

## **Response to the Eleventh Report of the Treasury Committee, 2014-15 Conduct and Competition in SME Lending June 2015**

### **Introduction**

- 1.1 The Financial Conduct Authority (FCA) welcomes the Treasury Committee's Report on Conduct and Competition in SME Lending (the Report) which makes a number of recommendations relating to small businesses and their interaction with financial services.
- 1.2 The Report makes several recommendations which relate specifically to the FCA. We have set out in this document our initial response to these recommendations, and we describe our next steps towards implementation, where appropriate.
- 1.3 We recognise the importance of transparency and accountability not only to Parliament and the Treasury but to the wider public, particularly regarding some of the issues raised in the Report. We expect to continue our discussions on these matters with the Committee over the coming Parliament.

### **Mis-selling of Interest-Rate Hedging Products: Sophistication test**

- 2.1 In 2012 we identified failings in the way that some banks sold interest-rate hedging products (IRHPs). The banks agreed to review their sales of IRHPs to unsophisticated customers since 2001. Following a pilot phase, the full review started in May 2013 and over 17,000 businesses have now been through the review process.
- 2.2 The IRHP review was designed to ensure the banks reviewed the sales of IRHPs to those smaller businesses that were less likely to have understood the risks associated with IRHPs or to have had resources enough to access independent, expert advice. To determine which customers would fall into this category, known as 'non-sophisticated customers', and to enable redress, where appropriate, to be provided quickly, a set of eligibility criteria were determined between the FCA and the banks.

2.3 The Report expresses specific concern about one of the criteria used in the main review: the £10 million cap on the aggregate notional value of IRHPs held by a customer. The Committee requests that the FCA **'should write to the Committee to explain its decision-making on this cap. This explanation must state whether, in its view, it represented a concession to bank lobbying, and if not, why not' (Paragraph 99).**

2.4 The £10 million cap criterion was introduced following the 2012 Pilot Study, in which the banks identified several shortcomings in objectively determining customers' sophistication solely by valuing their assets, for example:

- Customers with large assets were incorrectly automatically regarded as sophisticated. For example, schools which often owned valuable land and buildings, or farmers who owned valuable land and machinery.
- Customers who had arranged their companies in complex structures which resulted in them having limited assets (e.g. special purpose vehicles used by property companies; subsidiaries of larger groups) were incorrectly automatically regarded as non-sophisticated.

2.5 The use of financial thresholds as a proxy for financial sophistication is widely accepted in both UK and EU financial regulation. There are a number of reasons why using the notional value of IRHPs as a proxy for financial sophistication is logical:

- Customers entering into transactions of such size are more likely to understand the financial ramifications of such a decision.
- Customers entering into these large transactions are more likely to have access to the resources necessary to obtain expert advice before purchasing the product and, where appropriate, to bring legal proceedings for mis-selling on their own behalf.

2.6 The £10 million cap formed only part of the revised criteria. To understand the proper impact of the cap it is necessary to look at the criteria as a whole. By way of example, under the original sophistication test, a customer who satisfied the Balance Sheet Threshold and Employee Threshold would have been considered sophisticated and therefore excluded from the scheme<sup>1</sup>. Under the amended sophistication test, the same customer would now be considered non-sophisticated and included in the scheme,

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<sup>1</sup> The Balance Sheet Threshold, Employee Threshold and Turnover Threshold are based on definitions set out in the Companies Act 2006: the Turnover Threshold is a turnover of more than £6.5 million; the Balance Sheet Threshold is a balance sheet total of more than £3.26 million; and the Employee Threshold is more than 50 employees.

provided they met the £10 million cap part of the test. The amendments to the criteria, of which the £10 million cap was one, resulted in some customers being excluded from the scheme; however, it also meant other customers were included when previously they would not have been.

- 2.7 This criterion has been tested in the courts. In 2013, in dismissing an application for Judicial Review against the FCA regarding the sophisticated customer criteria, the Administrative Court concluded that we were entitled to specify a financial threshold, in particular the £10 million cap, to identify those “who lacked or were perceived to lack sophisticated financial knowledge”.
- 2.8 The introduction of the £10 million cap does not represent a “concession to bank lobbying”, as the Committee suggests. The cap was one of a number of criteria used in creating a test to identify priority customers, in order to deliver redress quickly and deliver an appropriate level of customer protection. The level of the cap was based on analysis of bank customer data, with a clear objective of addressing the shortcomings identified during the Pilot Study.
- 2.9 The scheme does not prevent any customer deemed sophisticated, and therefore ineligible for the review, from complaining to the banks in accordance with the banks’ usual complaint procedures, or from pursuing action through the courts. Since the beginning of the scheme, approximately 300 such customers have complained outside of the review.

### **Performance of the IRHP Review**

- 3.1 The FCA believes that the IRHP review process has delivered its objective of providing fair and reasonable redress to the vast majority of customers as quickly as possible, and so far £1.9 billion has been paid in redress.
- 3.2 All nine banks have now completed their sales reviews and have delivered redress letters to the vast majority of these customers. The banks have sent 17,000 redress determinations to customers – 14,000 of these include a cash redress offer, and 3,000 confirm that the IRHP sale complied with our rules or that the customer suffered no loss.
- 3.3 To date, over 12,000 customers have accepted their redress offer. This means that, so far, 88% of offers have been accepted. For those banks who sent their letters out very early, the acceptance rates are above 90%.

- 3.4 The Report notes however, that despite good outcomes for many, there have been complaints that the process has fallen short in achieving its objective. The Report recommends that **'the FCA should collect the information necessary to establish whether there are systemic failures in the review and publish its findings, a summary of the complaints it has examined, and take any action that might be appropriate to ensure that all customers receive fair and reasonable redress' (Paragraph 115).**
- 3.5 We agree with the Committee that it would be of serious concern if there proved to be systemic failures in the review, and if customers were not receiving fair and reasonable redress. While we are confident this is not the case, we nonetheless recognise the potential merit in conducting a review of how the redress scheme has been operating.
- 3.6 It is important that we do not prejudice the completion of the remaining cases within the scheme as designed, and any review of complaints should not delay the receipt by the outstanding claimants of their redress on a timely basis. It should reassure the Committee to note that we consider every case that is brought to us. We are not in a position to determine the amount of redress that should be paid to individual customers, as to do this would require us carry out a detailed assessment of all the available evidence (which for each case can amount to several hundred documents). However, in every instance where a case raises concerns which may indicate wider problems with the banks' approach to the review, we have followed up with the banks and independent reviewers. The feedback we receive from customers is an important part of the way we ensure the banks and independent reviewers are following the correct processes within the scheme.
- 3.7 There are also ongoing legal challenges which relate to the scheme. This includes a judicial review, *R (on the application of Holmcroft Properties Ltd) v KPMG LLP*, in which the FCA is an Interested Party. The case is considering whether an independent reviewer, who the banks were required to appoint under section 166 FSMA, is performing a public function and therefore amenable to judicial review, and if so whether they complied with public law duties they are claimed to have owed to the customer. Permission to seek judicial review has been granted and the case will proceed to a full substantive hearing in due course. Two further claims against independent reviewers have been issued.
- 3.8 We consider it would therefore be sensible to make any decision about the nature or extent of any review, including its oversight arrangements, after legal proceedings have

concluded, as the outcome of these may impact its scope. We will keep this position under review as the legal challenges develop. The Committee's expressed concern about the scheme will be a key factor in our considerations.

### **RBS Global Restructuring Group**

- 4.1 In November 2013, we announced that the FCA would commission a skilled person to review the allegations raised by the Tomlinson Report about the treatment of SMEs by the Royal Bank of Scotland's Global Restructuring Group (RBS GRG).
- 4.2 The timeline for the delivery of the report has changed due to the complex nature of the review and the seriousness of the allegations. We intend to publish the outcomes of the review once the skilled person has reported.

### **Access to the Financial Ombudsman Service**

- 5.1 The mis-selling of IRHPs raised the question of whether access to the Financial Ombudsman Service (FOS) should be extended to a larger share of the SME population, as the relative lack of sophistication within many small businesses poses a risk of mis-selling, and yet many businesses may face challenges taking firms to court and are ineligible to complain to the FOS.
- 5.2 The Parliamentary Commission on Banking Standards (PCBS) recommended that the FCA should consult on options for widening access to the FOS for small businesses. We agreed with the Commission that it may be useful to broaden access to the FOS more generally and at the time proposed to consult on the issue. The Report reiterates this recommendation, suggesting that **'the FCA consultation on the scope of the FOS, prompted by the PCBS, should also consider how this gap in coverage can be closed, and, as a matter of urgency, report to Parliament their conclusions' (Paragraph 174).**
- 5.3 This summer we will publish a discussion paper which reviews the level of protection and redress SMEs can expect from the FCA's regime, as users of financial services. The paper is the first stage of seeking views on the issue of widening the jurisdiction of the FOS. The paper also considers the protections afforded to SMEs by Rules throughout our Handbook and by our Principles.
- 5.4 This is a complex subject, and one on which there is little evidence readily available. In light of this and the range of information we are requesting, we will be extending our

usual consultation period and are allowing a substantial period for responses. We intend to provide feedback on the responses received later this year, and will then consult on any changes to our Rules.

## **The FCA's competition objective**

- 6.1 One of the FCA's three operational objectives is to promote effective competition in the interests of consumers. The Committee recommends that **'the FCA must continue to transform its regulatory approach in order to fulfil this objective. It is essential that the FCA's approach to meeting this new objective is not siloed within an individual department of the regulator, but instead permeates through the entire culture and approach of the organisation'** (Paragraph 250).
- 6.2 In December 2014, we announced a new strategy for the FCA, with more emphasis on sector and market-wide analysis, allowing us to look across regulated sectors and their products and identify issues that are common across firms and markets and consider appropriate remedies. Interventions at the market level mean we can respond comprehensively to issues and promote competition in the interests of consumers. The increased emphasis on markets and market dynamics will facilitate further embedding of competition across the FCA.
- 6.3 We agree with the Committee that it is essential that our approach to competition is not siloed. Competition is not limited to the use of tools by a single department, but is instead utilised across the organisation. We will continue to work to ensure that any competition intervention is informed by the intelligence gathered, and work conducted, across the FCA, and that any regulatory intervention is compliant with our competition duty. This approach is supported by our competition duty, which requires us to pursue our consumer protection and market integrity objectives in a manner that, as far as possible, promotes competition.
- 6.4 We have built a strong team of competition experts within the FCA's new Competition Division, with significant experience in competition authorities, concurrent regulators and private practice. Over the last two years we have moved from no staff employed to specialise in competition matters, to over 90 staff today. The Competition Division leads on market studies, works with colleagues in the Enforcement and Market Oversight Division on competition enforcement, and, importantly, provides competition advice and support to other departments.
- 6.5 We already have some examples of good practice. Our efforts to embed competition reflect that regulation can have more impact on new, innovative businesses than on

established players, who are more used to operating within regulation. In 2014, following consultation and engagement which identified a clear demand for support for innovators, we set up the Innovation Hub. The Innovation Hub provides direct support to those who qualify and identifies areas of the regulatory regime that need to adapt to foster useful innovation in financial services. Policy areas that need to be challenged to support innovation include improving access to bank accounts for innovators and tackling regulatory uncertainty. The Innovation Hub, which is not directly led by the Competition Division, is an example of competition thinking within a cross-FCA project led by Policy with colleagues from the Supervision and Authorisations and Enforcement and Market Oversight Divisions.

- 6.6 We also note the importance of other expertise on projects led by the Competition Division. As an example, the core team working on any market study will include people from other departments with the relevant sectoral expertise. The FCA teams involved in the joint CMA market study, and subsequent CMA investigation, on SME banking<sup>2</sup> are multi-disciplinary, with competition analysis being informed by and informing the work of a range of departments, including Authorisations, Policy and Supervision. As another example, the core team conducting the recently launched investment and corporate banking market study integrates staff from the Chief Economist's Department and Supervision, and will utilise the expertise of people working in wholesale banking supervision, wholesale conduct policy, enforcement, and across the Strategy and Competition Division.
- 6.7 We continue to look across the FCA to identify and address barriers to competition arising from the financial regulation regime. This includes reviewing the proportionality and unintended consequences of regulation, bearing in mind that the impact of regulation might evolve over time as the sector develops. Competition is factored into significant regulatory developments, and the Competition Division is represented on a number of key internal governance and decision-making committees, including the Divisional Supervisory Risk Committee and Policy Steering Committee. Decisions at Executive level on any significant regulatory initiative or development must be informed by an analysis of the implications of such decisions on competition in that market.
- 6.8 Whilst we have made significant progress towards more effective collaborative working where a competition issue has been identified, further work remains to be done. This includes better equipping the FCA to identify competition issues earlier. Seeking to address this issue, we are revising and extending the training that is offered to staff across the FCA, including competition training for frontline supervision staff, and through a network of 'competition champions'. We are also exploring and acting on

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<sup>2</sup> <https://www.fca.org.uk/news/market-studies/joint-fcacma-sme-banking-market-study>

opportunities to increase staff awareness and understanding of our competition mandate.

- 6.9 We are also changing our intelligence and data analysis processes to support our markets-led approach. Within the new Market Intelligence and Data Analysis Division, we are bringing together the intelligence that we collect across the organisation to form a common view of each of the markets and sectors that we regulate. Competition very much informs this work. The intelligence collected – from firms, consumers, market research and other sources – will form a rich picture of dynamics in the markets we regulate, and will inform prioritisation of our activity, including competition interventions.
- 6.10 It is important for the FCA to be aware of structural issues and seek to ensure that regulation mitigates or, at least, does not reinforce them. It is also crucial that we ensure that the behaviour of incumbents does not lead to barriers to entry or expansion. Alongside our work to reduce barriers to entry, with which the Committee is familiar, the FCA's new competition enforcement powers, exercised by competition, supervision and enforcement colleagues working together, will further contribute to the meeting of our competition objective.
- 6.11 There is also a role for regulatory bodies to ensure that consumers are able to take advantage of effective competition in the market. In this respect, the FCA has been active in understanding the dynamics of switching, including through specific projects such as the review of the Current Account Switching Service. We have also undertaken further work to ensure that the regulatory framework does not facilitate incumbents to take advantage of complex and/or unclear charging structures. The FCA's ongoing policy work on price comparison websites and other types of aggregators, which aims to empower consumers – in part through utilising their transactional data in a secure environment – also has a significant competition dimension.
- 6.12 We agree with the Committee that barriers to competition can and do arise as a result of the regulatory regime. We recognise that this is a substantial and ongoing challenge, especially given the multi-faceted nature of the regulatory regime. Whilst the FCA has made some progress towards making specific regulations more competition-friendly, we continue to work towards achieving our objectives as a regulator in a proportionate manner, one which does not impose unnecessary barriers to competition.

## **Competition concurrency and Annual Report on Competition**

- 7.1 The FCA is now a concurrent competition authority alongside the CMA, giving us additional powers to enforce competition law and make Market Investigation References to the CMA.
- 7.2 We acknowledge the challenges associated with an effective and efficient implementation of concurrency and the need to ensure that concurrency genuinely works in practice. We consider that the arrangements that are currently in place - which are based on statutory provisions supported and strengthened by a wide range of joint contacts and working initiatives - provide an appropriate framework for addressing these challenges.
- 7.3 The FCA's approach to its work is set out in the FCA's guidance on concurrency<sup>3</sup>. The processes outlined in the guidance document are informed by the statutory framework on competition interventions, as well as our existing practices under other legislation such as FSMA. These processes are, to a large degree, aligned with those used by the CMA and identify the stages at which interaction between both organisations will take place, thereby avoiding duplication or omissions in potential investigations. For example, we will discuss case allocation with the CMA to ensure that cases are taken forward by the authority best or better placed to do so. We expect the coordination between the FCA and the CMA to be, as has been the case with other concurrent regulators, both swift and substantial; we have entered into a memorandum of understanding with the CMA which sets out the framework for our cooperation.
- 7.4 If the FCA decides not to open a formal investigation into a matter under the Competition Act 1998 (the Competition Act) it is open to the CMA, or any other regulator with concurrent jurisdiction over the agreement or conduct in question, to do so, following consultation with the FCA. Similarly, if the FCA is to close an investigation, the CMA has the power to take over that investigation.
- 7.5 In relation to market studies, when deciding whether to launch a market study, under either FSMA or the Enterprise 2002 Act (the Enterprise Act), we will liaise with the CMA to avoid duplication, ensure a joined up approach and efficient use of resources. We will continue to engage while the market study is being conducted. Moreover, we may decide to work jointly with the CMA on a market study, as was the case with the recent SME Banking market study<sup>4</sup>.
- 7.6 The FCA is also a member of the UK Competition Network (UKCN), a partnership that aims to strengthen the collaborative working framework between the CMA and sector

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<sup>3</sup> <https://www.fca.org.uk/news/cp15-1-fca-competition-concurrency>

<sup>4</sup> <https://www.fca.org.uk/news/market-studies/joint-fcacma-sme-banking-market-study>

regulators. Through capability-building, advocacy and sharing of best practice, the UKCN aims to identify opportunities to use competition and regulatory powers to further the interests of consumers and ensure the consistent application of competition law in the UK.

- 7.7 The Report recommends that **'the FCA, with oversight from the CMA, produce an annual report on the implementation of its pro-competition activities' (Paragraph 251)**. An annual report on the FCA's competition work is already required by virtue of Section 25(4) of the Enterprise and Regulatory Reform Act 2013. This requires the CMA to publish an annual report containing its assessment of how the concurrency arrangements are operating. The 2015 Annual Report on Concurrency was published on 1 April<sup>5</sup>. This contains a separate section on the experience of each concurrent regulator, including the FCA, providing details of cases in progress as well as those closed during the year in question. The report also considers, more broadly, the overall operation of the concurrency regime and each regulator's contribution to the development of competition within its relevant sector.
- 7.8 We consider that a rigorous assessment of the FCA's activities along the lines envisaged by the Committee is already required in the context of the annual concurrency report. Further, now that the FCA has concurrent powers, future annual reports will cover more of the FCA's activities and will, consequently, be more comprehensive in nature. The Committee should note that the FCA is also required to report annually – in our Annual Report – on progress against each of our objectives, including our competition objective.
- 7.9 The FCA and the CMA recognise the crucial importance of effective concurrent working in contributing to the overall success of our respective pro-competition activities. We are therefore working together not only as formally required, but also by way of regular high-level contacts at Chairman and CEO level supported by a range of working level contacts, a programme of joint training, sharing of expertise and secondments.

## **Disclosure of confidential information**

- 8.1 Section 348 of the Financial Services and Markets Act (FSMA) 2000 imposes restrictions on the disclosure by the FCA of information which we receive in the course of carrying out our duties.
- 8.2 Section 348 has been the subject of criticism in the past, and in 2012, during the passage of the Financial Services Act, the Treasury initiated a review of Section 348.

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<sup>5</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/419636/Annual\\_report\\_on\\_concurrency\\_2014-15.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/419636/Annual_report_on_concurrency_2014-15.pdf)

The Joint Committee charged with pre-legislative scrutiny had expressed concern that Section 348 could 'impact on the information available to Parliament and the information available to firms and consumers'<sup>6</sup>.

- 8.3 The Treasury's review concluded that 'there are sound and justifiable policy reasons for the approach taken in Section 348 and associated provisions; making changes could have significant unintended consequences without necessarily delivering the benefits that consumer groups and other advocates of change are hoping for.'<sup>7</sup>
- 8.4 Our experience has found that the existence of a clear confidentiality restriction encourages the free flow of information to the regulator from the firms we regulate, and from third parties ranging from whistleblowers to overseas regulators. If there was uncertainty about information becoming public, our sources may be less willing to give it to us. However, we also appreciate that regulation should not unnecessarily restrict the disclosure of information, and we have taken steps to improve transparency.
- 8.5 The Report asks for the FCA to '**come forward with suggestions as to how these difficulties in disclosure could be prevented in the future (Paragraph 118)**'. The Report comments on the protracted discussions between the FCA and the Committee which eventually led to the publication of the voluntary agreements between the FCA and the banks, which form the basis of the IRHP Review. This was achieved with the consent of the banks; the independent Information Rights Tribunal had previously decided that the agreements could not be disclosed publicly because they were confidential under Section 348. Going forward we are minded to ensure, insofar as possible, that this type of agreement is made public at the start of the process. Our experience is that the confidentiality regime set up under FSMA is well understood by our stakeholders and is generally fit for purpose. Within this regime, the FCA must ask firms for their consent in each case where information is requested by the Committee. This was the approach we took with the IRHP agreements, although it resulted in significant delays to our disclosure and we recognise a continuation of this policy is unlikely to satisfy the Committee.
- 8.6 While we agree that this was an unfortunate situation, leading counsel has advised that there is no exception (often called a "gateway") in the relevant regulations through which we can disclose confidential information to Parliament, either for publication or for consideration privately by the Committee. Any remedy is therefore outside the FCA's control, and it would be in the hands of the Treasury to amend the regulations to create a gateway to enable us to do so.

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<sup>6</sup> Joint Committee report on the draft Financial Services Bill, December 2011

<sup>7</sup> <http://data.parliament.uk/DepositedPapers/Files/DEP2012-0817/document2012-05-21-143636.pdf>