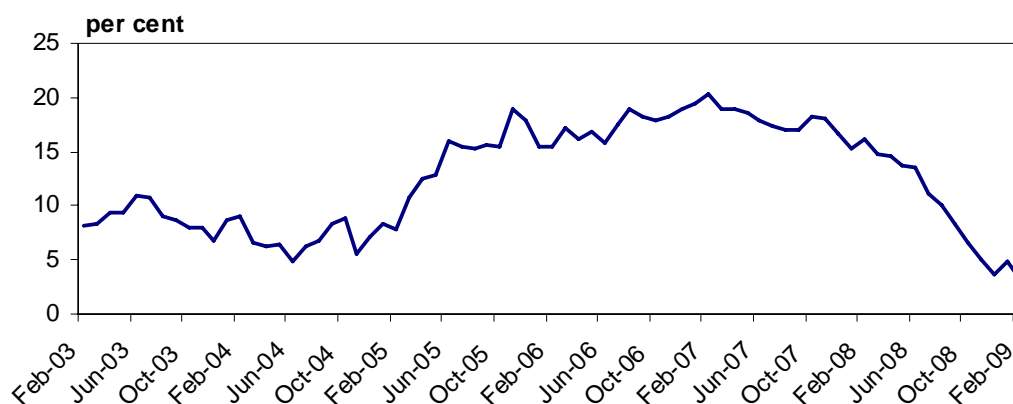
Table 1: Annual Growth in Total Lending to Individuals, 1996-2007 compared to 2008 - 2009

<i>Percentage change on a year earlier</i>					
	Averages	2008		2009	
	1996-2007	Nov	Dec	Jan	Feb
Total Lending	10.2	4.1	3.6	3.1	2.6
Secured	9.5	3.9	3.4	2.9	2.4
Consumer Credit	13.8	5.1	4.9	4.5	3.4

Source: Bank of England

B.17 There is also evidence to show that bank lending to private non-financial corporations has slowed significantly compared with 2008 levels.

Figure 1: Annual Growth of UK Banks and Building Societies' net lending to Private Non-Financial Corporations (PNFC), February 2003 to February 2009



Source: Bank of England, not seasonally adjusted

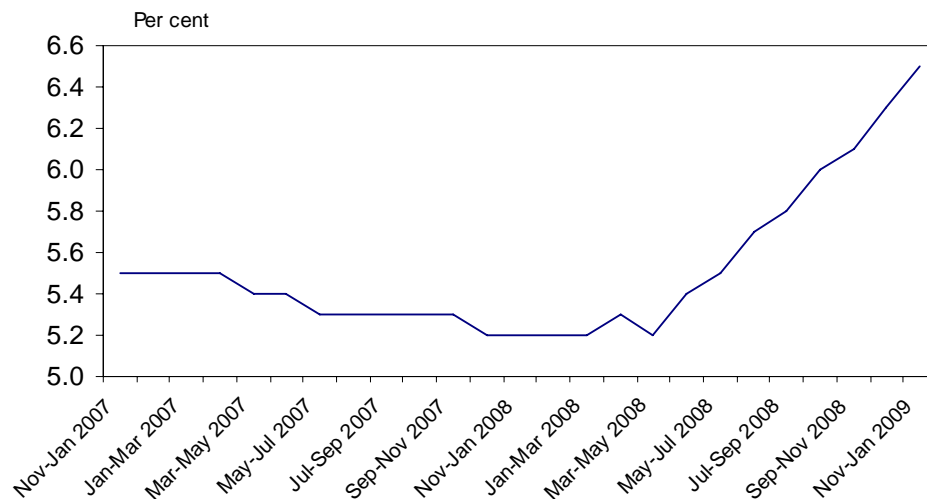
B.18 This slowdown reflects a combination of factors: a number of important lenders leaving the market (e.g. the mortgage banks Bradford & Bingley and Northern Rock; a reduction in lending by major UK banks and fewer foreign lenders providing new finance to UK companies than a year ago). Those lenders responsible for providing funds to riskier individuals and companies may face particular problems.

B.19 Looking forward it is anticipated that lenders will continue to tighten/ration access to credit as negative expectations as to the cost and availability of funds set in and the economic outlook deteriorates.

Rising unemployment

B.20 As the financial crisis has spread through the economy, there has been a rise in the rate of unemployment. The Office of National Statistics reports that unemployment rose by 0.5 per cent to 6.5 per cent in the three months to January 2009 compared to the previous quarter. The number of unemployed people reached 2 million over the same period.¹⁸

Figure 2: Unemployment Rate, 2008



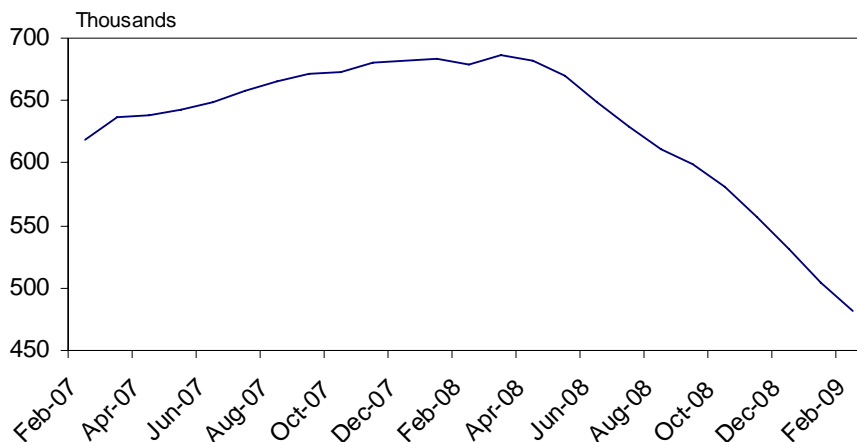
Source: Labour Force Survey, seasonally adjusted, ONS

B.24 At the same time the number of vacancies is also currently sharply in decline. According to the Office of National Statistics' Vacancy Survey, there were 482,000 job vacancies in the three months to February 2009, down

¹⁸ Labour Force Survey, First Release: March 2009, Office of National Statistics, www.statistics.gov.uk/pdfdir/lmsuk0309.pdf

74,000 over the previous quarter and 203,000 over the year. The February 2009 figure represented the lowest figure since 2001.¹⁹

Figure 3: Total vacancies, February 2007 to February 2009²⁰



Source: ONS Vacancy Survey, seasonally adjusted, ONS

Loss of confidence in the system

- B.21 More generally consumers may start to lose confidence in the financial services sector. High profile failures within the banking system, (such as the Icelandic banks), recent media coverage of investment fraud, and poor experience of financial products could lead many consumers to disengage from financial services.
- B.22 There is already some evidence to show consumers are experiencing lower confidence in the retail banking system. A recent survey by the ABI showed almost half (49 per cent) of all respondents thought that the

¹⁹Labour Force Survey, First Release: March 2009, Office of National Statistics, www.statistics.gov.uk/pdfdir/lmsuk0309.pdf

²⁰ The table shows the average number of vacancies in the three month ending in the month shown.

risk of losing their savings had increased compared with a year ago. But, this was down on the previous three months suggesting that government initiatives to restore confidence in financial markets, for example increasing the level of depositors' guarantees, are having a positive effect.²¹

Impact on consumers

- B.23 Many consumers will find that they are in unanticipated difficulties with significant debts to service at a time of rising unemployment – an increase in the level of 'distressed consumers'. Furthermore the attempts by banks to shrink their balance sheets in pursuit of stability are likely to lead to credit rationing and increased costs of servicing debts.
- B.24 Rising unemployment may also mean that consumers are less able to save and may have to draw on savings in the absence of regular income.
- B.25 Particular consumer group, (for example consumers on low fixed incomes, such as pensioners) may also increasingly find themselves in difficulties. This may be because pensions and other savings/investment payouts may be reduced due to reduced returns from falling equities, asset prices and annuity rates.

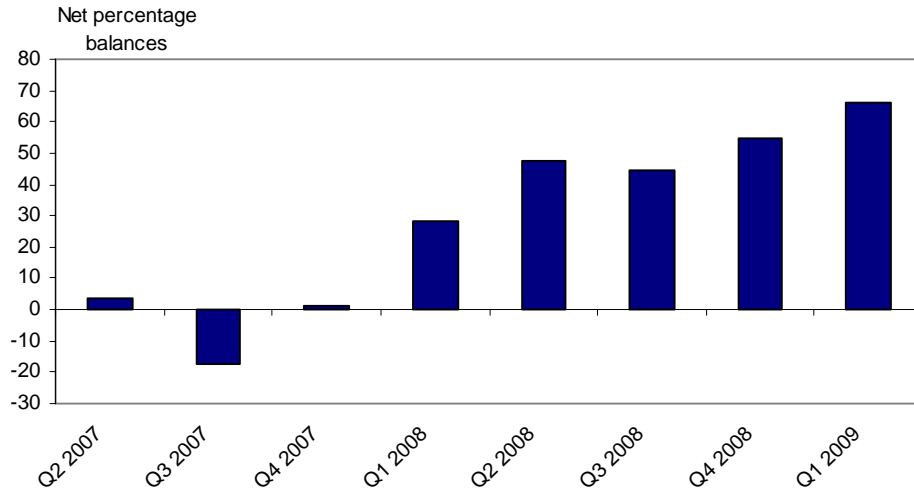
Rise in distressed consumers

- B.26 The result of a rise in the number of distressed consumers may be seen across a number of indicators.
- **Rising default rates on secured and unsecured loans** – The Bank of England's latest Credit Conditions Survey already shows there has been an increase in default rates on secured lending to households and small businesses as well as an increase in the average losses

21 See Q4 2008 ABI Savings and Protection survey
www.abi.org.uk/BookShop/ResearchReports/20090115%20Q4%202008%20Savings%20and%20Protection%20quarterly%20survey%20Research%20Brief.pdf

made on these defaults. The chart below shows default rates has been growing consistently since 2008.

Figure 4: Default Rates on Secured Lending to Households^{22,23}



Source: Credit Conditions Survey, Bank of England

- Rising mortgage arrears and repossessions** - Statistics from the Council of Mortgage Lenders show a sharp rise in mortgage arrears and repossessions on 2007. Around 10,400 properties were repossessed by first charge mortgage lenders in the fourth quarter of 2008, up from 6,900 levels the previous year. In addition, around 1.57 per cent of total mortgage holders in the UK have accumulated arrears equivalent to 2.5 per cent or more of the outstanding balance in 2008. This compares with 1.08 per cent in 2007.
- A rise in the number of scams and other schemes whose primary intention will be to target distressed consumers.** For example, the

²² The net percentage balance is a weighted response of lenders. A positive balance implies increasing defaults.

²³ The values for Q1 2009 are based on Banks' expectations for the following three months reported in the 2008 Q4 survey.

OFT recently warned 11 financial management businesses with 'look alike' websites posing as official or charity advice sites to close them down immediately, and is warning consumers to take care when searching for debt advice online.

Changing consumer behaviour

- B.27 The financial crisis may also change consumers' behaviour. Prior to the crisis, competition in financial services took place on parameters such as price, rates offered, product range, quality and brand. Consumers may now place greater weight on factors such as security and soundness of financial institution.
- B.28 Customer behaviour based on these parameters may result in reinforcing the existing status-quo and reduced opportunities for small innovative players to enter the market.
- B.29 Consumer preferences may also change with regard to the type of products they seek. Consumers may move away from long-term savings and investment products in favour of shorter-term, more liquid, products. As the FSA notes in its Financial Risk Outlook 2009, while prioritising liquid options may be a rational response to financial uncertainty, there is a risk of embedding behaviours that are difficult to reverse when more stable conditions return. This could have significant implications on the economy's long-term rate of growth with less funds available to channel into new investment projects and innovation as well as an impact on individuals' retirement plans.

Impact on businesses

- B.30 Businesses are likely to find themselves in increasing difficulties as tightening credit conditions and lower consumer demand feed through into their finances.
- B.31 The slowdown in demand has led to an increase in the number of trading partners failing to make payments in time and/or settle their debts. This failure to make payments has spread throughout the economy increasing

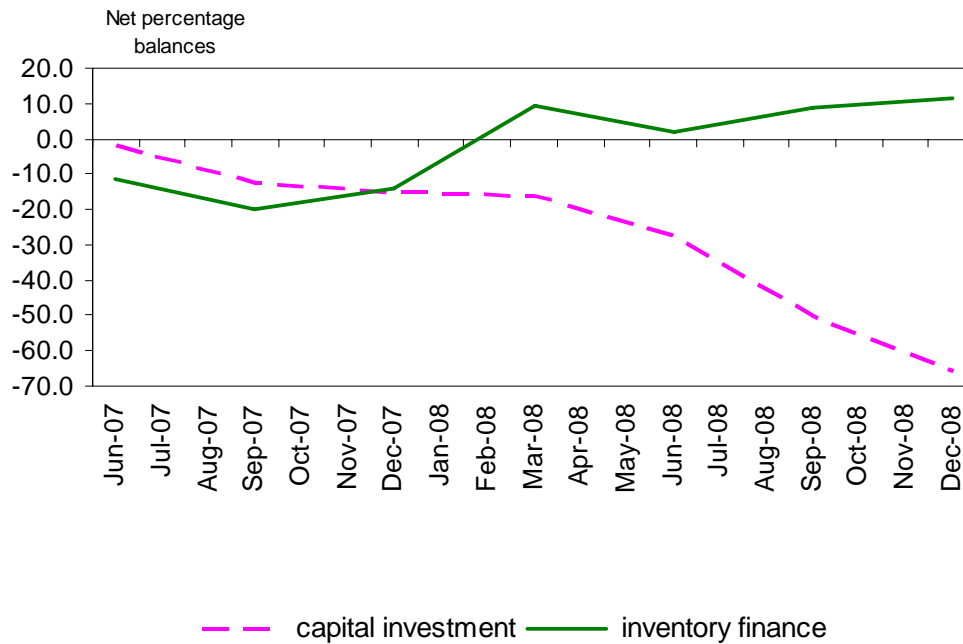
the risk that other business will also fail. Trade credit insurance aims to cover against risks of non payment, due to insolvency, and protracted default of buyers. According to the ABI, trade credit insurance claims by businesses in the Q3 2008 rose sharply on the previous year. The total number of claims in Q3 was 6,085, up 35 per cent on the previous year.²⁴

- B.32 The shortage of credit and changing risk-profile of businesses have caused many trade credit insurers to scale back on available credit insurance limits and/or increase cost, leaving many businesses particularly SME's exposed.
- B.33 Another implication of the shortage of credit has been on the nature of the funds businesses are demanding. Evidence from the Bank of England's Credit Conditions Survey shows that net demand for loans to fund new capital projects, merger and acquisition activity and/or purchase of commercial real estate has declined steadily since 2007. On the other hand, net demand for funds to cover businesses working capital, such as inventory finance or for balance sheet restructuring has increased. It is anticipated that this trend will continue in the immediate future.²⁵

²⁴ Association of British Insurers,
www.abi.org.uk/Members/circulars/viewAttachment.asp?EID=21280&DID=16960

²⁵ For further details on lending to PNFC please see Consumer Credit Survey, Bank of England
www.bankofengland.co.uk/publications/other/monetary/creditconditionssurvey090102.pdf

Figure 5: Change in Demand for Corporate Lending by Purpose, June 2007 to December 2008



Source: Credit Condition Survey, Bank of England

B.34 Finally, the shortage of credit is likely to manifest itself in a rise in the number of company liquidations and insolvencies. This in turn may increase the number of businesses seeking debt management solutions. According to the Insolvency Service there were 4,607 company liquidations in Q4 of 2008, up 51 per cent from the same period a year ago. Additionally, there were 2,428 other corporate insolvencies in Q4 2008. This figure has more than doubled since the same quarter last year. It is anticipated that this rising trend in company liquidations and insolvencies will continue in the future.

Impact on businesses within the financial services sector

B.35 The financial crisis is likely to have a particular impact on businesses operating within the financial services sector. FSA Financial Risk Outlook 2009 sets out the possible impacts on a range of businesses in the financial services sector. These can be summarised as:

- **Banks and building societies:** will be vulnerable to further shocks and will need to focus their strategy on medium-term survival rather than on short-term profitability. Business models will need to be realigned to focus on sustainability and be underpinned by strong risk management. Much of the banks changing of business models will be in part driven, at least in part, by the changing regulatory landscape and agreements made with government as part of the nationalisation and part-nationalisation of some of these institutions. Looking further towards the future banks will also need to be in a position to cope with the eventual withdrawal of public support.
- **Life insurers:** will face increased risk from falling asset prices, lower consumer confidence, falls in individuals' disposable income, as well as implications from other wider structural developments, such as, the introduction of automatic enrolment into an occupational scheme in 2012 which could contribute to consumers delaying decisions over retirement savings. Life insurers are expected to face increasing difficulties in acquiring new business and will need to ensure they have sufficient capital reserves until markets recover.
- **General insurers:** like life insurers they will face increased operational risks and will need to be prepared for these.
- **Retail intermediaries:** their business models may be placed under stress and so may need to be adapted. Agents will also need to ensure the quality of advice given is suitable in a time of turbulence.
- **Asset management:** businesses involved in asset management will need to be careful that essential functions are not compromised in any efficiency drives. Firms will need to have adequate controls to control for risk and stress.

C THE OFT'S CURRENT WORK

	Choice	Competition	Fairness	Responsibility
Personal Current Account Market study	✓	✓	✓	
Investigation into unarranged overdraft charges	✓		✓	✓
Contributing to the implementation of payment protection insurance remedies	✓	✓	✓	✓
Northern Rock Report		✓		
Payments Council review		✓		
Christmas Savings Schemes	✓			
MasterCard/Visa		✓		
Irresponsible lending	✓		✓	✓
2 nd Charge lending			✓	✓
Charging orders			✓	✓
Claims management			✓	✓

D CONSULTATION CRITERIA

Public bodies are required to perform consultations in accordance with the following criteria wherever possible:

- D.1 **When to consult** – formal consultation should take place at a stage when there is scope to influence the policy outcome.
- D.2 **Duration of consultation exercises** – consultations should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
- D.3 **Clarity of scope and impact** – consultation documents should be clear⁴ about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
- D.4 **Accessibility of consultation exercises** – consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
- D.5 **The burden of consultation** – keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
- D.6 **Responsiveness of consultation exercises** – consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
- D.7 **Capacity to consult** – officials running consultations should seek guidance in how to run effective consultation exercises and share what they have learned from the experience.
- D.8 The full *Code of Practice on Consultation* can be found on the website of the Department for Business, Enterprise and Regulatory Reform:
www.berr.gov.uk/files/file47158.pdf

E LIST OF CONSULTEES

The following organisations and individuals have been consulted. We would welcome suggestions of others who may wish to be involved in this consultation process.

Advertising Standards Authority

Advice NI

Advice UK

Age Concern

Association of British Insurers

Association of Independent Financial Advisors

Association of Finance Brokers

Association of Payment and Clearing Services

Banking Code Standards Board

British Bankers Association

British Retail Consortium

Citizens Advice

Citizens Advice Scotland

Citizens Advice Wales

Confederation of British Industry

Consumer Credit Counselling Service

Consumer Credit Trade Association

Consumer Focus Scotland

Consumer Focus Wales

Consumer Focus Post (NI)

Council of Mortgage Lenders

Department for Business, Enterprise & Regulatory Reform

Department of Enterprise Trade and Investment (NI)

Federation of Small Businesses

Finance and Leasing Association

Finance Industry Standards Association

Financial Ombudsman Service

Financial Services Authority

Financial Services Consumer Panel

General Consumers Council for NI

Goldman Sachs

Her Majesty's Treasury

HSBC

Institute of Credit Management

Local Authority CORS

Money Advice Liaison Group

Money Advice Scotland

NI Association of Citizens Advice Bureaux

Payplan

Trading Standards Institute

Which?