Financial services regulation – proposals for change.

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This note summarises the proposals put forward in two documents published in July 2009, that address the issue of reforms to the regulation of the financial services sector post credit crunch. Other relevant Library standard notes include:

European responses to the financial crisis SN/BT/5099

Also of interest will be the Treasury Committee's review of much of the same ground in: The Banking crisis: regulation and supervision.

Contents

1 Introduction

Two documents were published in July 2009 that addressed the issue of reforms needed for the financial services sector in the light of the financial crisis between 2007 and 2009. The first (chronologically) document is *A Better Deal for Consumers*, CM7669. This looked at a variety of consumer issues of which finance, in particular consumer credit, was just one. This note will only look at the consumer finance section.

The second document is *Reforming Financial Markets*, CM 7667. This is the more major of the two documents and looks at the whole structure of the financial sector and considers issues such as systemic regulation and the macro-prudential control and regulation of the banking sector. It follows publication of the Turner Review – *A regulatory response to the global banking crisis*- published by the Financial Services Authority (FSA) in March 2009. A separate Library standard note summarised the findings of that report.[1] The same note looked at EU and US proposals produced at around the same time (March – June 2009).

It might be noted that when first announced, *Reforming Financial Markets* was to have been a White Paper published at the time of the March Budget. Delay in publication enabled it to incorporate ideas in 'Turner' and of other bodies. It is also now far more typical of a Green Paper since there is much in the paper that calls for consultation and responses, or is dependent upon reviews yet to be established or to report. Since it is the wider ranging of the two reports it is dealt with first.

2 Reforming Financial Markets (RFM)

2.1 Overview

At 170 pages, RFM is a substantial document. But despite this, it is less full of firm proposals than one might imagine given both the delay in publication and the seriousness of the situation it addressed. The first quarter of the document is an analysis of the causes of the crisis and an account of the Government's response to it. Much of the remainder reflects the fact that the scope for independent national action is limited. This is because either the subject matter is not within the compass of independent national determination, for example bank capital controls; because there is an upcoming European legislative initiative to wait for or action is dependent upon it passing; or because the Government has chosen to extend consultation by establishing review groups to look at specific issues. For the convenience of readers, the RFM collates Primary Legislation Proposals in Annex A. The document is split into four main themes:

> first, strengthening the UK's regulatory institutional framework, so that it is better equipped to deal with the issues raised by globally interconnected markets and firms;
>
> second, dealing with high impact firms that may be seen as being "too big to fail", through improved market discipline; and through improved supervisory focus on such firms;
>
> third, identifying and managing systemic risk as it arises across different financial markets and over time; and

1 Proposals to reform financial regulation, SN/BT/5100 (Note now withdrawn)

fourth, working closely with international partners to deliver the global action required to respond to the lessons of the financial crisis.[2]

2.2 Strengthening regulatory institutions

The central proposal under this heading is the replacement of the standing committee of the Bank, the FSA and the Treasury with a Council for Financial Stability (CFS). The conduct of the existing committee, the tripartite authorities and the Memorandum of Understanding (MoU) under which they operate has been examined closely post-crisis. The original MoU was published in October 1997 alongside the *1997 Bank of England Bill*. A version of it was reproduced in the *Bank of England Quarterly Bulletin* for May 1998. It was amended in 2006 and can be found on the Bank's website here. The key part of MoU is the division of responsibilities between each party. Of particular interest after the crisis has been the allocation of duties between the Bank and the FSA with questions being asked as to the appropriateness of the allocation of duties and the extent to which there has been 'underlapping' between them, thus leaving 'holes' in the regulatory net. The current allocation is:

The Bank's responsibilities

2. The Bank contributes to the maintenance of the stability of the financial system as a whole – one of its two core purposes. This involves:

i. ensuring the stability of the monetary system as part of its monetary policy functions. It acts in the markets to deal with fluctuations in liquidity;

ii. overseeing financial system infrastructure systemically significant to the UK, in particular payments systems whether based in the UK or abroad. As the bankers' bank, the Bank stands at the heart of the payments system. It falls to the Bank to advise the Chancellor, and answer for its advice, on any major problem arising in these systems. The Bank is also closely involved in developing and improving the infrastructure and strengthening the system to help reduce systemic risk;

iii. maintaining a broad overview of the system as a whole. The Bank is uniquely placed to do this, being responsible for monetary stability and having representation on the FSA Board (through the Deputy Governor (financial stability)). Through its involvement in markets and payments systems it may be the first to spot potential problems. The Bank advises on the implications for UK financial stability of developments in the domestic and international markets and payments systems and assesses the impact on monetary conditions of events in the financial sector;

iv. undertaking, in exceptional circumstances, official financial operations, in accordance with the arrangements in paragraphs 13 and 14 of this Memorandum, in order to limit the risk of problems in or affecting particular institutions spreading to other parts of the financial system.

The FSA's responsibilities

3. The FSA's powers and responsibilities are set out in the Financial Services and Markets Act 2000. Within the scope of the Act, it is responsible for:

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[2] Reforming Financial Regulation, CM 7667 p45

i. the authorisation and prudential supervision of banks, building societies, investment firms, insurance companies and brokers, credit unions and friendly societies;

ii. the supervision of financial markets, securities listings and of clearing and settlement systems;

iii. the conduct of operations in response to problem cases affecting firms, markets and clearing and settlements systems within its responsibilities, where:

a) the nature of the operations has been agreed according to the provisions of paragraphs 13 and 14 of this Memorandum; and

b) the operations do not fall within the ambit of the Bank defined in paragraph 2 above. (Such operations by the FSA may include, but would not be restricted to, the changing of capital or other regulatory requirements and the facilitation of a market solution involving, for example, an introduction of new capital into a troubled firm by one or more third parties.)

iv. regulatory policy in these areas, including that intended to promote the resilience to operational disruption of authorised firms and Recognised Bodies. The FSA advises on the regulatory implications for authorised firms and Recognised Bodies of developments in domestic and international markets and of initiatives, both domestic and international, such as EC directives.

The objective of the new CFS is "to analyse and examine emerging risks to the financial stability of the UK economy"[3] Clearly there are areas of similarity and difference between the new CFS and the old MoU, some of these are shown in the table below.

	Council for Financial Stability	**Tri-partite system**
Constitution	Established by forthcoming statute	Non-statutory.
Membership	Will be chaired by Chancellor; possible participation by external members from other bodies allied to Bank, FSA and Treasury.	Membership limited to tripaprtite members; normally chaired at official level.
Advice	Access to Bank's *Financial Stability Report* & FSA's *Financial Risk Outlook.*	Access to Bank's *Financial Stability Report* & FSA's *Financial Risk Outlook.*
Transparency	Minutes will be published but "a significant proportion..will not be suitable for publication".	No minutes published.
Accountability	Annual Report describing CFS activities to be presented to Parliament.	No report.
External policy work	CFS will "discuss and coordinate UK authorities' position on EU and international financial stability and regulatory policy issues.	Currently Treasury responsibility.

Source: CM 7667, p49

As well as looking at the joint structure the document also examined the individual bodies with a view to proposing new legislation.

[3] CM7667 p48

Legislative proposals

Bank of England

With respect to the Bank no further changes are deemed necessary beyond those already introduced by the *Banking Act 2009.*[4]

Financial Services Authority (FSA)

The legislative base for the FSA is the *Financial Services and Markets Act 2000* (FSMA). Changes are proposed for the FSA the main ones being:

> The Government therefore intends to legislate to provide the FSA with an explicit financial stability objective, which will help to clarify that the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic risks.[5]

And

> the Government intends to legislate to create an explicit duty for the FSA to have regard to the need to work internationally.[6]

Beyond noting the 'increased international focus' of regulation, the paper does not elaborate on how this role will interact with government's traditional role of participating at inter governmental such as at the EU.

The Government intends to amend FSMA to:

- extend the rulemaking powers of the FSA, beyond making rules just for consumer protection;
- give the FSA more discretionary power to amend rules on a case by case basis;
- to extend its disciplinary and enforcement powers; and
- amend existing powers to ban 'short selling' such that a ban does not have to be triggered by market abuse considerations.

Significant as these changes may prove to be on the really big regulatory issues the FSA is expected to work with, capital adequacy rules and liquidity requirements, the fact that these are set internationally means that there can be no meaningful proposals promised in the RFM. Similarly, but for different reasons (independence) the RFM can make only supportive noises regarding the FSA's fundamental review of its own supervisory practices, exposed so obviously with its failure over Northern Rock. Thus, answers to questions about what the new rules should be and how they should be enforced are largely outside of the scope of the Paper. The Paper does however, helpfully, bring together the main recommendations of the Turner Review which are currently being taken forward in discussion in the Basel committee and elsewhere.[7] The Government 'agrees' or 'welcomes' all of the Turner recommendations.

Consultations

The document lists various issues on which the Government wish to consult before proposing change:

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4 See Library Paper on Banking Bill 2008; RP 08/77 for details.

5 CM 7667 p51

6 Ibid p52

7 Ibid pp58-59

- allow the Financial Services Compensation Scheme (FSCS) to act as an agent for overseas regulators in effecting compensation payments;
- requiring the FSCS to contribute to the cost of the Special Resolution Regime dealing with failed financial institutions;
- introducing pre-funding for FSCS resources from deposit taking institutions; and
- a review of the governance of the FSCS;

2.3 Systemically significant firms

Often referred to as firms that are 'too big to fail' systemically important firms are those which, if they failed, would have important negative implications for other firms in the financial services sector or for financial stability in the wider economy. There has been much criticism of the emergence of such institutions. They are seen as reaping (internalising) the rewards of their size in the good times, but impose significant externalities, in terms of public sector costs when they fail. The Government's strategy is multi-faceted; how to stop them failing in the first place – tighter market and internal regulation or governance; stricter external regulation – by the FSA; and better procedures if they do fail.

Internal regulation and governance

This strand is largely being taken forward by the *Walker Review of corporate governance* published 16 July 2009. At 142 pages this is another substantial Report. According to the publication press release issued by the Treasury the main proposals contained within in it are:

> Specific proposals include:
>
> - Board level risk committees chaired by a non-executive
> - Risk committees to have power to scrutinise and if necessary block big transactions
> - More power for remuneration committees to scrutinise firm-wide pay
> - Remuneration committee to oversee pay of high-paid executives not on the board
> - Significant deferred element in bonus schemes for all high-paid executives
> - Increased public disclosure about pay of high-paid executives
> - Chairman of remuneration committee to face re-election if report gets less than 75% approval
> - Non-executives to spend up to 50% more time on the job
> - Non-executives to face tougher scrutiny under FSA authorisation process
> - Chairman of board to face annual re-election
> - Financial Reporting Council to sponsor institutional shareholder code
> - FSA to monitor conformity and disclosure by fund managers
> - Institutional shareholders to agree MOU on collective action

In tandem with Walker is a new Code of Practice on director remuneration published by the FSA in February 2009 and which will be added to its Rulebook by November 2009.

Increased capital requirements

The Government propose that systemically significant firms should hold more capital to reflect the "potential cost as well as the likelihood of failure".[8] In simple terms, a firm double the size of two others will be required to hold more than twice their capital. Examples of Switzerland and the United States of America which have both proposed similar rules are listed, but no indicative UK proposals are included preferring instead to wait upon "international coordination".

Reducing the impact of failure

The Government expect that the Banking Act 2009 reforms, which introduced a new resolution procedure, elements of which are being adopted in the United States of America, will provide a better, more secure way of dealing with failed institutions. The limited use the new Act has been put to so far, would suggest that this is true. Beyond that though, the proposals are undefined. The Government has a broad commitment to:

> work with the FSA and the Bank of England to ensure that all banks are adequately prepared and organised internally for their own resolution. These resolution plans should be proportionate to the size and complexity of the bank in question, and should include an assessment of how difficult it will be to resolve. The Government believes that the quality of a bank's resolution plan should have a direct bearing on the FSA's overall assessment of the prudential risks borne by the firm, including, if necessary, by feeding into regulatory capital and / or liquidity requirements.[9][10]

And:

> 5.23 The Government will work with the FSA and the Bank of England, as well as international partners, to develop a framework for identification and stronger regulation of systemically significant institutions and produce findings by the end of this year, with conclusions on the appropriate institutional arrangements for implementing this framework to follow.

The Government has, however, come down firmly against the idea of separating deposit banks from investment banks – a form of control and regulation that was a central feature of the only recently repealed American Glass Steagall Act of 1933. The Government give five reasons for not adopting limits on absolute size or a separation of activities on banks.

It would not automatically reduce the likelihood of failure

Banks of all sizes have suffered during the crisis. Some non-bank institutions have failed (AIG). Separation would not prevent systemic risk passing between like institutions. Bank losses have arisen out of all activities as a result of poor governance.

No reduction in costs of failure

Liquidity risks and counterparty risks would not be reduced. The RFM quotes the example of the failure of Lehman Brothers although, most commentators have noted that whatever other problems this failure caused, and there were plenty, counterparty failure was almost completely absent.

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8 Ibid p71

9 Ibid p72

10 In the press this has been described as firms having to write their own 'will'.

There are advantages in having big banks
Risk diversion, international business coverage encourages cross border trade and capital flows.

Define big.
Fixing an absolute maximum size would necessarily be an arbitrary exercise. Although, it could be argued, imposing additional capital controls on systemically important firms, involves a similar choice to be made about who is and who is not important.

International co-operation
A Glass-Steagall approach would need to be applied across all countries to be effective. The document does not say how it worked, or didn't, when it only applied in the United States of America.

2.4 Managing systemic risk

After capital and liquidity issues, systemic risk to the financial system is the biggest problem to emerge from the credit crisis. The issues that have dominated discussions amongst academics, officials and politicians include the security of complex financial instruments; the location and measurement of risk; the linkages between different parts of the system and ways to implement some sort of macro-economic control (macro-prudential as it has been called) control of financial activity and innovation.

Most of the reforms being discussed require international co-operation and consultation; hence, this section of the document is rather longer on tracking those consultations than presenting a firm list of UK specific legislative proposals.

Consultations

- Through the FSA, explore improved accounting standards and treatment of loan loss provisioning and valuation standards.

- Government encouragement of industry attempts to improve valuation standards and transparency of securitised assets.

- In consultation with the EU, progress the Capital Requirements directive which would restrict the use of off balance sheet securitisation. The Basel Committee and International Accounting Standards Board are also involved in aspects of the treatment of securitisations activity.

- With the EU and international bodies working to improve the workings of the derivatives markets.

- "The Government is working closely with the FSA and the Bank and in international fora to develop" new regulatory tools such as

  > regulatory rules-based powers including: leverage ratios; reducing the pro-cyclicality of regulatory and accounting standards; requirements to encourage the build up of buffers of capital in times of economic expansion; and mechanisms to improve banks' access to capital markets in the event of an economic or financial downturn;
  >
  > and

discretionary powers: including more effective official communication and varying regulatory settings in response to the build up of risks in the financial system.[11]

- With the FSA consideration of high loan to value mortgages and their desirability.

The Government has given some guide to its current thinking on several of these issues. It supports

- The idea of an overall leverage ratio;
- Counter-cyclical capital 'buffers' built up in expansionary times; and

> "international work to develop regulatory mechanisms to mitigate pro-cyclicality should focus to a greater extent on preventing the build-up of imbalances through excessive leverage and asset price growth".[12]

Legislation and internal policy developments

Aside from those areas the Government has necessarily left to international consensus, this chapter also sketches the outlines of how the Government thinks that the new system will operate (with whatever rules emerge internationally). In one section, 'discretionary tools to lean against credit cycles', it appears to envisage a very flexible and even informal manner of control and regulation centred upon the new Council for Financial Stability (CFS). In a section that sounds faintly reminiscent of the 'Governor's eyebrows' the document says of the CFS:

> The new Council for Financial Stability […], with its minuted discussions encouraging public debate and scrutiny of the risks highlighted and the authorities' response to them, which should in turn influence market participants' behaviour.[13]

As the document says in the very next section "the challenge, of course, will be to find a way to make these warnings credible". Indeed.

The only other (part) commitment to legislative change in this section of the Paper is that envisaged to strengthen the FSA's "system-wide focus":

> reviewing and amending the FSA's objectives and the principles of good regulation to clarify that:
>
> o the FSA's regulatory and supervisory approach should include an enhanced focus on monitoring, assessing and mitigating systemic risks; and
>
> o the FSA's regulatory decisions should take into account the wider economic costs of financial instability in addition to the immediate impact on market confidence and the direct costs to consumers of financial services.
>
> • enhancing and extending the FSA's enforcement powers to ensure that it has the ability to:
>
> o take action to address systemic risk and protect financial stability;
>
> o sanction firms or individuals that are guilty of misconduct; and

11 Ibid p85
12 Ibid p87
13 Ibid p89

○ take emergency action to place restrictions on, and to require disclosure of, short-selling.[14]

These changes would be effected by amending FSMA, but are subject to consultation at this stage.

2.5 Consumer protection

There is a large section in the Report dealing with individual and retail finance issues. This is in addition to the larger consumer issues Report published a few days previously mentioned in the introduction to this note.

There are four strands to the improvement of consumer protection:

- measures to raise financial capability;
- improving access to simple, transparent products;
- enabling consumers to take group or representative action to obtain collective redress in the case of widespread complaints; and
- improving the arrangements for depositor protection.

Financial Capability

Efforts to improve financial capability have a long history. They are part of the financial exclusion agenda which itself was just one of several expressions of 'exclusion', which were the focus of the work of the Social Exclusion Unit set up in December 1997 to drive forward the Government's work on tackling social exclusion. It worked on a topic by topic basis, looking at intractable problems and those which involve different Government departments. The scope and scale of the problem of financial exclusion was set out in a report published by a Treasury Policy Action Team in November 1999.[15] Another Library Standard Note covers the development of this policy.[16] Few of the RFM initiatives are new, although they have never before been seen as a way of resolving the global financial crisis.

What does appear to be new is the promise of legislation to amend FSMA to require the FSA to "establish an independent consumer education and information authority". Currently the FSA has a limited consumer advice function effected mainly through its Moneymadeclear website. According to the RFM the authority will "take the strategic lead on consumer education and information provision relating to personal finance"

Simpler, more transparent products

As the RFM states, the Government has, since 1998 been trying to introduce simpler financial products, first through the CAT standards and then with the idea of 'stakeholder' products. Neither initiative has had a major impact on financial service provision largely because of poor take-up. Although a consultation process is promised, the Government's current preference appears to be for a compulsory:

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14 Ibid p82

15 Treasury Policy Action Team 14, *Financial Inclusion*, p 1, November 1999

16 *Financial Exclusion* SN/BT/3197

> "traffic-light" system which has been introduced into food labelling. While financial services and food are clearly very different classes of consumer products, there may be important lessons to be learned from food labelling for improving the transparency of financial products[17]

Included in this section of the Report are a number of consultation questions that do not necessarily fit well with the transparency agenda but which are important consumer issues nonetheless.

Mortgage regulation: in the current state of the market some lenders might sell on their mortgage books which could reduce protection for borrowers. The Government will consult on this.

Second charge lending: this relates to consumer loans (not mortgages) secured on the borrowers property. Difficulties in meeting a relatively small loan could result in repossession proceedings. The Government will review the case for transferring regulation of second-charge mortgages to the FSA.

Buy to let lending: this is currently unregulated by the FSA; the Government is reconsidering this position.

Collective consumer redress

Ongoing is an internal review amongst the FSA, the Financial Ombudsman and the Office of Fair Trading of the "wider implications" process. This process looks at issues that either affect a large number of similar consumers, the financial integrity of a large business, common industry practices or where there is genuine doubt over an FSA rule or legislation. When it applies, all the relevant regulators consult and possibly with industry and consumer representatives too, before coming to some agreed position. The Government is keen to encourage greater use of this process at an earlier stage and wants the system to be more transparent.

Collective legal actions are another way in which multiple claims for redress can be dealt with. According to a Report by the Civil Justice Council, current court procedures cannot keep pace with the growth of such claims.[18] The Council made a series of recommendations which at the time of publication of the RFM document the Government had not responded to. A subsequent Ministry of Justice press release included the following response:

> The government is grateful to the Civil Justice Council for carrying out this review, and welcomes the report and its analysis, identifying where further work or reforms are needed and setting out the case for change. Following detailed consideration the government has concluded that collective actions would be best taken forward on a sector by sector basis and that the creation of a generic right of action would not be appropriate.[19]

The Government's full response can be found here.

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[17] *Reforming Financial Markets*, p107

[18] Improving Justice Through Collective Actions, CLJ p34

[19] Ministry of Justice press release 20 July 2009

2.6 Competition and choice in financial markets

The final strand of the Reforming Financial Markets (RFM) document is the role of competition and effective choice in financial markets. This has four strands:

> given the importance of regulation in creating barriers to entry, it is essential to ensure that market access is firmly embedded into decisions about financial rule-making, including through the work of the OFT, the FSA and the EU, and that these and other institutions work together closely;
>
> • supporting competition and choice through diversity, most importantly through maintaining a strong mutually-owned financial sector, by:
>
> o ensuring that its regulatory and legislative framework is modernised;
>
> o supporting better governance; and
>
> o considering the sectors needs for capital and funding;
>
> • Government action where markets cannot provide solutions, such as supporting innovation – through the Innovation Fund – and social investment; and
>
> • ensuring an orderly exit from the various interventions, in the UK and internationally, making clear that the Government intends to sell the equity stakes that it has invested in UK banks.

Competition

The RFM starts from the position that the banking market is uncompetitive. Evidence for this is the low rate of account changeover by individuals and structural barriers to entry of new banks, for example the costs in establishing a trusted brand or branch network. It then lists initiatives and studies by the OFT (mainly) that are looking at aspects of structure or firm behaviour that might improve competitive pressures. These include improved ease of switching accounts; personal, portable, bank account numbers (the number stays with you not the bank); and increased transparency of tariffs. It then mentions some technological developments that might improve consumer accessibility to accounts and make switching easier. One is the use of mobile phone banking which might help people who do have a mobile phone but who don't currently have a bank account.

An example of this is given with reference to a system used in Kenya that allows money to be transferred by mobile phone for people who don't have a bank account, or indeed where there may be no banks. It says "This could offer opportunities for new entrants and could increase financial inclusion".[20] It does not mention that this system involves the intermediation of a network of agents to whom one must physically travel and with whom one must deposit cash balances before the telephonic transfer can take place. In fact such a transfer system is available already in the UK, using banks to make telegraphic transfers.

Another part of the Report looks at the impact of the wave of consolidation occasioned by the financial crisis. This includes:

- the major merger between Lloyds Bank and Halifax Bank of Scotland;
- Alliance & Leicester and Bradford & Bingley banks becoming part of the Santander Group;

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[20] *Reforming Financial Markets*; p123

- the Yorkshire Building Society taking over the Barnsley Building Society;
- the merger of the Co-operative Bank with the Britannia Building Society; and
- the Nationwide Building Society absorbed the Derbyshire, Cheshire and Dunfermline Building Societies.

Added to this must be the decline of the Northern Rock Bank which has a cap on market activity as the price for EU approval of state support. According to the RFM, despite this concentration in supply and the disappearance from the market of a range of other, often foreign lenders:

> While in normal circumstances a concentration in supply could be expected to feed directly into a diminution in competition, the other factors at play, and in particular consumer inertia, mean that the position is slightly more complicated. While there has undoubtedly been some decline in competitive pressure as a consequence of the consolidation driven by the financial crisis it is certainly not clear that there are now insufficient suppliers to provide effective competition in the UK banking market.[21]

It is not clear how this conclusion fits with what appears to be the basic premise of this chapter in the RFM that banking isn't competitive in many aspects.

The other new and potentially significant, proposal in this chapter is the Government's commitment:

> To support the growth of the social investment market, the Government is launching a consultation in the coming weeks on the design and functions for a Social Investment Wholesale Bank, and will report back with substantive proposals.[22]

There is an interesting link here between this proposal and when the subject of a social investment fund was last discussed, namely during proceedings of the *Dormant Bank & Building Society Accounts Bill*.[23] Part of that Bill, now Act, allocated sums for expenditure in England between three causes, young people, financial capability and "a social investment wholesaler". During Committee the minister, Ian Pearson, was asked to indicate which of these three causes had priority. He replied:

> I confirm that we regard youth provision as a priority. Financial inclusion and financial capability are rightfully areas in which the Big Lottery Fund could make a significant difference. We clearly put it on the record in the other place and on Second Reading that, if resources permit, we would consider funding for a social investment wholesaler. That remains our position.[24]

Similarly in Grand Committee the minister, Lord Davies of Oldham talked about the 'top two priorities' (young people and financial capability) and "the third concept (the Investment Bank) in the clause is dependent on resources being available".[25]

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[21] *Reforming Financial Markets* p124
[22] *Reforming Financial Markets* p133
[23] Bill80 of 2007-08
[24] PBC 15 October 2008 c75
[25] HL Deb 15 January 2009 c494

3 A Better Deal for Consumers (BDC)

The second document with a bearing on financial reform is *A Better Deal for Consumers*.[26] This document includes a range of consumer issues, only one aspect of which is finance.

The finance section of BDC starts with an explicit recognition of the central dilemma over regulation of consumer finance – "We recognise that any move to strengthen regulation and reduce the risk of over-indebtedness carries the risk of making credit more expensive and less readily available". This is a key constraint.

There has been considerable critical comment about the cost of credit in the 'sub-prime' market, often by people who don't ever use it. Seldom, however, is the point raised that attempts to control it, or to make it cheaper, could simply lead to its withdrawal to the obvious detriment of the millions of people who do rely on it.

The Government appears to be particularly concerned about the use of credit and store cards. BDC trailed a complete review of credit card practices.[27]

The Government has already indicated, during the second reading of the Lending (Regulation) Bill, that it intends to ban unsolicited credit card cheques from being sent to card holders.[28] The promised consultation document was issued in October 2008 by the Business Innovation & Skills Department.[29] The key proposals contained in it were:

> **Changing the rules that set out the order in which debts built up on a credit card are paid off**
>
> Most credit card companies make customers pay the cheapest debt off first.
>
> This is a particular problem for consumers who withdraw cash on their card, typically charged at 25 per cent APR or more. They are often the most likely to be vulnerable to financial difficulties. The Government is considering rules that would mean the most expensive debt is paid off first.
>
> **Raising the minimum monthly repayments levels to encourage people to pay off their debt faster.**
>
> Around one third of people who don't pay off their credit card bill in full each month make only the minimum repayment. This can mean consumers take decades to pay off the debt. The Government is considering the introduction of a mandatory higher minimum payment each month.
>
> **Banning the practice of increasing credit limits without prior consent**
>
> It is common practice for credit and store card lenders to increase credit limits without consent. According to recent research by Uswitch 5.7 million consumers saw their credit limits changed in this way in the last year. The Government is considering banning this practice or requiring consumers to opt-in to credit limit increases.
>
> **Placing restrictions on increasing the interest rate on existing debt**
>
> The Government is concerned about interest rates being increased without proper explanation. Consumers using their cards responsibly and making payments on time

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26 *A Better Deal for Consumers*; CM7669

27 *A Better Deal for Consumers* p35-36

28 HC Deb 27 February c553

29 *Review of the Regulation of credit and store cards*

should not pay the price for excessive risk-taking by financial institutions. The Government is considering banning or restricting the re-pricing of existing debt[30]

With respect to high-cost lending, the Government has indicated that the main work will be taken forward by the Office of Fair Trading (OFT) in its study into consumer credit which has as a focus the sub-prime lending market.[31] This review started in July 2009 with initial results expected by the end of the year.[32] The Government did however, indicate that it did not support one reform often canvassed by critics of high cost lending, namely an interest rate cap:

> Some people would like to see a cap on the level of interest which can legally be charged on these types of credit. When we have previously considered the case for this, we have concluded that caps could be detrimental to consumers, resulting in lenders withdrawing products or substituting the reduced interest with higher charges on late payment or default. Higher-risk consumers could be denied access to legitimate sources of credit and have no option but to resort to illegal, unlicensed lenders, exposing them to much higher borrowing costs and potentially violent methods for obtaining repayment. The OFT review will, among other things, look at the experience of other countries including those that have introduced interest rate caps.[33]

It may be worth remembering that this will be the second review of the sub prime market in five years. In 2004 the OFT referred the home credit market to the Competition Commission. This resulted in a Report[34] published in April 2006 which recommended the following remedies:

- Greater data sharing by the big lenders;
- Publication by lenders of price information on a wider range of their loans;
- The provision of more frequent and more informative statements of loans to customers;
- A fairer deal on early settlement rebates[35]

With respect to high-cost lending, the Government has indicated that the main work will be taken forward by the Office of Fair Trading (OFT) in its study into consumer credit which has as a focus the sub-prime lending market. This review started in July 2009 with initial results expected by the end of the year. It did however, indicate that one reform often canvassed by critics of high cost lending, namely an interest rate cap, was not supported by Government.

Another strand of reform is to improve responsible lending. BDC states that:

> Individual lenders have also tended to base their lending decisions on whether they are likely to be paid back, rather than on whether the consumer can really afford the credit that is on offer.[36]

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30 BIS press release 27 October 2009
31 OFT press release 7 April 2009
32 See subsequent OFT Release refining terms of reference July 2009
33 CM7669 p37
34 Competition Commission Home Credit enquiry
35 Competition Commission Home Credit enquiry; chapter 9.
36 *A Better Deal for Consumers* p39

The fineness of the distinction is indicative of the delicate balance that all proposals have to tread if they are not to have 'unintended consequences'. Specific proposals thus far include:

> New requirements on consumer credit providers adequately to explain their products to consumers, including the consequences of any failure to repay. The requirement to provide a consumer with an adequate explanation of their credit product is one of the major provisions of the EU Consumer Credit Directive (CCD). We want to see consumer credit providers face up to their responsibilities to explain products properly even if it means a change in the way some lending takes place, particularly for in-store credit. We will publish draft regulations implementing this provision later in the summer.
>
> New requirements on all consumer credit providers to check consumers' creditworthiness. This is another central provision of the CCD and draft regulations implementing this provision will also be published later in the summer. We want to see all consumer credit providers checking consumers' creditworthiness before lending.
>
> New guidance on what constitutes irresponsible lending to be issued by the OFT. The requirement not to lend irresponsibly is a cornerstone of the reforms introduced by the Consumer Credit Act 2006. The new guidance will apply to all steps in the transaction process from advertising and marketing through to the handling of arrears and default. The OFT will consult on draft guidance this summer with a view to issuing final guidance early in 2010.[37]
>
> Lending irresponsibly contrary to the provisions of section 25(2B) of the Consumer Credit Act 1974, by failing to take reasonable care in making loans or advancing lines of credit, including making only limited or no enquiries about consumers' income before offering loans, and failing to take full account of the interests of consumers in doing so.[38]

37 *A Better Deal for Consumers* p40

38 OFT Consumer credit licensing, general guidance, January 2008