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HOWARD DAVIES

Financial Regulation & Consumer Protection

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In May 1997 I was unexpectedly asked by the incoming Labour government to set up an integrated financial regulator in London, which came to be known as the Financial Services Authority. Although I had had responsibility within the Bank of England for banking supervision, among other things, for about 18 months, I could hardly be said to have been an expert in financial regulation at the time. And the task of merging nine different regulatory bodies, employing over 2000 staff, into one new entity was a daunting one. I quickly looked around the world for examples of similar structures, and models to follow.

The only models available were to the North and East of London, in Scandinavia. The first of them, of course, the grandfather of integrated regulation, was Kredittilsynet in Oslo. So my team and I looked hard at what had been done in Norway and subsequently Sweden and Denmark, as we planned our new structure. While the FSA cannot be said to be exactly a copy of the Norwegian financial regulator, I shall always be grateful for the lessons we learned from the Norwegian experience. Also, throughout my time at the FSA, the most valuable international meetings I attended were those of the integrated regulators around the world, a select but growing group. One of those meetings was held in Oslo, and I have particularly good memories of the discussions and the hospitality extended then.

I am therefore pleased to be able to help celebrate the 20th anniversary of Kredittilsynet with these reflections on consumer protection and financial regulation.

As I have already suggested, the British reform of financial regulation was in a number of respects more fundamental and dramatic than those which had occurred before it in

Scandinavian countries. It involved a complete rewrite of the legislation underpinning financial sector activity. The previous Banking, Insurance and Securities Acts were all repealed and replaced with a single Financial Services and Markets Act based on a functional approach to financial activity. It also involved the merging of nine regulatory bodies, some statutory and entirely based in the public sector, such as the Securities & Investments Board or the Building Societies Commission, and others which were essentially self-regulatory organisations (SROs). The self-regulators were largely engaged in 'conduct of business', regulation, while the public sector regulators were largely focused on prudential issues. All of these were integrated into a single body which was formally launched in 1998. All the regulatory staff were transferred along with the functions.

At the same time, five different ombudsmen organisations – another example of Scandinavian influence in the UK – were similarly merged into one large organisation, which itself employed more than 400 staff. The new Financial Ombudsman Service was a kind of wholly owned subsidiary of the FSA, with the FSA appointing its Board and approving its rulebook.

These features of the reform meant that it was essential to find a way of integrating consumer protection concerns with the more traditional tasks of prudential regulators. For some, this was a traumatic change. The previous Governor of the Bank of England, now Lord George, once memorably remarked that consumer protection was "not the natural habitat of the central banker".

But is there a genuine conflict between the objectives of the prudential regulator and the conduct of business regulator? Some certainly argue that there is. The case rests on the proposition that, in some circumstances, a regulator focused on consumer protection may require a bank to make reimbursement, or offer more generous terms and conditions to depositors, in a way in which might damage its capital base and prudential soundness. Similarly, in the case of insurance companies, conduct of business regulators of the life insurance market may be inclined to press for larger payouts for consumers than can in the long run be afforded by insurance companies, once again with potentially damaging consequences for their prudential soundness. Influenced by these and related arguments, the British regulatory system until 1997 put the prudential regulation of life insurance companies in a section of the Department of Trade and Industry, while the conduct of business regulation was handled by the Personal Investments Authority, an SRO.

I do not accept on this argument, for two main reasons. First, if there is in practice a conflict between the two types of regulation, then that conflict has to be resolved in some way. Under the previous British regime there was indeed a provision whereby the prudential regulator of insurance companies could overrule the conduct of business regulators in certain circumstances. But I cannot see that it is necessarily better for this conflict to be resolved between two bodies, with different statutory responsibilities, than within one regulator which is able to balance the potentially conflicting dictates of consumer protection and prudential soundness.

This balancing act is not straightforward, as I learnt to my cost. There were occasions during my 10 years Chairman of the FSA when it was necessary to strike a balance, in very difficult

circumstances. The most difficult case related to what are known as endowment mortgages. Many mortgage borrowers in the UK take out investment policies which are due to pay off the principal after 25 years, while making only interest payments on the loan itself. The stockmarket crash of 2001 meant that many of these policies were then unlikely to pay out the required amount. Investors then argued that they had been 'mis-sold'. Some were certainly due compensation. But a very rigorous approach to compensating individual borrowers who had taken out life insurance policies to cover mortgages, could have resulted in huge payouts by life insurance companies, on a scale which could have threatened their prudential soundness. It was necessary to strike a balance in the interests of all the policy holders of insurance companies, and not just a particular subset of policy holders.

Furthermore, I believe that the theoretical conflict is significantly overstated by those who argue for keeping the two forms of regulation separate. After all, the ultimate purpose of setting prudential standards for banks and insurers is to make them reasonably safe homes for deposits or for long term savings. Prudential regulation does not seek to achieve some higher good, unrelated to the interests of customers of financial institutions. So, properly understood, the objectives of the two forms of regulation are quite compatible. And the FSA has not in practice found itself riven with internal conflicts.

But how did we organise the new authority to allow it to carry out these two parallel roles?

The first important point to make relates to the structure of the new legislation itself. Under the Financial Services and Markets Act 2000 the FSA is given four statutory objectives. The first would be found in most financial regulators, in one form or another. It is to maintain confidence in the UK's financial markets. The fourth was to reduce financial crime, designed to cover the authority's powers in the areas of money laundering and insider dealing in particular. Objectives two and three, which need to be read alongside each other, cover the consumer protection responsibilities. They are to protect consumers of financial services, and to promote public understanding of the financial system. The consumer protection objective itself is accompanied by a caveat, to the effect that the authority should bear in mind that consumers are responsible for informing themselves about the risks involved in financial decisions. So there is a caveat emptor qualification at the heart of the legislation.

The way these objectives are drafted, and their appearance in parallel in the statute, points towards a regime with a strong informational content. It points towards an approach which is based on ensuring that consumers are given clear information about the terms of the financial products and services they "buy" and the risks inherent in those transactions.

Unfortunately, it is very clear that most consumers find it difficult to understand the fine print, or even the headlines of the information they are given, and find it hard to understand the concept of financial risk. A quite recent FSA study, for example, showed that if asked whether they thought an index tracking investment fund was subject to stock market risk, 60% of investors thought it was not. So requiring firms to provide clear information is not enough, unless consumers are also properly educated to understand that information, and that is a long term project. As a result, the UK regime includes a number of requirements on firms themselves, if they are giving financial advice in particular, to inform themselves about the consumer's financial position and to meet suitability requirements. In other words, firms can

be disciplined if they sell products which they know to be unsuitable for the financial circumstances of the consumer, even if that consumer is him or herself prepared to take on the risks involved.

So the regime involves a balance of information requirements, together with obligations placed on firms. Those who are interested in the detail can spend many happy hours interacting with the FSA's rather voluminous rule book!

The next question we needed to resolve, after the legislation and the overall character of the regime we wished to introduce, was the way in which the authority should be structured to deliver these objectives. Our first conclusion was that we ought to establish an FSA consumer panel, made up of consumer representatives, to advise the authority of consumer protection issues. This model was "borrowed" from the old Personal Investments Authority which had introduced such a panel a couple of years before its demise with, we thought, some positive consequences. But the FSA's consumer panel was much broader in scope, looking across the whole financial sector and not simply at the sale of long term insurance policies. (In the end, the requirement to have a consumer panel was put into the legislation, but that happened after the FSA had itself set up the panel on the non-statutory basis). The consumer panel sits alongside a practitioner panel, and both are formally required to be consulted in relation to any new regulatory initiative.

But there is an important difference between the two: the arrangements are deliberately asymmetrical. The practitioner panel is organised by the financial firms themselves, which also provide some support for it. The consumer panel has always been staffed and funded by the FSA itself, on the grounds that consumer groups in the financial services sector were not staffed and structured in a way which allowed them to respond effectively to the consultation exercises which the authority was required to conduct, on a particularly intensive frequency as the new legislation was implemented. Financial market practitioners accepted this asymmetry, for which they could see a reasonable argument. The panel has, I believe, established itself as an important part of the regulatory landscape, and has moved from being largely responsive in nature, to being a body which carries out research and analysis of its own in a way which influences the development of the regulatory regime.

The consumer panel is, if you like, half inside and half outside the FSA. Within the authority itself we introduced a Consumer Director. The first holder of that position was Christine Farnish, who is now the Director General of the National Association of Pension Funds. The second was Anna Bradley, who had previously been the Director of the National Consumer Council. One way of thinking about the role of the Director of Consumer affairs in the authority was that she (while I was Chairman it was always she) acted as a kind of conscience of the authority. The Consumer Director was entitled to be involved in all policy making and sat as a member of the main Executive Committee of the FSA. Her staff were consulted on new regulatory requirements in all areas. But the Consumer Directorate had other important roles as well.

We also made the ambitious decision that the FSA should provide 'direct to consumer' information. The authority now publishes a wide range of fact sheets on different financial products, which attempt to explain in clear language what those products are for, who should

consider using them, and how the benefits and risks should be assessed. There is a very comprehensive website with a wide range of frequently asked questions and answers on all types of financial transactions. There are self-help calculators, allowing people to determine the amounts they should save to reach particular outcomes in terms of pension provision or mortgage protection. And there is a very extensive set of comparative tables of different financial products and services, with the terms and conditions, interest rates or payouts listed in an easy to compare format. The financial industry itself was at the outset very nervous about introduction of these comparative tables, as indeed where some members of the board of the authority. But they have become a very useful source of information both for consumers themselves and for financial market intermediaries.

We also decided that we had to make a start on improving financial literacy, which was a particular problem in the United Kingdom. There is some evidence that UK consumers are, on average, significantly less financially literate than those in Australia, for example, which is in other respects a rather comparable country. Initially, the financial sector was very reluctant to see the FSA move in this direction. The first response from the practitioner panel to suggestions that a proportion of the fee income provided by financial firms (all of the FSA's income comes directly from the financial sector itself) should be spent on financial education and what is now called developing financial capability was hostile. A couple of years later, when members of the panel began to see more clearly that there was a trade off between investment in financial capability on the one hand, and lightening of the burden of direct regulation on the other, practitioner representatives became more sympathetic to investment in this activity.

The establishment of the FSA also coincided with some changes in the school curriculum. Survey evidence suggested that young people in Britain wanted to know more about how to manage their finances. Indeed surveys showed that they attached a higher priority to financial literacy than to sex education or information about drugs. The Government considered but rejected the idea of making the promotion of financial literacy an explicit and specific requirement on Schools, but did agree that financial literacy should be part of the 'citizenship' element of the National Curriculum, which all schools in the UK are obliged to deliver. At the FSA we therefore set out to provide curriculum materials which could be used by schools. (As a related exercise, the Chancellor of the Exchequer asked me to carry out a review, on a personal basis, of enterprise education in British schools which revealed that UK teenagers were in principle enthusiastic about business creation, but felt that they did not have the basic tools in terms of financial understanding to give them the confidence to start up their own businesses).

Three sets of curriculum materials were devised in the early years. One of them was a very basic tool for use in primary schools: "Mega Money" based on large cardboard coins and a variety of games. For the early teenage years there was a somewhat more sophisticated package and for 15 to 18 year olds a more complex set of materials called "Making the Most of it", which tried to generate interest in that age group by linking financial concepts to subjects which are of more consuming interests to teenagers. For example, insurance concepts where built around some material on HIV and AIDS. Was it reasonable for insurance companies to use genetic testing to determine whether they would accept people

for health insurance? That is an ethical issue which teenagers are keen to debate, but which also introduces them to the understanding of what insurance projects are trying to achieve. I believe that all of this work hung together quite well, and was integrated into a coherent strategy. But there is no doubt that the time scales attached to the different strands of work were very different. A requirement on firms in relation to suitability could be imposed more or less overnight. New information could be provided to consumers quite quickly, too. But the process of building financial capability in the population as a whole, beginning in schools, is an investment where the payback period is measured in decades. It is also fair to say that the FSA's own work, in the early years, was perhaps not as well integrated with the efforts of others in this area as it might be. So my successors have built a more comprehensive financial capability framework, with a steering group involving people from the industry, other consumer groups and charitable organisations with an involvement in the area, to produce a more comprehensive national approach to building financial capability. Once again, those with a particular interest can find this material on the FSA's website.

Finally, we needed to decide how far to pull the different factors of supervision together.

Initially, we had separate teams handling the prudential and conduct of business work. Then, as an experiment, we brought the two strands together in the case of a small number of the largest firms – which were supervised by a group of staff with complementary skills. This turned out to work well, so the FSA has gradually implemented 'one–stop' supervision for more and more firms. Staff found it possible, and indeed more interesting, to handle both types of work.

Combining the two has the benefit of emphasising the ultimate purpose of prudential supervision, and ensuring that it does not become a rarefied activity, remote from the real world. Being involved in consumer related issues improve the quality of work done by institutional supervisors. It is often the case that firms who treat their customers badly are poor managers of other parts of their business as well. So supervisors with an integrated view of the institutions in their care will often be more effective all round. And it means that the financial supervisor has a higher and very different profile than it would otherwise have. That brings some challenges in its wake. The press coverage associated with the FSA increased on a log scale for the first five years of its existence, as people came to understand the significance of its policies and actions for individuals. There were times when I regarded this as very much a mixed blessing, especially when I sat in Parliament being harangued by MPs inviting me to comment on individual cases affecting their constituents. But, on balance, it made for a more interesting life, and caused one to feel, on occasion, that one was able to make a real difference to the financial circumstances of ordinary people. That is, ultimately, very rewarding.

So in spite of the difficulties, and the long time scales involved, I am personally entirely unrepentant about the decisions to integrate consumer regulation into a single authority alongside prudential supervision.