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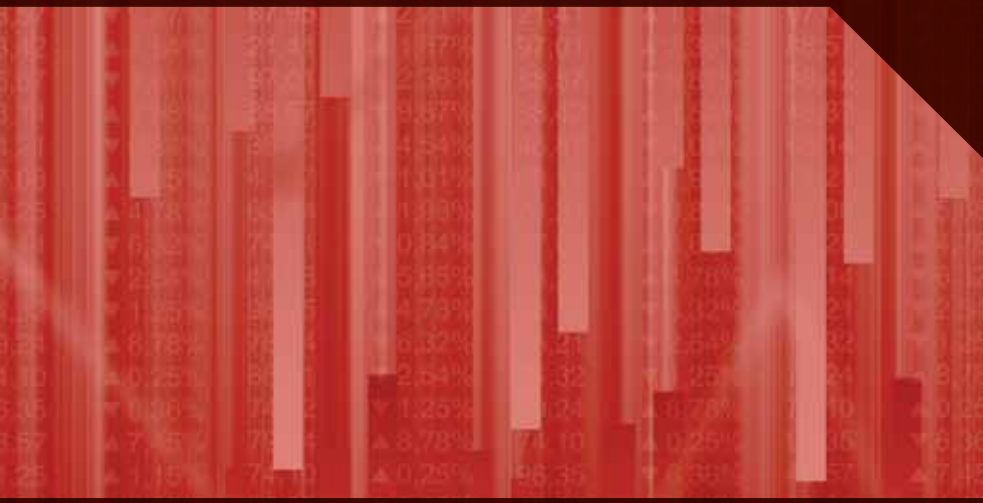
Social Market Foundation

A CONFIDENCE CRISIS?

Restoring trust in financial services



edited by John Springford

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THE SOCIAL MARKET FOUNDATION

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YouGov conducted the survey and focus group.

FOREWORD

Consumer trust is central to a competitive and properly functioning financial system, yet its fragility and complexity means it can take time to restore once dented. The recent financial and economic crisis has had a profound impact on many UK consumers, who are now looking for direction and even inspiration to restore their faith in financial services and provide them with products and services that genuinely enhance their lives.

Financial services are the lifeblood of the British economy so it is vital that the system operates to its full potential. With household consumption accounting for 70% of UK GDP, the growth of the economy is dependent upon people trusting and engaging with financial services. As policymakers begin to look more broadly at economic growth, it is therefore imperative that industry, government and consumers come together to find solutions to this conundrum. We are already seeing some established financial institutions responding to consumer demand to rebuild and strengthen their customer relationships, but an opportunity exists for new market entrants, including from non-traditional sectors, to strengthen relationships with customers and further build trust.

This important piece of research from the Social Market Foundation has started an essential conversation on how consumer trust in financial services might be rebuilt. Introducing 'simple products' may be one method of achieving this, but the industry should also adopt a more sophisticated approach that explores how innovation and new technologies can simplify the consumer experience and enhance their interaction with financial services. This in turn will enable the delivery of faster, safer and more convenient ways for consumers to handle their finances, independent of government intervention.

Consumer trust and strong economies run in tandem, which is why MasterCard has supported this important project to explore

how this link can be strengthened and encourages government to examine this issue in greater detail. MasterCard's business touches many participants in both the UK and global economy, something that we say places us at the 'Heart of Commerce'. On a daily basis we interact with stakeholders such as consumers, retailers, telecommunications companies, transit operators, local and national Government and of course financial institutions.

Consumers want a simple and clear interaction with financial services that have a positive impact on their everyday lives and the industry must continue to respond with innovative propositions that support this desire. MasterCard's role in the payments system enables us to not only offer unique insights into the everyday consumer spending habits of the British people but to help deliver the innovation and change that we believe can help to re-establish consumer trust and drive economic growth for the benefit of society.

Hany Fam,
President, UK and Ireland,
MasterCard

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Michael Skapinker is an assistant editor of the *Financial Times*, a columnist and the editor of the FT's special reports. He began his

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Jonathan Michie is Professor of Innovation & Knowledge Exchange at Oxford, where he is Director of the Department for Continuing Education and President of Kellogg College. From 2004 to 2008 Jonathan was Director of Birmingham Business School and a member of Council at the University of Birmingham, where he was Professor of Management; from 1997 to 2004 he held the Sainsbury Chair of Management at Birkbeck, University of London where he was Head of the School of Management & Organisational Psychology; and from 1992 to 1997 he was a University Lecturer in Accounting & Finance at the Judge Business School in Cambridge where he was also a Fellow & Director of Studies in Economics at Robinson College and a Research Associate of the ESRC Centre for Business Research.

SUMMARY

It is a cliché that the financial crisis has destroyed trust in the financial services industry. After government bailouts and continued banker bonuses, the recession and the deficit, and volatile interest rates, the relationship between government, citizens and the financial sector has broken down in a wave of blame and anger.

Surveys show the general public's trust in financial services is at a low. A recent University of Nottingham study found that public trust of the financial services sector is falling, two and a half years after the crisis.[1] A survey of American individual investors found that a majority believed that financial services institutions acted "in a greedy manner".[2] In March 2011, Bank of England Governor Mervyn King said that since the late 1980s 'Big Bang' deregulation programme, too many in financial services have thought "if it's possible to make money out of gullible or unsuspecting customers, particularly institutional customers, that is perfectly acceptable."[3]

But what is meant by 'trust' in financial services, and why does it matter? What impact did the financial crisis really have on it? And what more long-term, endemic problems in the market have driven distrust? This project aims to answer these questions and to propose policy solutions.

If distrust is a cause of poorer outcomes for consumers – if, say, they trust the hiding place under their mattress more than banks to safeguard their money – then policymakers should worry about it. Low take-up of financial services leads to a range of bad outcomes

1 The University of Nottingham's Trust Index has given banks a score below 50 (a score below 50 out of 100 shows distrust) since the financial crisis started, bottoming out at 35 in the third quarter of 2010. Christine Ennew, 'The financial services trust index', (Nottingham: University of Nottingham/Financial Services Forum, 2008-11).

2 Edelman, 'Trust in US financial services survey', February 2011.

3 *Daily Telegraph*, 'Mervyn King interview: We prevented a Great Depression ... but people have the right to be angry', 4th March 2011.

both socially and economically. Hence restoring trust is a central goal for public policy, as well as an aim for firms' marketing strategies.

Part One: Trust and financial market failure.

For the first part of this volume, the Social Market Foundation has conducted an in-depth analysis of trust and consumer financial markets, based upon a major survey. The financial crisis has been held up as the prime cause of a collapse in trust in the sector. This part of the analysis tests this assumption, and also the evidence for longer-term drivers of distrust, in a new analysis of the relationship between trust and financial services markets.

We find that the financial crisis had no discernible long-term impact on consumer trust. Even though several major incumbent banks failed, those institutions appear to have regained consumers' confidence and restored their advantage over newer entrants into the banking market. The financial system is back to the status quo ante, in which large and apparently impregnable institutions remain in control of the market and stifle innovation.

Overall, consumer trust does not appear to have been significantly damaged by the financial crisis, but it has been low for a long time. These longer-term drivers of distrust have their roots in the distinctive nature of consumer finance products. First, consumers are buying the expertise of the provider. They find it difficult to assess that expertise, so they don't know whether they're getting a fair deal. Second, unlike most other products, consumers' relationships with providers are typically ongoing. The products therefore do not require a person to periodically reconsider the available alternatives on the market, as in the case where a good has been consumed. These characteristics have profound effects on both the provider and consumer sides of the market.

On the consumer side, inertia is rife. Consumers perceive the costs – in hassle and expense – of switching between providers to be

high. But evidence presented here suggests that, while commonly cited as the key cause of consumer inertia, switching costs are less significant than two other explanations for inertia. First, a pervasive sense of distrust among consumers means they are likely to write financial service providers off as 'all the same', without even checking what is on offer on the market. Furthermore, behavioural economics suggests that consumers become disengaged in the face of market complexity: they are therefore less likely to check the market if they cannot easily understand or compare products on it.

Providers compete to exploit this consumer inertia. They compete for new customers who are buying products for the first time, and tempt them with low headline prices (teaser rates, interest free overdrafts) which divert attention from poor quality (terms and conditions, reduced coverage and hidden charges). There are therefore big incentives for firms to compete for first-time buyers of products, which entails a cross-subsidy from existing inert customers through time-limited teaser rates and interest-free overdrafts. In short, competition for first-time buyers drives greater product complexity, hidden charges and poorer coverage. All of this reinforces consumer distrust, which ultimately benefits nobody.

Competition is especially fierce to get consumers to sign up for current accounts, because they allow banks to cross-sell loans, credit cards and other products. But the loss-leaders in this competitive part of the market have to be paid for by other customers. This erodes trust, when teaser rates expire and inert consumers receive charges, narrow coverage or poor service. The market is consequently stuck in a low-trust equilibrium.

In response to these problems, policy solutions that seek to make consumers more active and more financially savvy are doomed to fail. There is little evidence that consumer education works. Switching rates remain low, despite repeated attempts to make it easier. Meanwhile, those that seek to shackle the market with heavy-handed

regulation are unlikely to deliver the optimal result for consumers. The FSA's 'product intervention' and Retail Distribution Review initiatives will tackle the problems with fringe products and financial advisors, but do little to address broader market failures. The answer is to make the market work better by helping consumers to bridge the information asymmetries that dog the market.

This report proposes two wide-ranging interventions in the marketplace. First, the regulator should create a kite-mark for a wide range of privately provided '**trusted financial products**', from current accounts to pensions, which would conform to mandated standards and act as market norms against which all other products could be compared. To receive a kite-mark, a product could not use teaser rates to tempt first time buyers at the expense of the inert, or in any other way exploit consumer inertia. The products would feature transparent charging, easy access, and fair terms, but crucially would not involve price caps.

All advertisements for non-kite-marked products would have to offer a description of how they differ from the 'trusted product'. Consumers would therefore frequently be alerted to the key differences between 'trusted products' and the rest of the market, and would buy non-'trusted' products for positive reasons, understanding their pitfalls, rather than by default. These reforms would ensure that competition in consumer finance does not come at the expense of product quality. 'Trusted products' would be targeted at all mainstream retail consumers, in distinction from the concept of 'simple products' aimed at those who otherwise may not take up beneficial financial services. The kite-mark would establish a norm for all products, instead of improving quality only for the marginal consumer.

Second, having secured product quality through the 'trusted product' kite-mark, **competition** between providers should be strengthened. Cross-selling, where firms sell existing customers new products, is as much of a cause of unhealthy competition

as are low levels of consumer switching. Yet most debate around strengthening competition focuses only on boosting the latter. This is not realistic given human nature, nor should consumers be expected to be constantly vigilant to rough treatment from their providers. As well as being a more viable approach to enhancing competition, tackling cross-selling is also easier to achieve. Competition would be strengthened if consumers taking up a new financial product for the first time – say, a credit card – were strongly encouraged to check the alternatives on the market, rather than simply taking the deal offered by their current account provider.

To impose some competitive pressure on providers reliant on cross-selling, therefore, we propose extending to all financial products the principle currently behind the 'open market option' for annuities. All product advertisements, including deal offers from firms by email, would refer customers to the Money Advice Service website to consider alternative products. As evidence suggests that the Money Advice Service site is a trusted form of intermediary, online links to its trustworthy information about products are likely to encourage shopping and switching.

Simply boosting competition in the financial service marketplace, as others have suggested, is not sufficient to ensure that consumers get a better deal. The unique nature of financial products means that more competition on its own is likely to be harmful to product quality and consumer trust. Meanwhile, encouraging a few more consumers to become a bit more active is both wishful thinking and will not remove providers' ability to exploit the inertia of the majority.

The two interventions proposed here – a new range of kite-marked 'trusted products' and the extension of the open market option – would stop firms from taking advantage of consumer inertia and boost competition in a market that currently relies upon cross-selling uncompetitive products to existing customers. By

strengthening both quality and competition, these measures have the capacity to restore trust in Britain's battered consumer finance sector, for the benefit of all.

Part Two: Expert essays

For the second part of the volume, the Social Market Foundation has invited politicians, financial services policy experts and commentators to contribute essays. They examine different aspects of the relationship between trust and financial markets, and how trust or the lack of it has an impact upon their particular area of specialism. This half of the book is divided into three sections: consumer trust, advice and supply.

SMF has invited three experts to discuss the consumer side of the market, to examine how consumers can get a better deal – and how trust and the lack of it prevents them from doing so. **Peter Vicary-Smith**, Chief Executive of Which?, discusses competition in the banking sector and its impact on trust. **Chris Pond**, senior advisor and former Director of Financial Capability at the Financial Services Authority (FSA) discusses how consumer education can help consumers find the confidence to participate in financial dealings. Finally, **Brian Pomeroy**, former Chair of the Treasury's Financial Exclusion task force, examines the interaction between trust in financial services and economic disadvantage.

Two experts on the advice market offer analyses of why the market fails, and how the resultant mistrust can be tackled. Labour peer **David Lipsey**, former board member of the Personal Investment Authority and journalist for *The Economist*, provides an overview of the failures in the advice market. **Adam Phillips**, Chair of the FSA's Financial Services Consumer Panel, argues that professionalisation of the financial services industry broadly and advisors in particular is the best response to misaligned incentives between consumers and advisors, and mis-selling.

Michael Skapinker and **Jonathan Michie** discuss how pay and structural change on the supply side of the market have driven consumer (and taxpayer) distrust, and how structural reform might rebuild it. Michael Skapinker has been covering the high pay issue for decades as a columnist for the *Financial Times*, and asks whether financial market remuneration really makes a difference to consumer trust. Professor Jonathan Michie of the University of Oxford is a specialist on mutual forms of corporate governance, and proposes mutualisation of banks to make them focus on the needs of consumers.

PART ONE

Trust and Financial Market Failure

John Springford

CHAPTER 1: TRUST AND FINANCIAL MARKETS

What is meant by trust in financial services?

Trust is a slippery concept with many definitions. But it has a core definition in market theory: trust is reliance on an agent to act in your interest.

Markets for one-off, simple transactions – for apples, say – are not very dependent upon trust for two reasons. Consumers of apples are capable of objectively evaluating a good apple from a bad one. And when consumers finish their apples, they have to buy some more: they have to constantly go back to the market to re-choose. If another apple merchant has better apples, consumers will switch to them.

In financial markets, by contrast, consumers enter into a relationship with an agent – a bank, a pension provider, an insurer – where they rely on the agent's expertise. Safeguarding and increasing the value of deposits, insuring against risk, and lending require knowledge that consumers do not have.

Furthermore, the relationship between a consumer and an agent relies on trust over time, because financial transactions are usually ongoing. Once you take up a savings account, the provider usually continues to look after your money until you take action to withdraw it. When buying a financial product, consumers are contracting services for the future, and so an ongoing relationship is necessary.

So, given these unusual market characteristics, the consumer of financial services needs to:

- Believe that the agent tells the truth.
- Believe that the agent will act in their interests.

If trust is lacking, a market will work poorly. There are two ways to mitigate the problems that arise from a lack of trust. First, consumers can rely on regulation to secure their interests. Additionally, the consumer can seek information about the quality of the agent's service by going to intermediaries, who provide information to differentiate good products and providers from bad. Where consumers cannot objectively value a product, and they do not trust the agent to give them what they want, an intermediary market matching demand and supply will spring up.

An intermediary market works by providing consumers information to help them navigate the product market. This is crucial in a financial market, where services are complex. The consumer may find it difficult to work out what they are missing if they choose one product over another: have they failed to spot a detail in the small print that will render that product of lower quality than an alternative, despite the fact that the headline price is better?

Independent intermediaries can therefore strengthen trust in the market as an institution even where trust in the ultimate providers is weak. As such, a well-functioning intermediary market can encourage consumers to take up financial products, putting their money to productive use, rather than hiding cash at home, to the benefit of all.

There are therefore three types of trust that matter if financial markets are to operate smoothly, between consumers and their agents, between consumers and intermediaries, and between consumers and the market, regulated to protect their interests.

- First, the consumer needs **agent trust**: that is, trust that the provider will guard and increase the value of savings or provide the financial service when needed in the future, consistent with the terms the consumer agreed to when signing up.

- Second, consumers need **trustworthy information** to make choices, where product quality is not objectively verifiable.
- Third, they need **market trust**. They need to trust the marketplace to offer them a choice of agents who will act in consumers' interests or else they will not seek out financial products.

Without at least one of these conditions being met, a financial market will have a limited number of participants, and will operate below its potential, to the detriment of both providers and would-be consumers. All three forms are weak in retail financial markets, due to the failures of the market.

Financial market failures

The financial system is a series of interlocking markets, each of which needs trust between firms and consumers to operate effectively. Financial markets arise because non-experts find it difficult to pick out productive investments. There are also economies of scale: a firm can gather and analyse information about investments, and insure against risk more efficiently than individuals. So banks, insurance companies and pension funds act as agents of consumers' interests. They take deposits and payments, use mathematics to balance risk and return, and lend the deposits for profit. Both buyers and sellers should benefit from this transaction, if the market works well.

Expertise on the part of the agent is the point of the financial services system, but it is also its Achilles heel. Consumers are reliant upon the expertise of the provider, unlike many other markets, which can cause the market to fail. Furthermore, because financial markets are more reliant on trust to function, a lack of it is a grave problem.

Unlike normal markets, financial services markets have two main differences which result in market failure.

First, they are founded on **information asymmetries**, with sellers knowing much more than buyers. The firm knows much more about financial markets than the consumer does – this is in fact why they exist, as the consumer is employing the firm to take advantage of their expertise to get the best return. As a result, consumers find it difficult to value products: for example, they may find it hard to know if a given insurance policy is appropriate for them, even if it is cheaper than the alternative because assessing the cover on offer and terms under which it would apply is difficult. This leaves them open to manipulation, and can allow the provider to extract a high proportion of the benefits of the transaction.

Second, financial services transactions continue over time, making the **costs of switching** highly perceptible to the consumer. Consumers do not have to frequently re-choose, as with other markets, because the service continues indefinitely. When apples run out, consumers have to buy more apples. They can switch to another provider of them, and that switch costs them nothing extra as they have to go to market anyway. In financial services, on the other hand, consumers do not *have* to repeatedly re-choose. In other words, what economists refer to as the 'opportunity cost' of switching financial services products is high, even if the direct cost of switching is no higher than in any other retail market.

Consumers need providers, who supply expertise and economies of scale. But the information asymmetry at the heart of this relationship causes problems – chiefly, price competition at the expense of quality. High opportunity costs build consumer inertia into the nature of the market. As later chapters show, these ingredients in combination are a recipe for a state of chronic distrust between consumers and their agents, the financial providers.

Why should policymakers care about trust?

Bank bailouts and bonuses are the most oft-cited causes of the collapse of trust in the financial sector. Taxpayers are furious that

the financial services industry gets special treatment, unavailable to other sectors, as government money was used to shore up the system. Their fury has been increased further by executives' and traders' continued receipt of very large bonuses, despite their poor performance.

Politicians should care about the financial crisis, who should pay for its costs, and how to stop it happening again. But that is a question of justice for taxpayers, not *consumer* trust per se: taxing and regulating the financial sector more stringently will not restore consumer trust in the marketplace, even if it relieves taxpayers of the burden of future financial crises. Sir John Vickers' Independent Commission on Banking (ICB) has been charged with removing – or reducing – the subsidy banks receive through the state guarantee of retail deposits, which should help to reduce taxpayer exposure to the banking sector. But it will do little to restore consumer trust (as opposed to taxpayer trust) unless the commission boosts competition over quality as well as price.[4]

Yet politicians should care about consumer trust as well as taxpayer trust. Trust between consumers, providers and financial markets is an important driver of good outcomes in other areas of public policy. Without it, consumers will not take up the range of financial products, many of which would be beneficial to them, and consequently to society more broadly.

When consumers do not use financial services, there are a range of public costs that arise. Financial exclusion results in higher costs for the disadvantaged and to the taxpayer. People without bank accounts pay more for credit and have higher utility bills, exacerbating fuel poverty, and employers often require bank accounts before taking on staff. Financially excluded people also

4 John Springford, 'More banks won't solve failure in the retail market', *Daily Telegraph*, 11th April 2011.

often lack insurance and savings, which can mean the state has to step in to provide financial support if things go wrong.[5]

Without trust in savings and pensions products, many people will not take them up, relying instead on the state. This may result in inequitable transfers from workers to retirees, especially in ageing societies. People may rely on housing wealth as a safety net, which increases the house price risk they face. The UK's low household savings ratio – it had fallen to 1.7% before the crisis struck in 2008[6] – also reduces the total amount of capital available in the economy that can be lent to businesses, reducing the potential for economic growth. Capital inflows make up the difference, but are often unsustainable over the long term.

A well-functioning consumer financial market is therefore an important public policy goal. Trust is a key lubricant for the market, and one that is lacking. But to understand what policies should be enacted to improve it, we need to understand whether the crash has had an impact on consumer trust and behaviour, as well as the more long-term drivers of distrust.

To do so, the analysis of the market that follows is divided into three, to reflect the three potential drivers of consumer distrust. Chapter 2 examines what the financial crisis did to consumer trust in leading banks. The third chapter examines the drivers of consumer inertia. Chapter 4 considers how providers have responded to inertia, and how this has led to a slow downward spiral of trust in the sector. Finally, Chapter 5 recommends policy prescriptions to promote quality and boost competition to restore trust in consumer financial services.

5 Lavinia Mitton, 'Financial exclusion in the UK: review of policy and practice', (London: Joseph Rowntree Foundation, July 2008) 3-4.

6 Office for National Statistics, 'Household sector: Use of disposable income account' dataset.

CHAPTER 2: THE FINANCIAL CRISIS AND CONSUMER TRUST

This chapter examines the impact of the financial crisis upon consumer trust in banking markets. There are a range of reasons why consumers might distrust banks. But a necessary condition for trust more broadly is that consumers believe that banks will fulfil their primary role – looking after their money. So, this chapter focuses on the impact of the government bailout on consumer trust in *the security* of leading banks, compared to newer entrants to the market – ex-building societies, online banks and banks entering the market from overseas.

The 'Big Four' versus new entrants through the financial crisis

In any market, the near collapse of several major players should be a huge opportunity for smaller firms. Before 2007, one might have expected retail financial markets to be no different. The incumbents' reputations for safely guarding customers' deposits would be severely damaged allowing new entrants to seize the opportunity to take market share.

Is there any evidence that this has happened in banking markets since the financial crisis? After all, in the UK, at least three major banks and one smaller lender (HBOS, LloydsTSB, RBS and Northern Rock) have put their customers' money at risk, and have relied upon large injections of taxpayer cash to keep them afloat.[7] Theoretically, their brand should lie in tatters, and other banks should be increasing market share.

Banks spend vast sums on branding and marketing, partly to make customers believe depositing with them is riskless, to build 'brand trust' in their security and integrity. The 'Big Four' banks –

7 Other banks were probably also kept afloat as a result, because government bailouts eased pressure on wholesale markets, and because the state made its implicit guarantee that the banking sector was too big to fail explicit.

Lloyds Banking Group (which now includes the Halifax and Bank of Scotland brands), Barclays, HSBC and Royal Bank of Scotland – between them control around 78% of the current account market.[8] The size, branch network, reputation and age of the Big Four has – before the crisis at least – been a major barrier to entry for others, as consumers imagine them to be safest.

To test what the banks' failures to protect their customers' deposits did to customer perceptions, SMF used YouGov's 'Brand Index' data, which asks respondents to rate various financial firms for customer service, value for money, quality and so on.

Consumer ratings of banks' 'quality' are a good proxy through the financial crisis for how safe they were perceived to be. We can tell this by comparing quality ratings with share prices, which offer a rough measure of equity risk, especially in a banking crisis. Chart 1 plots HSBC's share price – a bank that came out of the crisis well – against the YouGov consumer panel's quality ratings through the crisis, between January 2008 and September 2009. The quality rating closely follows the pattern of the share price. The share price is an indicator of the future profitability of the bank, as well as the risk the shareholder in the bank faces that the bank will fail and they will lose money. During the period of high uncertainty about the safety of the financial system, between September 2008 and May 2009, both shareholders and consumers had a heightened fear that their investments and savings were in jeopardy, reflected in a falling share price and quality rating. Thereafter, once it became clear that the bank had weathered the storm, the two indices climbed in sync.

8 Mintel. 'Finance Intelligence: current accounts' data, June 2007.

Chart 1: HSBC's share price and quality perceptions, January 2008 – September 2009

Sources: YouGov BrandIndex and Google Finance historical share price data.[9] Share price: 4th January 2008 = 100.[10]

HSBC's high quality rating may be deserved (in the eyes of the public, at least), but what about the perceived quality of banks that fared less well in the crisis? Chart 2 shows how incumbency remains a major advantage in the wake of the crisis, irrespective of institutional failure. The chart averages consumers' quality ratings for the incumbents (which controlled 79% of the current account market in 2007),[11] and the seven newer entrants, which make up most of the rest of the market. Before the collapse of Lehman Brothers and the banking crisis that ensued, the established players enjoyed a six to nine percentage point advantage in quality ratings.

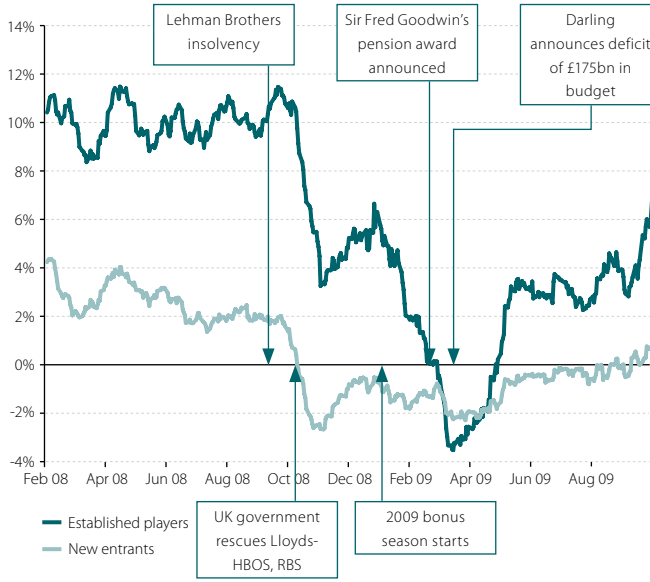
9 YouGov's BrandIndex data asks their consumer panel daily whether they think a range of firm are 'good' or 'bad quality', or whether they are neutral. On the charts that follow, a positive figure shows that more consider the FSI to be good quality than bad – as a percentage of people who are neutral. The 'established players' are Royal Bank of Scotland, Barclays, HSBC, LloydsTSB, Halifax-Bank of Scotland, and NatWest. The seven 'new entrants' are Bradford and Bingley, Cheltenham and Gloucester, Egg, First Direct, Northern Rock, Sainsbury's Bank, Santander and Tesco Bank.

10 A common measure of correlation, r^2, measures the proportion of variance of one series against another. 1 is perfect correlation, 0 is absolutely no correlation. The r^2 of HSBC's share price to its quality rating was 0.650 between January 2008 and September 2009, showing a fairly close correlation. In a financial crisis, the rating for quality becomes much more strongly driven by the risk of losing deposits. The r^2 of the HSBC share price to quality rating was 0.782 between the insolvency of Lehman Brothers, announced on 15th September 2008, and one year later.

11 Mintel, 'Finance intelligence: current accounts' data, June 2007.

After the financial crisis struck and the Government moved to recapitalise the system in October 2008, the quality rating for the established players dipped dramatically. The rating includes RBS, LloydsTSB and HBOS, which received taxpayer money to rebuild their capital base. None of the new entrants needed recapitalisation apart from Northern Rock, which had been nationalised in February 2008, and their quality rating fell less far. But even after this major shock to incumbents' brands, consumers' perceptions quickly returned to the pre-crisis norm. Established players were rated higher for quality than entrants by June 2009, and by the end of September, their advantage had risen back to six points.

Chart 2: Consumer ratings of banks' quality through the financial crisis



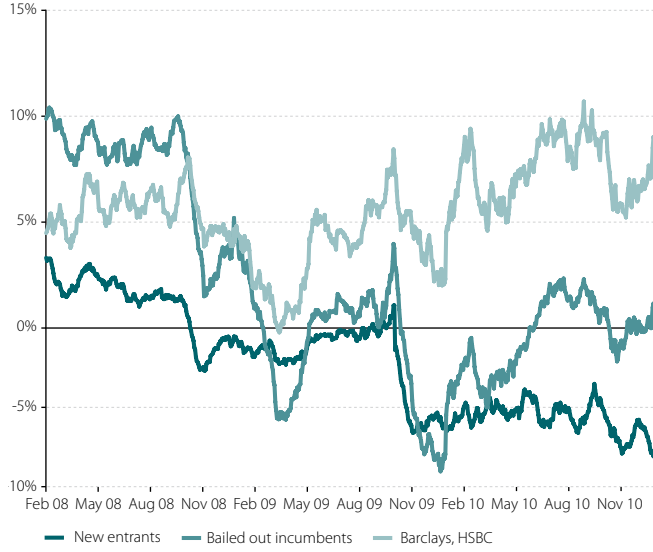
Source: YouGov BrandIndex

For those that failed, however, quality rankings plummeted with the share price, but thereafter the two indicators diverge, with quality perceptions recovering much faster than share prices, as government rescues restored depositors' confidence in incumbents.

However, some incumbents failed and some did not, so high ratings for Barclays and HSBC might mask negative ratings for RBS and Lloyds Group brands in Chart 2. What does the picture look like if we consider the two groups separately? Chart 3 compares the three incumbent bailed out banks' quality ratings to those for Barclays and HSBC on the one hand, and the new entrants on the other. Before the financial crisis hit, the major banks rested on their customers' faith that their deposits were secure. When the banking crisis hit, this faith was sorely tested, as consumers feared they may lose their deposits. As might have been expected, those incumbent banks that did not receive taxpayer money were rated highest for quality from the point of recapitalisation onwards.

But, remarkably, the bailed-out banks also bounced back. Through late 2009 and the Budget in 2010, the bailed out incumbents suffered similar quality ratings by consumers as the new entrants. However, by the summer of 2010, even their quality advantage had been restored.

Chart 3: Bailed-out incumbents vs. Barclays HSBC vs. new entrants, YouGov quality ratings



Sources: YouGov BrandIndex. YouGov made methodological changes to their BrandIndex survey in September-October 2009, which explain the high volatility between October 2009 and January 2010.

This demonstrates that in financial services, incumbency is key. Entry is very difficult even after the complete failure of incumbents, when they are backed by Government. The lack of entry threat provides incumbent banks with huge competitive advantage. The financial crisis temporarily jeopardised this advantage, and then the Government bailout has restored it: consumers now know that their deposits are safe, if they did not know already. By bailing out the financial system – a necessary move, for which it had little choice – the Government restored the major players' reputation for security, whether earned or not, thus closing the door to entrants. Consumer faith in the system returned.

Trust in the incumbents, the Big Four, bounced back as soon as it became clear there would be no systemic collapse – but this was entirely due to government action. Therefore, a major pillar of trust in the banking market is the government guarantee. Counterintuitively, given policymakers' and financiers' fears that the crisis destroyed trust in the financial sector, this evidence suggests that it actually had almost no persistent effect on consumer trust. Failure went unpunished: several major banks did not keep consumers' deposits safe, but that did not make consumers less inclined to rate them more highly than less established players who performed better. Crucially, the financial crisis showed that the market was unable to generate trust on its own, by rewarding the safer banks with bigger market share and allowing poorer performers to fail. Only government backing was able to shore up the status quo.

Trust in financial services has actually been weak for a long time. And in bailing out banks, government reinforced some of the characteristics of the market that are the endemic drivers of distrust. In particular it reinforced consumers' tendency to be inert. This, and some of the other problems with financial services markets are discussed in turn below, with reference to a survey of consumer attitudes and behaviour towards the financial sector, carried out by the SMF.

CHAPTER 3: INERT CONSUMERS, RIPE FOR THE PICKING

The banking crisis and government bailout, then, restored the status quo ante: a banking market founded upon a small group of incumbents with a reputation for keeping deposits safe, either because of their size or age, or after the crisis, because of government guarantee.

However, it is clear that consumer distrust is an endemic, long-term problem in retail financial markets, with its roots in the nature of competition, rather than the financial crisis. This section analyses the unique nature of the demand side of the market that contributes to the problem. The following section explains how this nature drives pernicious competition on the supply side.

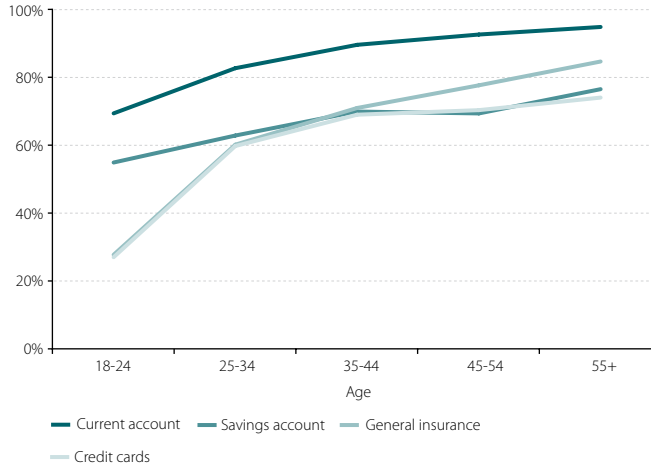
Inertia, distrust and firms

A healthy financial services market would be characterised by consumers switching between products based upon prices and quality. Yet switching rates between financial products are very low. Working with YouGov, we surveyed 2,076 adults on the 20th and 21st December 2010 to explore their attitudes towards consumer finance. Our survey found that 36% of respondents had never changed current account providers. Sixty-four per cent had switched, but 45% had only switched once or twice. Even among respondents who said that they had been treated unfairly by their bank in the past 12 months, 65% had not switched to another provider in response. Thirty-five per cent said they had switched.

This low level of switching means that most people making choices on the market are new entrants, rather than people switching provider. This is also true of financial products other than bank accounts. Chart 4 shows what proportion of our survey's respondents hold different products, broken down by age. Younger people (18-34) are less likely to hold each financial

product, and the likelihood that consumers already have a product increases with age.

Chart 4: Proportion of consumers holding various financial products, by age



Source: SMF/YouGov, 'Trust in financial services survey', January 2011.

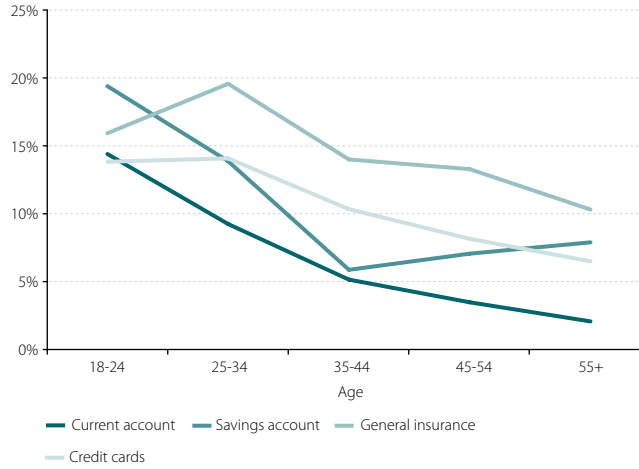
Chart 5 shows what proportion of our survey's respondents have taken up different products in the last two years, broken down by age. Young people are far more likely to have signed up for each product in the last two years. This is particularly true of current accounts and savings accounts where competition focuses on consumers just coming onto the market. There is more competition based upon switching among existing customers in general insurance and credit cards, but first-time consumers remain the largest single group of 'choosers', with existing consumers much less active.

Previous studies have put this inertia down to high exit costs.[12] Indeed, our survey found that most respondents complained

12 Consumer Focus, 'Current account holders switched-off from switching', 9th October 2010.

about "hassle" rendering switching unprofitable. A tenth said they thought "the money they would save is not worth the hassle of changing" – that high exit costs were greater than the money they would have saved. However, theory, as well as new evidence, suggests that inertia is caused by a more complicated set of factors than this "rational actor" model would imply.

Chart 5: Proportion of consumers who took up various financial products in the last two years, by age



Source: SMF/YouGov, 'Trust in financial services survey', January 2011.

There are two additional explanations for inertia, which policymakers should take into account: the behavioural effect of a complicated market, and distrust of providers.

Behavioural economics shows how consumers react to conditions of market complexity: they do nothing.[13] Most people need simple financial products. Yet the market is a sea of complexity, with endless permutations of different sorts of

13 Jessica Prendergast et al, *Creatures of habit? The art of behavioural change*, (London: Social Market Foundation, 2008) 36.

products. Firms have a powerful incentive to try to reduce liability by burying as many caveats as possible in small print, which adds to the information fog. This has an impact on take-up. Researchers in the US studying '401(k)' pension plans tracked the proliferation of plans over time and found that, all other things being equal, every ten funds that were added to the market reduced the participation rate by 1.5-2%.[14]

Our survey found that distrust is a more significant cause of inertia than exit costs. In polling, we asked two groups of respondents why they had not switched banks – those who had never switched, and those who had not switched despite saying they had been treated unfairly by their current provider in the last year (Chart 6). For the former group, the largest proportion (43%) said they were happy with the service the bank provides. But the next largest group, 24%, said "they're all the same so it's not worth it". Just 10% cited high exit costs as the problem, agreeing with the proposition that "I think the money I would save is not worth the hassle of changing".

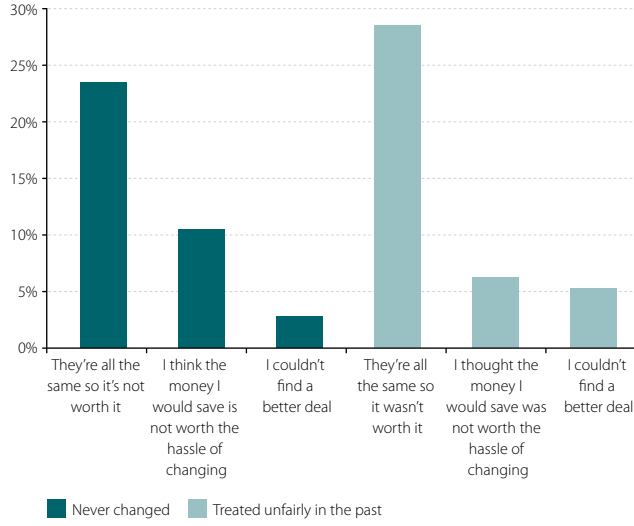
For those that felt they had been treated unfairly by their current provider, a larger proportion gave their reason for not switching as "they're all the same" – 28% – against only 6% who complained of high exit costs. This suggests that a substantial minority of consumers distrust providers leading them to cast a general 'plague on all banks' houses', and therefore, failing to switch – and that this reason is more powerful than exit costs in generating inertia. Crucially, few consumers make the effort to compare switching costs to what they would save by taking up a new product. They assume they can do no better.

It also suggests that generalised distrust in the banking market is created by (perceived) unfair treatment from one bank. A larger

14 Sheena Iyengar et al, 'How much choice is too much? Contributions to 401(k) retirement plans', (Philadelphia: Pension Research Council, 2003).

proportion of the respondents who complain of unfair treatment do not bother to check out the market afterwards, compared to those respondents who have merely never changed provider.

Chart 6: Reasons for not switching banks



Source: SMF/YouGov, 'Trust in financial services survey', January 2011.

Finally, very few people imply they have checked the market, and decided to stick with their current provider afterwards because they could not find a better deal. Of those who had never switched, just 3% said "I couldn't find a better deal". The proportion of those who had been treated unfairly is 5%.

A generalised state of distrust in banks therefore prevents many consumers from going onto the market and checking whether they could get a better deal. For the market to work, consumers must seek out information about better providers and then switch to them. They fail at the first hurdle.

Evidence does not support poll respondents' views that all providers are the same, and suggests that good deals are available. The OFT found that challengers to the established banks offered interest rates between 2% and 3% on current accounts on average between 2000 and 2008, while the established banks offered between 0.5% and 1%. Challengers offered 12% APR on arranged overdrafts on average in the period, against 16.5% for the incumbents.[15] Not only are providers not 'all the same', but better deals are available, and the benefits will over time easily outweigh the costs of switching. For a rational actor, frequent switching would therefore be worthwhile. But consumers are discouraged from comparing products by confusion and distrust.

This suggests that attempts to encourage consumers to switch more often – which has become a central goal of policy towards financial services – will be unsuccessful unless the problems of confusion and distrust are tackled. We suggest ways to do so in Chapter 5.

In most complex markets where expertise is required, intermediaries often appear to tell consumers where to go to get good deals. Given the offers available, there are strong incentives for intermediaries to promote the value of switching and help customers navigate the market.

Distrust and the intermediary market

But the intermediary market in consumer finance has its own problems, such that it does not resolve the market failures outlined above. Providers have taken advantage of information asymmetries to sell consumers products that are unsuitable or failed to tell consumers about risks and charges. There has been a steady stream of mis-selling scandals, in which intermediaries have been complicit.

15 Office of Fair Trading, 'Personal current accounts in the UK: an OFT market study', (London: OFT, 2007), 39, 41.

In the late 1980s, more than a million people were incorrectly told that they were better off taking out personal pension plans, instead of staying with their company scheme. Independent advisors were given large commissions to sell the pensions, and overstated the benefits and understated the risks as a result. In the 1990s, advisors also understated the risks of endowment mortgages. Under the scheme, housebuyers took up interest only mortgages. They also paid insurance premiums to pay off the capital. If the funds in the insurance pools did not grow in value sufficient to pay the capital, the buyer would be left with a shortfall. For many, this is exactly what happened.[16]

This chronic incentive for intermediaries to overstate benefits and understate risks nearly brought down The Equitable Life in 2000. The insurer allowed policyholders to take a guaranteed payment on retirement, but failed to hedge properly against the risk that their fund would not match the guarantees or to inform policyholders of the risks. In the last decade, several firms have lost compensation cases and have been fined for mis-selling payment protection insurance. This purported to protect credit card, mortgage and loan debt from default if the debtor fell ill or lost their job. But the coverage was much narrower than many advisors led customers to believe, resulting in large profits for suppliers.[17]

In all of these cases, intermediaries were heavily implicated in the problem, eroding consumer trust, as the latter rightly suspected that advisors had been captured by provider interests.

Competition on the intermediary market

Consumers are aware of the mis-selling incentive. They know too that the intermediary market is also founded upon an imbalance of

16 Government response to the Treasury Committee report, 'Restoring confidence in long-term savings: endowment mortgages', (London: HMSO, response to committee's 5th report of session 2003-04).

17 Parliamentary and Health Service Ombudsman, 'Equitable Life: a decade of regulatory failure', (London: HMSO, July 2008).

information, and they are unsure whom to trust as a result, for fear of being sold to rather than advised.

Chart 7 shows how different types of intermediaries in the market for consumer information are perceived by consumers relative to each other. Only three sources of advice showed positive ratings for trust for both accuracy of information *and* acting in the best interests of the consumer.

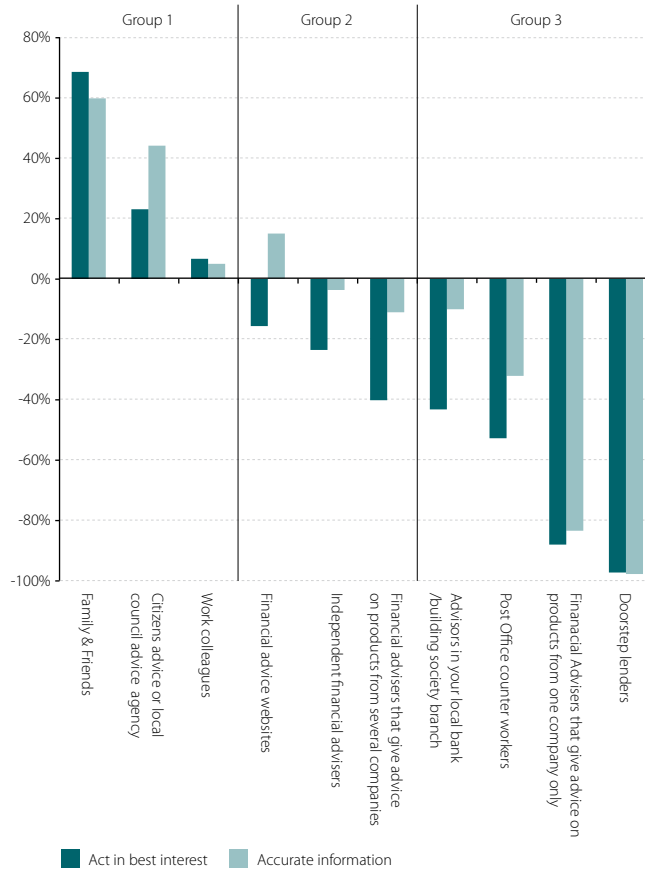
- Respondents trusted people they had personal relationships with (family, friends and work colleagues) and Citizens' Advice Bureaux the most – i.e. sources of advice that had no incentive to give wrong information because they would not gain financially from doing so.
- The next group, independent intermediaries, are on balance distrusted, because it is not clear how they are paid.
- The final group are advice sources that firms themselves provide. They combine information with sales. Instructively, Post Office counter workers are less trusted even than bank/building society advisors, despite the fact that the Post Office is a government corporation, which might suggest that they act in the public interest. However, any advice from a firm that sells products, even if it is state owned, is distrusted.

The intermediary market suffers from the same pricing problem that dogs the product market. (See the next section.) Consumers do not know whether they are being charged fairly for advice, because visible prices are zero. Consequently the cost of their advice is either subsidised by cross-selling, or paid for by commission, both of which have obvious implications for the impartiality of the advice and consumer trust.

Professional intermediaries are also incentivised to offer more complex products than the simple products that most people need. Since professional intermediaries are mostly paid on commission for

more complex products that create larger returns for the suppliers, and because they need to display expertise to justify their fee, they are biased towards complexity, irrespective of consumer need. This is despite the fact that the vast majority of consumers' needs could most likely be met by a relatively narrow array of products.

Chart 7: How much do you trust the following to give you accurate information/act in your best interests?



Source: SMF/YouGov, 'Trust in financial services survey', January 2011.[18]

18 Both series = proportion of trusting minus distrusting responses.

All of this means that consumers are less likely to trust intermediaries. In our survey, 48% assumed that independent financial advisors are paid by commission by the company whose product is bought, while 21% thought they charge the customer, and 17% thought the customer can choose between a charge and a commission. The default assumption is that financial advisors are paid on commission and that they are trying to sell the consumer something, rather than giving them impartial advice.

The FSA is attempting to tackle the misaligned incentives in the intermediary market through the Retail Distribution Review (RDR). From 2012, independent financial advisors will have to charge consumers, rather than selling them products and taking commissions, to make sure that their interests are aligned with consumers, not providers.[19]

This is a welcome move, and an essential measure to begin to restore consumer trust in the intermediary sector. But industry representatives are also right that the reforms are likely to significantly reduce demand for professional advice.[20] Consumers are reluctant to pay for financial products that they have previously had for free (see Chapter 4), and the increase in price for financial advice will put some people off. To complement the RDR a wider set of policy reforms is needed to resolve these problems. Policy must act to close the advice gap in some way, either by reducing the need for advice or by providing or subsidising it, to ensure that first time buyers of financial products and switchers select the most suitable products. The way to do so is discussed in Chapter 5.

In sum, consumers are inert because they think switching costs from current products are high, because of information overload,

19 FSA, 'Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules', (London, FSA, March 2010).

20 Association of British Insurers press release, 'Clarity needed from FSA to ensure wider access to financial advice', 30th October 2009.

and because they take a negative and distrustful view that providers are all the same. There are deals to be made on the market – new entrants' current accounts are a good example – but inertia driven by these three factors prevents them from doing so.

A pervasive sense of distrust also prevents people going onto the intermediary market. Consumers assess the quality of intermediaries' advice by whether they are profit-making or not, and whether they are tied to a supplier or not, and therefore perceived to be in the business of selling, rather than advising. People on the market for advice cannot distinguish the sales from advice. So, the default state is one of distrust, which means that many are unlikely to go to the intermediary market in the first place. It remains to examine how providers respond to the nature of the demand side, described above. Their response reinforces distrust.

CHAPTER 4: SUPPLY SIDE PROBLEMS: IT PAYS TO BE CONFUSING.

Chapter 3 showed that inertia dogs the demand side of the consumer finance market, because of the high opportunity cost of switching, product complexity and confusion, and a sense among consumers that all providers are as bad as each other. This inertia is easily exploited by the providers.

Providers can discriminate between 'choosers' on the market and the inert. Inertia encourages providers to focus their marketing strategies predominantly on those entering each product market for the first time. They therefore engineer prices to attract new entrants.

This comes at the expense of the quality of products, as hidden charges and small print proliferate. It also entails huge cross-subsidy: choosers (predominantly new consumers) are subsidised by the inert. There is no incentive for firms to stop this cross-subsidy, if it means they will have to increase headline prices, because the product will not be chosen by highly headline-price-sensitive consumers. If a firm wants to succeed in the financial sector, it must exploit the inert and favour the minority of choosers.

So, banks and other providers compete on visible prices, at the expense of product quality. And because signing people up for current accounts makes cross-selling easier, the battle for young people to take up current accounts is most intense.

Teaser rates feature in various markets, and are a manifestation of competition over headline prices. Most cash ISAs now offer a higher rate for the first 12 months, which then becomes variable (inevitably falling). Credit card companies tempt customers with 0% APRs for the first year.

In insurance, the advent of price comparison websites heightened this effect. When brokers intermediated between

insurance firm and consumers, price was still important. But the broker was also in a position to offer information on product coverage concurrently.[21] With price comparison websites, where headline prices are compared more easily than levels of coverage, there are strong incentives for providers to reduce prices at the expense of coverage (with information buried in small print) in order to protect margins.

All of these techniques are a recipe for disgruntlement and distrust for the consumers who have not checked the small print, or do not switch providers once introductory periods are up. And since current accounts are a 'gateway' product that allow lucrative cross-selling of other products, they are crucial to the entire financial services industry, and so deserve detailed analysis.

The current account market

Current accounts are gateway products: once they have been taken up, banks can then cross-sell credit cards, loans, insurance, pensions and mortgages. By exploiting their privileged marketing position – banks can send letters and emails directly, and advertise on their website when people check their accounts – banks in particular can make profits from a captive market. Cross-sold savings products often feature interest rates far below the market average; some rates are even below the Bank of England base rate.[22] Despite the fact that 'loyalty deals' often punish loyalty, existing current account customers are likely to buy other products from the same bank, further intensifying competition for customers coming onto the current account market. This dynamic increases consumer inertia when it comes to buying subsequent products. The scale of cross-selling in the current account market is huge.

21 Uwe Föcht et al, 'Intermediation and matching in insurance markets', (Bonn, Deutsche Forschungsgemeinschaft, May 2010).

22 *Financial Times*, 'Savers count the cost of loyalty', 9th-10th April 2011.

Banks use a variety of pricing techniques to attract new entrants, whom they can cross-sell to. Most current accounts in the UK are now based on the 'free if in credit' charging model, which means that there are no monthly charges to pay for the fixed costs of offering the service (the branches, payments systems, regulatory compliance costs and ATMs). In some cases, this headline price has become negative, to act as a 'loss leader'. For example, at the time of writing, Santander is offering new current account customers £100 to join the bank. In the student market, large interest-free loans are on offer. HSBC, Santander, Barclays, Ulster Bank, NatWest and Smile offer an interest free overdraft up to £2,000 for students. Bank of Scotland offers up to £3,000 interest free.[23] The cost of these give-aways is recouped the cross-selling of other products and inert current account customers.

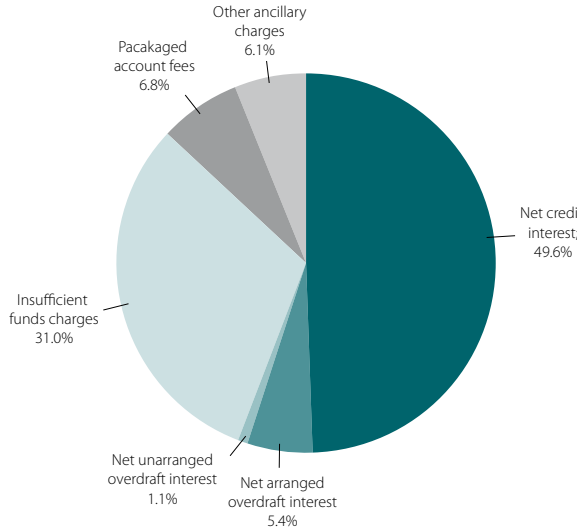
Office for Fair Trading (OFT) data from 2006 shows the scale of the cross-subsidy from inert customers. The average proportion of banks' current account revenues that arise from each feature of current accounts – overdrafts, positive balances, and so on – is shown in Chart 8. The largest proportion, 49.6%, came from the 'spread' between low interest rates on positive current account balances, and the interest rates charged on loans made to other customers. The second largest proportion, 30.9%, came from unauthorised overdraft/insufficient funds charges. These two were much larger than the other sources of revenue.

Overdraft and insufficient funds charges are a recipe for distrust. Prices have become out of step with the costs of different consumers to banks. Typically, there is no standing charge to the consumer for the largely fixed costs to banks of providing current account infrastructure – branches, staff, ATMs, and regulatory compliance. Instead, banks cross-subsidise from more hidden charges: large spreads between large current account balances and

23 Prices advertised on moneysupermarket.com, 15th March 2011.

the interest rates they can get by lending these deposits out, and overdraft charges. Given this substantial cross-subsidy, it is hardly surprising that once a consumer gets hit with a charge, they feel cheated, since typically banks charge them much more than the costs they face. Consumers who have high credit balances also get a raw deal, even if they do not realise, because banks typically pay miniscule interest for funds that they can lend at much higher rates. Since most consumers are inert, these interest rates are not competed upwards.

Chart 8: Banks' sources of revenue from current accounts, 2006



Source: Office of Fair Trading, 'Personal current accounts in the UK: an OFT market study', (London: OFT, 2007), banks' annual reports, 2006.

Market testing trustworthy current account charging

So would customers prefer products which did not take advantage of complexity and hidden charges? We decided to find out. We commissioned an online focus group, to test a charging structure for a current account that could break the low-trust equilibrium in

current account provision by making charges to customers better reflect the costs they impose on providers. The group was drawn from respondents to our survey who signalled distrust in financial services and represented a range of incomes.

Current account users can be split broadly into three categories: those using overdrafts, those with higher balances who could use a savings account to get a better return, and those with low balances. In most 'free if in credit' current accounts currently on the market, the first two subsidise the latter.

We developed a current account which does not rely on these cross-subsidies. In our current account, costs to these different categories of consumers more closely tracked the costs incurred by providers. The likely demand for a fairer type of product was tested by putting it to the focus group, in comparison to a current account with a standard pricing structure. Crucially, the 'trustworthy' account was designed to be revenue neutral for the bank that offered it.

In the warm-up discussion for the focus group, the moderator asked the group about current account overdraft charges. All respondents thought they were highly unfair. One respondent complained that "they don't take into account that you have never been in overdraft before", and charge you anyway. Another said that you go "a few pence over and they can charge you a bomb". Several thought banks take advantage of consumer behaviour: "people tend not to pay attention, until they get caught. Banks know this." Several members of the group called for more transparent charges and fees.

To test reaction to the 'trustworthy' charging structure, the SMF presented two charging structures, one with cross-subsidy (of the type commonly available on the market today) and one without to the group. **Account A** represents an average bank account from

2006 (Table 1).[24] The charging structure entails substantial cross-subsidy from those who pay overdraft/insufficient funds charges and have high current account balances to those with lower balances.

In the alternative **Account B**, prices were, by design, much more closely aligned with costs to the bank of the three different types of client. This model was entirely revenue neutral for the hypothetical bank that offered it: we used data from banks' annual reports in 2006 to find the average revenue from the current account part of their business.

There were three differences between Account A and our 'trustworthy' charging model, Account B.

- We **eliminated insufficient funds charges**, retaining only the higher APR on overdrafts.
- We changed interest rates on positive balances from their 2006 average (0.47%), applied flat across all positive balances, to a **varied interest rate**, to reflect the fact that those with higher balances provide more funds for banks to lend. Thus, those with a positive balance of £0-500 would receive 0.3%; £500-1000 receive 0.5%; £1000-2000 receive 1%; £2000-5000 receive 2%; and balances over £5000 receive 3%.
- We imposed **a monthly charge of £4.45**, to cover banks' costs of operating the current account infrastructure, used by all. This monthly charge covered the revenue lost from the eliminated insufficient funds charges and reduced spreads on positive balances. This charging structure for Account B is therefore more transparent, with costs to banks and prices charged to account-holders more closely aligned for all customers.

24 It should be noted that since 2006 the average unauthorised overdraft/insufficient funds charge has come down substantially. In order to keep revenues and margins accurate, however, we had to stick to the 2006 averages.

Table 1

	Bank account A	Bank account B
Unauthorised overdraft/ insufficient funds charges	£30	£0
Unauthorised overdraft interest rate	22.7%	No unauthorised overdrafts and no fees
Authorised overdraft interest	15.4%	15.4%
Monthly charge	£0	£4.45
Interest on £0-500	0.47%	0.3%
Interest rate on £500-1000	0.47%	0.5%
Interest rate on £1000-2000	0.47%	1%
Interest rate on £2000-5000	0.47%	2%
Interest rate on £5000+	0.47%	3%

Despite the initial hostility to accounts like A, 'trustworthy' Account B was not a success overall with the focus group. Just two out of six respondents chose it, if they had to take one or the other. When giving self-interested reasons about which they would choose, if they had to choose one, the majority said that they did not have any trouble with their overdrafts, did not want to pay a monthly fee, and so would rather choose Account A. They appeared unconcerned about the interest foregone on positive balances.

There were four underlying reasons why Account B failed on our (admittedly small) market. First, the majority of account-holders have an incentive to maintain the status quo, because they are subsidised by a minority (in this case, people paying overdraft charges) who incur larger perceived costs than they do. One member who did not want B said, "Because I don't need an overdraft, I refuse to pay a membership fee for something I don't need." Another said Account B was "much better if you know you're going to need an overdraft" but that "I don't want to pay a [monthly] membership fee, and for how much I have in my account I'd get better interest rates most of the time from [Account] A".

Second, 'free' accounts have become the norm, and customers are reluctant to give them up. 'Free' banking which is hard to move away from, especially in an environment where account providers are deeply distrusted. The two members of the group who did go for Account B did not do so happily: one said "B is the better of the two options" but "I STILL do NOT agree with paying for a current account!" (The emphasis is his own.) Another said she would take B, but that the bank could improve it by "removing the monthly fee – and a realistic overdraft rate of 7.9%?" All of the respondents rejected the monthly fee: the second underlying failure of the product was that consumers are used to receiving current account services for free. Behavioural economics evidence suggests that when something is provided for free, consumers do not value it: because the price is zero for the service consumers are not forced to mentally account for the utility they receive from it by paying a fee. When asked to pay for the service, they are reluctant to do so.[25]

The third reason for the lukewarm reaction was bank profitability. High profits associated with banking make it hard for banks to be seen to raise revenue from standard current accounts. All respondents complained that banks make large profits and so they should not charge for banking services. One said, "Banks already make money with our money, enough to pay for their services." Consumers find it difficult to know whether they are getting a fair deal on their account balances: a respondent complained that "it just makes you realise – 'hang on a minute, if I had a fair amount in the bank, they are using my money and not paying me.'" Another said, "If banks were hard up and could not afford to pay wages, then I could understand it BUT they make billions every year and pay [big] bonuses, so there is no justification at all."

Fourth, it is unclear to customers why the charging structure under Account B is fairer than that for A – even if they agree that

25 Richard Thaler, 'Mental accounting and consumer choice', *Marketing Science* (1985).

the current one is unfair. Consumers are incapable of judging whether a charging structure is fair or not, because consumers lack information about banks' costs. One member labelled the interest rates on both Account A and Account B "appalling", and there was "no justification for the level of interest rates". Consumers have "no option but to be paid via a bank account, [and] the banks sit on our money when we are not using it and they make money out of it usually overnight".

The reaction of current account users to a charging structure that better matches the costs to the bank is instructive. It is easy to see how competition over the headline price of a current account has driven it down to zero, creating 'free banking'. The cross-subsidy this has generated is a clear driver of distrust among account holders. Nevertheless, the strength of the 'free banking' norm, combined with deep distrust of banks' motives, makes the low-trust equilibrium one that is hard to break.

The example above concentrated on current accounts, but providers' responses to consumer inertia are similar across all consumer finance products. Consumers are rational to distrust providers. Consumers are inert and switchers are few. Providers are driven by competitive pressure to structure charges that take advantage of inertia. The unique nature of finance allows providers to exploit the inertia through price discrimination and complexity. Many products use cross-subsidy to attract people coming onto the market with attractive headline prices, which fall over time, adding to the sense of distrust. Consequently the entire market has become stuck in a low-trust equilibrium.

Breaking the low-trust equilibrium will require a combination of policy actions that seek to remedy the underlying causes of poor outcomes outlined above. The next chapter outlines what the solution should be.

CHAPTER 5: POLICY RECOMMENDATIONS

Consumer distrust in financial markets stems from their inertia, and the sharp competitive incentives for providers to take advantage. Consumer inertia has three main causes. First, since financial products are on-going, consumers do not have periodically to re-choose their provider as they do after consuming most other goods. Hence consumers are reluctant to incur costs shopping around for a new product even if their existing one no longer offers good value. Second, in the face of a complex and confusing array of financial products, they tend to disengage from the market. Finally, consumers distrust providers, and think "they're all the same as each other". For all these reasons, many consumers do not go to market.

Firms are therefore compelled to compete for the non-inert customer, targeting prices at the few people who do switch or those who are taking up products for the first time, and cross-subsidising from inert consumers. Cross-selling of other products to existing customers further reduces competition over inert consumers.

All of this creates an unhealthy market, stuck in a low-trust equilibrium. Consumers have little trust in the agents upon whom they rely. They do not trust the information that is available through intermediaries, due to the latter's incentives to sell, rather than advise impartially. And they cannot trust the market itself to produce products that will treat them fairly over time. The result is a market in which product coverage and savings rates are more limited than they should be.

Doing nothing is not an option. The market failures are broad and the costs to society are large. Doing nothing will cause distrust to grow and consumer disengagement to continue, increasing the externalities to the taxpayer. The market could work better for both consumers and providers.

For policymakers, there are a range of potential options to make the system more competitive, fairer and therefore trusted. Interventions can address the three dimensions of trust identified at the start of this analysis.

- Improving **agent trust**, by making firms provide trustworthy products.
- Ensuring **trustworthy information**, by aligning intermediaries' incentives with the interests of consumers, and mandating that providers disclose clear information about quality as well as price.
- Augmenting **market trust**, by encouraging providers to compete over quality, as well as price.

Within these types of trust, there are six broad categories of policy action which could be deployed. These are as follows:

1. Increase competition in the market by reducing the market share of major banks.
2. Intervene in the product market itself, trying to orientate each and every product towards consumer interests.
3. Intervene in the intermediary market: tackle the misaligned incentives on the intermediary market, and/or mandate better disclosure of information about the quality of products.
4. Make consumers savvier and more active through financial education.
5. Reduce switching costs to stimulate competition.
6. Create government-approved 'simple products' with standardised product features.

The Treasury and FSA are considering a range of measures on each of these fronts at the time of writing. Each is discussed below, in the light of our analysis of the dynamics of the market. After this critique, policies that better address the unique problems in financial services markets are proposed.

1. Boosting banking competition

Policymakers hope that more competition in the banking market will drive up consumer outcomes. The Independent Commission on Banking (ICB) and Treasury Select Committee insist that a market with smaller and more numerous banks would better serve consumers. Alongside its remit to make the financial sector safer, and reduce the risk to the taxpayer, Sir John Vickers' ICB is considering ways to reduce the market power of the largest banks. In its interim report, the ICB recommended that Lloyds Banking Group, which includes Halifax and Bank of Scotland, should be compelled to sell even more high street branches than the 600 currently mandated by an EU ruling.[26]

The House of Commons Treasury Select Committee has also been investigating concentration in the retail market. In April 2011 it questioned whether "the need for economies of scale justifies [single] banks having a 30% share of the market, or whether such benefits, if they exist, will be passed onto consumers in a market where competition is deficient."[27]

While a less concentrated banking system may be one ingredient of a better-functioning market, it will not resolve the multiple market failures by itself. Greater competition could actually make them worse in the absence of other policies to prevent banking competition happening at the expense of product quality. As we have seen, the banking market is in fact already highly competitive in some areas; the problem is that competition, focusing on headline prices, currently comes at the cost of quality. Unless competition can be intensified around trustworthy products that do not deceive consumers, more competition risks driving visible prices further down and hidden charges further up. This may create

26 Independent Commission on Banking, 'Interim report', (London: Independent Commission on Banking, April 2011), 119.

27 House of Commons Treasury Select Committee, 'Competition and choice in retail banking', (London: HMSO, April 2011), 23.

further inertia, distrust and reduced incentives for competition over quality.[28]

2. Product intervention

The FSA is currently considering pursuing the second of the policy approaches listed above, through its 'product intervention' consultation. It is considering "a more interventionist and pre-emptive approach to retail conduct regulation".[29] The FSA plans to "anticipate consumer detriment where possible and stop it before it occurs".[30] This amounts to supervision, rather than regulation, of the market. Under the product intervention umbrella, it has set out a list of potential actions against products that it considers to be detrimental to consumers, from most to least intrusive:

- Product pre-approval;
- Banning products;
- Banning or mandating specific product features (including setting minimum standards for products);
- Price interventions; and
- Health warnings and mandated advice for products.[31]

The most interventionist aspect of the FSA's proposals relates to **product pre-approval** and **powers to ban products**. Intervention before the point of sale may damage consumer choice, by removing products from the market that some would buy even if they had perfect understanding of what they were buying. It is also hard to know how many consumers would suffer, and whether the satisfaction some consumers receive from the product is greater than the detriment to others. These options also risk stifling innovation, as providers have to ensure new financial

28 John Springford, 'More banks won't solve failures in the retail market', *Daily Telegraph*, 11th April 2011.

29 HM Treasury, 'A new approach to financial regulation: judgement, focus and stability', (London: HM Treasury, July 2010), 38.

30 Financial Services Authority, 'Product intervention', (London: FSA, January 2011), 11.

31 Ibid., 48.

products pass the FSA 'test'. The test – basically, the pre-approval of products – increases the cost of regulation, as each is checked to make sure consumers will not suffer adverse consequences. Finally, this kind of industry supervision abandons hope that providers might compete over price and quality, undercutting many of the competitive benefits of a market.

Price interventions can render products unprofitable for suppliers, meaning that they stop offering them, or they stop marketing them. A large proportion of financial services firms' costs are marketing costs: in a crowded market taking place online and in branches, providers will push the most profitable products hardest. Price caps, such as those employed on stakeholder pensions, curtail marketing activity. Without this activity, consumers would not take such products up. Moreover price regulation would be unnecessary if the market can be made to work better, with healthy competition driving down prices.

The FSA is also considering mandating **'health warnings'** for products that are clearly detrimental to the vast majority of consumers. As the products would have to be poor choices for most consumers, the FSA's lists of products with health warnings would inevitably be very short. They would only prevent a very small number of potential buyers from picking the wrong product. The FSA suggests that traded life policy instruments, some of the more complicated structured products, and leveraged Exchange Traded Funds – higher risk products that are generally only a small part even of professional traders' portfolios – should go on the list.[32] However, health warnings could be extended to cover a much broader range of products, to help consumers segment the market into complex, niche products for those with very specific needs, and more straightforward products with features that most consumers may need. This is discussed in more detail below.

32 Ibid., 57.

The FSA could only **mandate advice** for a small number of products, because otherwise the cost of advice to consumers would be too large relative to the cost of the product, and the take-up of socially useful products would fall.

As a rule, most of these interventions would have to focus on niche products with a small market of mostly richer and more financially savvy consumers. In restricting choice or regulating price, the FSA would have to tread very carefully so that they do not restrict the take-up or sale of products that have a high degree of private and social benefit – simple savings and insurance products, in particular.

3. Regulating the intermediary market

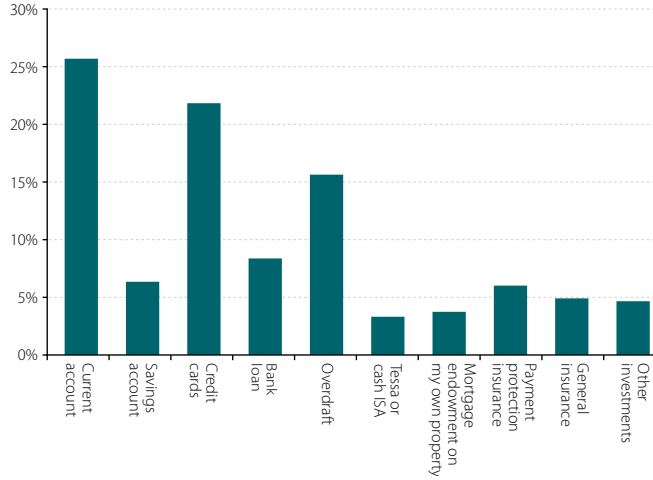
As described above, the intermediary market largely fails to alleviate the information asymmetry problems in the market because of consumer distrust of intermediaries themselves. The FSA is also seeking to rectify these problems. As noted above, the RDR is trying to realign financial advisors' incentives, by making them charge the consumer directly rather than taking a commission from the provider after a sale.

This is welcome, in that it will align IFAs' interests with consumers and remove the temptation to sell consumers products of limited value, simply because the commissions are large. However, it is also likely to reduce the demand for IFAs' services. Even allowing for an increase in IFA trust that could come from these changes, it seems certain that price increases for consumers will result in diminished demand for advice. The RDR will therefore create an information gap that needs to be filled – either by other forms of advice or by creating products that necessitate less advice in the first place.

Furthermore, consumers lack trustworthy information for a broad range of products, especially those at the simple end of the market – not just those that are so large or risky that they require a

visit to an IFA. Our evidence suggests that the breakdown in trust has stemmed predominantly from current accounts, credit cards, bank loans, overdrafts, and insurance products. Our survey asked respondents who said they had been treated unfairly in the last two years to say which product this experience related to (Chart 9). Niche products were less of a problem overall than products most people hold – because fewer people held them. But the problems that dog the niche markets and the widely held products are the same: mis-selling, price discrimination between choosers and non-choosers by non-transparent charging, and inert consumers. The market failures are broad, and consumers do not seek or cannot find information and advice at the simple end of the market. The RDR will not address this problem.

Chart 9: Unfair treatment in the last two years, by product



Source: SMF/YouGov, 'Trust in financial services survey', January 2011.

4. Making consumers savvier

Financial services firms, government and charities have expended a lot of time and money on financial education, in an attempt to make people more financially literate, and to encourage them

to compare and choose products on the market after they have reflected on their own needs.[33] Commentators, with the *Financial Times* in the lead, champion education and 'nudge' remedies to consumer apathy.[34] The relaunched Money Advice Service is working with employers, schools, youth agencies, corporations to teach young people financial skills.[35]

However, the evidence on the effectiveness of teaching financial literacy is mixed. The research that has been done has found a close correlation between financial literacy, socio-demographic status and the family wealth: a US survey found that a man with a degree, whose parents had stocks and retirement savings, was 45% more likely to know about risk diversification than a female with less than a high school diploma whose parents were not wealthy.[36] This, and common sense, suggests that financial literacy is highest among people who have the surplus funds necessary to take up complex financial products. Practice, rather than instruction, makes perfect.

Another US survey found that people were marginally more likely to take up '401(k)' pension products if employers offer them brochures or seminars to explain how they work.[37] This is however closer to advice than education: providing potential customers with advice on specific products is different to fostering consumers' ability to navigate product and intermediary markets. There appears to be scant concrete evidence that financial education works to effect wholesale change in consumer behaviour, despite the resources spent on it. And even if behaviour can be changed for a few people at the margin, it is clear that the unique nature of

33 Consumer Financial Education Body, 'Transforming financial behaviour', (London: CFEB, July 2010), 13.

34 *Financial Times*, 'Bank competition: a more dynamic UK market needs more aware consumers', 18th April 2011.

35 See the Money Advice Service website for more information. http://www.moneyadviceservice.org.uk/workingwithus/youngpeople/

36 Annamaria Lusardi et al, 'Financial literacy among the young', *Journal of Consumer Affairs* (2010).

37 James Choi et al, 'For better or for worse: default effects and 401(k) savings behavior', in David Wise, ed., Perspectives in the Economics of Aging (Chicago, IL: University of Chicago Press, 2004) 81-121.

the financial services market means that the advantages to those few will come at the expense of others.

5. Switching costs

As well as financial education, recent debate has focused on the need to reduce the costs of switching products as far as possible. The April 2011 Treasury Select Committee and ICB reports proposed portable accounts, where current account holders hold one account number, which they can then switch to another bank without significant disruption.[38] Any reduction in switching costs would be welcome, as consumers perceive them to be high, and it may boost switching rates. But if consumers continue to switch on the basis of headline prices, the damaging nature of current competition will not change, even as the intensity of it increases.

Moreover, consumers should not have to constantly check to make sure that the service they receive from financial firms is adequate, and that they are being treated fairly. In other services markets where information asymmetry is less prevalent, agent trust is generated by the agent providing a good quality service that the consumer finds satisfying, rather than changing the terms of the service over time or burying charges and poor terms and conditions in small print. Making firms compete over quality is therefore a policy imperative.

6. Simple products initiatives

The Government has tried 'simple products' initiatives over the last decade or more, with mediocre results. CAT standards were introduced in the 1990s for ISAs and in 2000 for mortgages. They mandated low, simple and clear charges, access and terms (hence the name) to make sure the consumer got a reasonable deal. Stakeholder pensions were introduced in April 2001. They attempted

38 Independent Commission on Banking, 'Interim report', 123; House of Commons Treasury Select Committee, 'Competition and choice in retail banking', 38.

to protect the consumer by capping annual management charges at 1%, allowing low minimum investments, and letting consumers move in and out of products and funds easily. The product's terms could not be changed over time. In April 2005, the stakeholder initiative was extended to cash funds, medium term investment products and Child Trust Funds, to try to boost medium term saving as well as that for retirement.

The Treasury recently concluded a consultation exercise on a new generation of 'simple products', focused on deposit savings accounts and insurance to protect against redundancy, illness or death.[39] It should heed the lessons learned from the failures of previous initiatives in their design, which are outlined below.

None of the government-sponsored 'simple products' on the market in the last decade have sold particularly well. After peaking at 1 million pension plans in 2004, stakeholder pension sales fell year-on-year, and by 28% between 2009 and 2010. CAT-marked ISAs only constituted 6% of the market in 2004. Both initiatives capped the charges at 1% of funds under management, with no up-front charges or charges through the administration of the policy.[40] This meant a wide difference in profitability for providers between these and other products.

The Government also insisted that CAT and stakeholder consumers should be able to switch products and providers without penalty. As might be expected for a product aimed at marginal consumers, most people who took up the products were on moderate to low incomes, and so the size of their contributions was small.[41] This made the initiative still less profitable for providers and hence unsustainable.

39 HM Treasury, 'Simple financial products: a consultation', (London: HMSO, December 2010), 14.

40 James F. Devlin, 'Literature review on lessons learned from previous "Simple Products" initiatives', (London: HM Treasury, December 2010), 11-12.

41 Ibid., 10.

As a result, firms did not bother to market them and consequently the initiatives tailed off. However, while unsustainable, these policies were not entirely unsuccessful. Stakeholder pensions were successful at driving down prices in the wider pension market. This was because they combined the fee cap with a regulatory 'benchmarking' requirement for the advisor to explain why they were recommending a pension product other than the benchmark, stakeholder pension. This regulation was known as RU-64.[42]

As a consequence, suppliers reduced the costs of non-stakeholder pensions, in order to be able to compete. Crucially, this experience demonstrated that by creating a benchmark product to establish a quality market norm, price competition can be stimulated around better products. Unfortunately – and ironically – that benchmark product proved unsustainable because government imposed a price cap upon it.

As our focus group showed, people desire fair products and transparent charging, but can be unwilling to pay for them. This problem will not be easily tackled. However, there is little evidence that mandating a combination of low prices *and* benchmarked products results in improved outcomes for consumers: without industry offering products and marketing them effectively, take-up will remain low.

Most of the six approaches outlined above are positive developments, but inadequate to the task of restoring trust and boosting the take-up of core financial products. A fresh approach to consumer regulation of financial services is needed.

42 Ibid., 18.

SMF POLICY PROPOSALS

Policy should instead focus on creating trustworthy products, without restricting consumer choice. Current product-focused proposals are either too narrow, or too heavy-handed: either tinkering at the furthest margins of the market, or restricting consumer choice.

So what should the government do about the broader market failure? The interlocking problems of information asymmetries, inertia, price discrimination and complexity dog the whole market, not just its fringes. Therefore, to tackle the low-trust equilibrium, the Government should focus on two main policy prescriptions that operate across the whole product market.

- Bolster product quality and pricing transparency by create a market-leading, **'trusted products' kite-mark**. To achieve the kite-mark standard, products must be designed so as not to exploit consumer inertia.
- Regulators should mandate the provision of clear, **trustworthy information** about competitor products at the point of every sale of every financial product to stimulate competition.

The 'trusted product' suite must not include price caps on products if they are to be sufficiently profitable for providers to become market leading products. Only by achieving this can trusted products drive competition throughout the product market in a way that benefits consumers, and rebuilds trust. Crucially, this is not primarily an agenda for extending product coverage at the margins of the market, but one focused on driving better competition for the vast majority of consumers who simply need fair and comprehensible mainstream products.

Reducing complexity and benchmarking trusted products

Drawing on the lessons of past experience, the Government should focus on creating a branded category of 'trusted products' with transparent charges and standardised quality and coverage, but without capping prices. This will mean that providers have the incentive to market them, because they will carry a similar margin to other, more complex products.

Central to the concept of the trusted product suite is the idea that products should be designed in such a way as not to exploit consumer inertia through time-limited deals, small print, or uncertain AER variability over time. Trusted products should act as a benchmark across the full range of product types: from current accounts, ISAs and other savings products, through to credit cards, loans and insurance products.

But past experience suggests that developing government-approved kite-mark alone will be insufficient to develop new norms in the market. There are other lessons from effective past policy which should be combined with the trusted products approach.

Crucially, any product that does not receive a trusted product kite-mark should have a warning attached. Mandating and extending the benchmarking principle will mean that suppliers will have to explain clearly how their alternative product differs from the closest comparable trusted product. For instance, when advertising a non-kite-marked ISA, the provider would have to alert the consumer to the teaser rate (see Figure 1). Mandating this kind of benchmarking should help consumers to navigate the market as well as increase the take-up of trusted products, leading consumers to ask: "do I need this more complex product?" and "even if it seems cheaper, will I end up paying more?" In this way the trusted product norm combined with mandatory benchmarking should also narrow the difference in price between trusted and complex products, as firms compete.

Figure 1: ISA benchmark example

Product warning!	The APR on this ISA only lasts for a year. Thereafter it can fall. The APR on a 'Trusted ISA' only changes when the Bank of England's interest rate does.

In developing a category of trusted products that can help to steward the market, the Government should adhere to the following guidelines:

- Pricing structures for trusted products should be standardised. The consumer should be made aware of all of the different prices, charges and interest rates up front, upon buying the product. There should be only one price, for the sake of simplicity, where possible: application fees, insufficient funds charges and 'teaser rates' should be folded into a single interest rate.
- As well as avoiding teaser rates, trusted products would not involve uncertain interest rate variability. Interest rates on such products should move with the Bank of England's base rate, rather than because firms are seeking to make a product more profitable after its sale and betting on consumer inertia.
- Where possible, consumers should have easy access terms: minimum transactions sizes should be as low as the leading non-kite-marked product on the market. Consumers should be able to switch easily between products.

This would lead the Government to create kite-marks for the following kinds of products on these criteria:

- Kite-marked cash ISAs and savings accounts would have a fixed spread over the Bank of England's base rate. At present, this spread would be around 1% for most banks. Thus, when credit conditions in the wider economy changed, so would the interest rate, removing the problem that the product becomes a poorer deal over time. Trusted products would not feature teaser rates, designed to take advantage of consumer inertia.

- 'Trusted' current accounts would have no unauthorised overdraft or insufficient funds charges. They would instead offer a clear APR on authorised overdrafts and positive balances. The overdraft APR would be higher than for most existing current accounts, reflecting the reduced revenues to the bank from charges.
- Pension holders should be able to stop, start or change their payments without notice under the trusted product kite-mark. They could also switch at short notice from one provider to another.
- Kite-marked mortgage products would only be available in four forms to aid understanding about their differences between the main product types: fixed, variable, interest-only and repayment. There would be no application fees: all costs would be rolled into the interest rate offered on the mortgage to aid comparability.
- Kite-marked insurance policies would have a standardised level of coverage and excess, aiding comparability and allowing price competition to proceed without prejudicing product quality.

These types of products would create simple benchmarks against which all other products would be compared. Deviations from these rules would have to be briefly explained by providers at the point of sale to comply with the benchmarking rules. Kite-marked products might have higher headline prices than others offering teaser rates or other temptations, but consumers would have at least been alerted to the risks associated with 'non-trusted' products. Allowing firms to make a decent margin on such products should also ensure their sustainability and make their marketing worthwhile.

By establishing market norms of transparent charging, easy access and fair terms, without mandating prices, the market should establish itself around products consumers can trust. Trusted products would become the norm against which others would

be compared, and consumers would be easily able to differentiate trusted from other products. To help to create these benchmarks, the Government needs to create a brand for the products, as James Devlin suggests in his review of 'simple products' for the Treasury.[43] But policy should go further.

Encouraging active choice and competition

With quality assured through the trusted products kite-mark, the second element of a successful trust strategy is to boost competition between providers. However, the focus should primarily be on reducing the uncompetitive practice of cross-selling to existing consumers, instead of trying to boost switching rates. Making inert consumers switch is difficult. But encouraging and facilitating first time buyers to seek out competitive deals will put pressure on providers to reduce their prices.

Cross-selling is essential to the industry as a whole, as firms make massive revenues by using their privileged marketing position to sell to existing customers. Therefore, trusted products are not enough on their own to shift the market towards competition that reduces prices while sustaining quality: it is also necessary to make people choose more frequently.

Past experience suggests that it is both possible and desirable to tackle cross-selling through an extension of the 'open market option' (OMO) promoted to people buying annuities. This has been a major feature of the pensions market since 1975. It mandates that pension providers let consumers who are about to turn their pension savings into annuities know that they can check other providers on the market to achieve better value for money.

Similarly, the regulator should mandate that all products advertised tell the consumer that they may want to compare the promoted

43 Ibid., 15.

product with alternatives available on the market. This would reduce the competitive advantage that firms create by cross-selling new products to pre-existing customers. When existing customers receive an advert by email, in the post or online, their attention should be drawn to alternatives in the marketplace that may offer a better deal.

In the abstract, the idea of comparing the market is unlikely to have a powerful effect. But by linking the OMO to a trusted intermediary offering generic advice and price comparison, the measure could be extremely effective in promoting competition. As demonstrated in Chapter 3, consumers are ambivalent about how trustworthy privately run price comparison websites are, so the Government sponsored information service, the Money Advice Service, has a key role to play in boosting the availability of trustworthy information. Under the proposed integrated system, whenever a consumer receives any product advertisement or information online, a link to the Money Advice Service would be provided, with text showing that alternative products were available for comparison there. The OMO information could be provided with the benchmark next to each advertisement (see Figure 1).

The scope for encouraging consumers to shop around is substantial since the internet has become a key tool for the provision and marketing of financial services. The number of adults using internet banking services grew by 500% in the seven years to 2008. Twenty-one million adults, or 42% of the population, used the internet for financial services in 2008.[44] This proportion will surely continue to rise, offering the prospect that the OMO can be a powerful and costless tool to disrupt cross-selling, which is to the detriment of consumers. If the Money Advice Service site becomes the market leader in product comparison, and all consumers on the market directed to it via clickable URL links, it will significantly boost

44 *Financial Times*, 'Criminals target online banking', 26th July 2008.

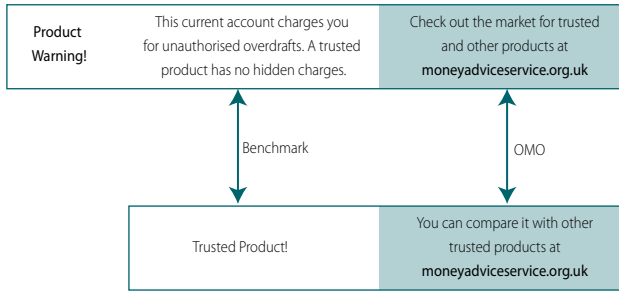
price competition. At the same time the 'trusted products' initiative will ensure that this does not come at the expense of quality.

How would the trusted products agenda and OMO work in practice?

The way this process would work from the vantage point of the consumer is laid out below. A consumer would enter the market, say, through a provider's internet site. Whether or not the product advertised were a 'trusted' product, the consumer will be given the option of either:

- Comparing products at the Money Advice Service, through the open market option; or
- Heeding the benchmark warning, and going for a 'trusted' product – either with that provider or another. (See figure 2.)

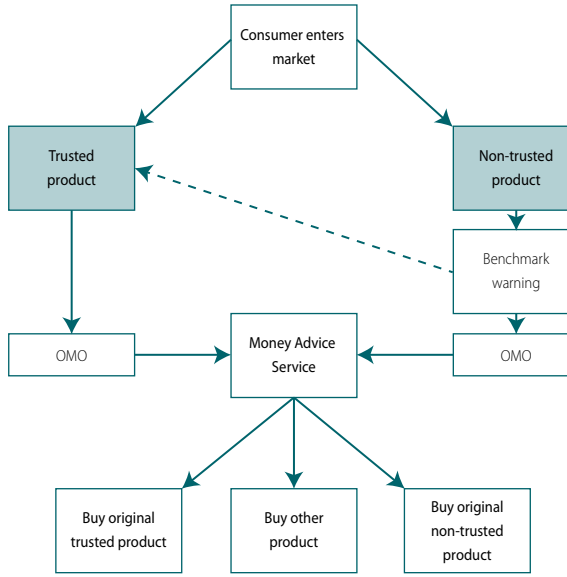
Figure 2: The open market option and benchmarking in practice



This process should make clear to consumers that they are buying a product where they should be wary, and give them an easy choice to go for a trusted product, or to choose a different but more competitive non-kite-marked product at the Money Advice Service site. If after that, they choose to go for the original product, they have at least been offered easy access to alternative products on the market.

Under the proposed system, the consumer in the market for a trusted product can go straight to Money Advice Service and compare it to others. The route for consumers seeking either a trusted or other product is laid out in Figure 3. This process should stimulate competition, help to drive down the cost of trusted products, without encouraging hidden charges or reduced coverage, as currently happens.

Figure 3: Consumer decision tree



This set of policies connects up the concepts of trusted, kite-marked products, mandatory benchmarking against them for alternative products, the extension of the open market option, and the Money Advice Service website, all in the context of a market place that is rapidly moving online. This holistic and co-ordinated approach offers the prospect of a market that functions much more effectively and in the interests of consumers, and restores consumer trust.

Conclusion

Contrary to expectation, it appears that the financial crisis had no persistent impact on consumer trust in banks. But it is clear that for a range of reasons, trust in financial services has been low for a long time. That distrust arises out of the information asymmetries that are rife in financial services, and the on-going nature of the products involved.

Poor consumer outcomes from financial services markets have been the focus of policy attention for some time, with little success. And there are many new policy initiatives in the pipeline, which risk making the same mistakes. Some will be beneficial, but none will tackle the causes of consumer distrust holistically.

The RDR will seek to ensure that advice is unbiased, but in doing so will create an advice gap. The ICB proposals for a more competitive banking sector risk exacerbating the cross-subsidies that currently make consumers understandably suspicious of providers. FSA plans to supervise the market through 'product intervention' risk being either heavy handed or irrelevant to the mainstream of consumer finance, where trust is weakest. The educational efforts of the Money Advice Trust are welcome, but will have no more than a marginal impact. Meanwhile the Treasury is considering improvements to previous 'simple products' initiatives. But the product range being considered is limited, and simple products aimed at marginal consumers will do little to address endemic distrust in the market.

These approaches tend to tackle the fringes of the trust problem, rather than its underlying causes, and implicitly assume that the mainstream market works well. But this premise is faulty. Rather, distrust, which hampers take-up, stems from the nature of all financial products.

The challenge for policymakers is to make the market work better across the board by cutting through the information asymmetries, and making shopping easier, rather than wishing away consumers' rational inertia. The proposals outlined in this report have the potential to do just that, and in doing so rebuild trust in the consumer finance market, for the benefit of everyone.

PART TWO

EXPERT ESSAYS

CONSUMER TRUST
1: COMPETITION AND THE CONSUMER

Peter Vicary-Smith

The general public's trust in the banking system is at an all-time low. Indifferent customer service, low savings rates, exorbitant bank charges and rocketing mortgage fees have left many asking why they were forced to bail the banks out after the financial crisis, and what they're getting in return. Consumers feel disempowered, frustrated, and fed up of being cash cows – they go into a branch to open a savings account, not to be pressured into buying pet insurance.

Financial services form an integral part of our modern economy; they are essential to allow us to live our daily lives and meet our aspirations. These financial services range from the mundane, 'utility'-like services of a current account to the complexities of choosing a mortgage, investment or insurance to support your family. In all cases consumers want to be able to trust their bank and rely on it to guide them through difficult decisions and stand by them when times are tough.

Public mistrust in the banking sector is nothing new. When Lord Myners gave evidence at the Which? Future of Banking Commission in 2010, chaired by David Davis MP, he referred to banking industry research from the early 1990s that asked bank customers: 'If your bank discovers it has made a mistake on your account, and that mistake has favoured the bank, do you think the bank would return the money if you hadn't noticed?' 80% of customers said 'no' – the banks would not volunteer to return the money. In Lord Myners' view, that was a low point, but there is now even less confidence in the banks.[45]

45 Lord Myners, Evidence to the Future of Banking Commission, 18th March 2010. http://www.which.co.uk/documents/pdf/future-of-banking-commission---evidence-session-18th-march---lord-myners-209873.pdf.

Trust means different things: trust in the banking system as a whole; trust in the competence of banks to deal with routine tasks, such as transferring our payments; and, finally, trust in banks to make our money work for us. The crisis has led to a breakdown of trust, needing unprecedented public support to rescue the banking system, disruption to customers from failed banks and a deep seated concern that banks have been playing fast and loose with our money. In each case the prevailing fragility and further weakening of effective, meaningful competition erodes this trust further: undermining the incentives for banks to earn trust and the incentives for consumers to reward trustworthy banks. Steps to strengthen competition will, by default, strengthen trust as it will be consumers in the driving seat, not banking executives.

So what's gone wrong? And could greater competition in the banking sector boost consumer trust? There is a common misconception that the banking sector is fiercely competitive, with numerous players all vying for consumers' hard-earned pennies. But this simply is not the case. Since the financial crisis, there has been a sharp increase in the concentration of key retail banking services. By 2009, the big five banks (Lloyds Banking Group, RBS, HSBC, Santander and Barclays) had an estimated market share of 83% of the personal current account (PCA) market and 77% of the mortgage market. Of this, Lloyds alone has a 28% share in the PCA market and 25% share in the mortgage market. The big banks have not achieved this increased market share by winning new customers through better value products or good customer service; they have gained these huge numbers through an increase in mergers. There have been fourteen since April 2008.

This consolidation has greatly benefitted the banks – indeed, the retail arms of the big banks remained profitable throughout the financial crisis. However, this benefit has been at the expense of consumers, who have suffered from worsening product terms as banks have increased margins. On personal current accounts, the overall

level of in-credit interest payments has fallen while the structure of charges has changed, sometimes for the worse. According to the Bank of England the average authorised overdraft rate on current accounts is 19.08%, higher than any rate for the last fifteen years. On mortgages, banks have increased their margins so that, while they now lend less, they make more money from each customer.

So, while Which? satisfaction surveys consistently show poor performance scores for the largest high street banks and worsening product terms for their customers, the banks themselves have thrived – and the retail arms of the big five banks have performed especially well financially. The big losses made by the banks were in their investment or wholesale banking arms.

Profit performance alone is not sufficient to draw conclusions as to the competitive health of an industry. It is, however, grounds to raise challenging questions:

- How has the retail banking industry made such significant profits, in such a short period of time, when customer service and product performance is exceptionally weak? In most industries, unhappy customers and poor quality products lead to falling profitability (and market share).
- To what extent have the changes in market structure played a direct role in increasing profitability? Market power can directly contribute to excessive pricing.
- Does the continued state support of banks enable exceptional profit performance?
- Are retail customers paying the costs of recklessness or incompetence in the investment or wholesale banking arms of the largest incumbents?

Competition and the consumer

The lack of effective competition also gives banks little incentive to improve their service over time in response to customers' needs

and to innovate in ways that improves both customers' experience and their bank balances.

Concentrated markets often suffer from an 'x-inefficiency', where the cost-base of firms in those markets becomes bloated or excessive. We can see this in the banking industry in the form of:

- Persistent and high-level bonuses, especially for investment banking (a banking service intrinsically linked to the crisis). These bonuses are part of banks' cost base, yet appear to be unconstrained by any market process or innovation to reduce these costs.
- Industry inefficiency or incapability to improve services on which customers rely. For example, the Office of Fair Trading (OFT) recently investigated the speed of ISA savings transfers, and has agreed changes to speed up the system without this intervention, it seems the industry would not have adopted any improvements.

There are some indications of innovation: for example, the Barclaycard touch and pay service that allows payment for small items without using a pin number. However, there has been no detailed investigation of bank efficiency in the decade since Don Cruickshank was asked to report on the state of competition in the banking market over ten years ago.

We believe it is critical that the Government and regulators take steps to increase competition so that consumers get a better deal and to support economic recovery. Which? has identified a number of ways in which reform of the retail banking sector can promote competition. These ideas are explored in turn below.

- **First**, the government should introduce a public interest test for the disposal of UK Financial Investments Limited (UKFI) shareholdings and the divestments of Lloyds branches, so that these disposals increase competition.

One of the major barriers preventing new entrants from gaining a foothold in the retail banking market is consumers' preference for banks with extensive branch networks. The Government has a once-in-a-generation opportunity to address this barrier and encourage new entrants through the disposal of government-owned stakes in banks. However, the initial signs are discouraging, and it seems that UKFI is showing a worrying disregard for its objective to promote competition.

As part of the agreement to benefit from state aid, RBS was required by the European Commission to sell certain branches. Which? viewed this as a prime opportunity for a new entrant, so was extremely discouraged by the announcement that RBS will sell 318 branches to Santander, especially as Which?'s satisfaction surveys have consistently rated Santander among the worst performers.

Which? believes a change in approach is needed for future sales, and to tackle the situation when the Government divests its public ownership of banks. We want UKFI to apply a public interest test to its disposal of shareholdings and the branch divestments required by the European Commission that balances the needs of current and future consumers. The public interest test should include objectives to make competition stronger post-divestment and the withdrawal of state aid, and place consumers' needs at the heart of a transformed banking system.

In addition, we think there should be a detailed examination of the benefits of more significant market re-structuring and, in particular, a break-up of the Lloyds Banking Group in light of the unprecedented change to market structure caused by its merger with HBOS. Which? argued strongly during the course of the merger that special measures should be put in place to tackle the consequential harm to competition, and was extremely concerned when no such measures were taken. This merger has had a material

impact on the nature and prospects for competition and the size of the merged bank has significant implications for financial stability. A detailed examination of whether Lloyds Banking Group should be re-structured to restore competition is now overdue.

- **Second**, the Government should give the Financial Conduct Authority (FCA) the power to assess charges.

For competition to be effective, consumers must be able to compare and contrast the different features of the products available. This will allow better value and better quality products and providers to gain market share. However, at present the lack of transparency in financial services, and in particular the levying of unfair charges, causes problems for consumers and prevents them from understanding whether they are getting a fair deal.

Which? is concerned that consumers are going to face an increasing trend in opaque ancillary pricing (charging for extra items not included in the headline price) following the Supreme Court's ruling on unauthorised overdraft charges. This case determined that the OFT cannot assess ancillary price terms for fairness, and has taken away a significant tool from the regulator's kit. It will, as a consequence, be difficult for regulators to make the banks act in any meaningful and beneficial manner to reduce the opacity and level of charges.

Using the example of unauthorised overdraft charges, despite declarations of intent from the Government and the OFT, charges are still unacceptably high. Indeed, the OFT found that these charges provided £2.5 billion in revenue in 2009, only slightly down from the £2.6 billion made in 2006.

Furthermore, banks are introducing increasingly complex charging structures which mean consumers may find it difficult to determine which charging structure suits their needs. In December

2009, the Halifax brand of Lloyds Banking Group introduced an authorised overdraft policy of a minimum £1 per day fee for all of its current accounts. Ostensibly this is a simpler, more transparent overdraft policy. However, a consumer would need to have an overdraft of nearly £2000 in order to pay less than the market average authorised overdraft rate (around 19%). This means around 90% of consumers who regularly use an overdraft are likely to be significantly worse off.

In order to address this issue and ensure transparent and proportionate ancillary charges, the legislation for the Financial Conduct Authority should amend the consumer protection regulations and give the regulator the power to assess ancillary terms relating to pricing for fairness.

- **Third**, the FCA should have an objective to promote competition.

Unlike many other regulators, the Financial Services Authority (FSA) does not have concurrent competition powers with the OFT. This means it is unable to directly apply competition law, including referring markets to the Competition Commission. As a result, when detriment arises, the FSA has to refer issues to the OFT who then conduct detailed inquiries and make recommendations for change. Consumers should not have to wait that long – and besides, we'd argue that prevention is far better than cure.

Taking the issue of ISA transfers as an example, the ability to quickly transfer between providers is key to encouraging consumers to switch products, therefore promoting competition in the market. Under the current regime, the FSA made rules which required banks to offer a 'prompt and efficient' service for ISA transfers, but then allowed the banks to codify existing industry guidance which gave them the leeway to take a month to complete the process. Action was not taken to speed up the process until a

super-complaint led to an OFT investigation. If the FSA had a duty to promote competition it would have encouraged the regulator to look at the impact of its rules, and to take action when it introduced them, to ensure they promoted competition in the market, rather than waiting for the OFT to get involved. The FSA should be forcing the banks to introduce an electronic system for ISA transfers so that they can be completed quickly and efficiently.

In order to address the gaps in the regulator's powers, a solution would be for the FCA to have a duty to promote effective competition. It should be given the necessary powers to fulfil this role, including the ability to apply specific licence conditions to banks, and to exercise competition and consumer protection legislation.

- **Fourth**, the FCA should introduce new measures to aid switching from one bank to another.

To incentivise banks to become more focussed on providing good services and products to consumers, it is necessary to explore ways in which we can encourage switching from one bank to another. Switching volumes remain low, with switching rates amongst Which? members averaging 6% per year. Our research suggests that the two key factors that discourage switching are doubts over whether the switch will be financially worthwhile, and concerns over the risk of errors affecting their regular payments. Meanwhile, the two main factors driving consumers' choice to switch was to obtain better customer services or a better credit interest.

To make switching more appealing, the regulator needs to address the lack of information that consumers receive on their own use of bank accounts, which is vital if they are to make easy comparisons. For example, recent research by Which? showed that if everyone with easy-access and notice savings accounts and cash

ISAs moved their money to best rate versions of those accounts, British savers would be £12 billion a year better off – equivalent to £322 for every saver. Action is also needed to address anxiety about the switching process, and in particular the problems a significant minority of people experience with direct debits or standing orders being transferred incorrectly. Regulators have concentrated on trying to speed up the transfer process but we believe consideration should be given to the introduction of 'portable account numbers', allowing consumers to switch their account without the worry of transactions going wrong. Increased consumer financial education should also help, so we believe the new financial health-check service should heavily promote and aid switching.

- **Finally**, banks should be allowed to fail in a safe way that protects our financial system and not bankers' bonuses.

The Government's intervention during the financial crisis has created distortionary subsidies: directly through state aid bailouts, and indirectly by reducing funding costs to the largest market incumbents, thereby strengthening their market power. The Bank of England estimates that the subsidy for the biggest five banks in the UK amounted to £50 billion in 2008 and over £100 billion in 2009. This subsidy erodes the ability of small or new entrant banks to become serious challengers to the large, established incumbents. Virgin Money, for example, estimated private equity investors demanded a 10–13% higher cost of capital from new entrants than from the largest incumbents.

Finally, if we are to ensure a competitive market in the future we need to introduce an effective regime to enable market exit by failing banks (whether due to poor management or dissatisfied customers) while preserving financial stability of the economy as a whole. In order to ensure banks can fail without causing excessive consumer detriment, living wills need to include measures to

ensure the fair treatment of customers. In addition, steps need to be taken to ensure a fit-for-purpose deposit guarantee scheme. Deposit protection needs to be 'per brand' rather than for each banking licence. Consumers shouldn't need to go into the detail of how their bank is authorised to find out if their deposits are protected.

Robert Peston, BBC Business Editor, giving evidence at the Future of Banking Commission said, "it is absolutely extraordinary given all this useful stuff they *[banks]* do that their reputation is so unbelievably poor. And you have to say that they've worked very, very hard at doing themselves that reputational damage given that they start from a base of doing some bloody useful things".[46]

Competition is a dynamic process of rivalry that rewards firms that deliver good value and quality to consumers. Firms that do not serve consumers well *should* fail.

Which? considers the evidence of poor competitive outcomes for banking services is incontrovertible. Banking markets have been subject to weak competition long before the financial crisis. However, the crisis has exacerbated these harms to a critical level, and now, something must be done.

It is certainly true that consumers need to do more – inertia to switch is such that they are reducing the incentives for firms to actively compete amongst each other. However, the blame can't solely be laid at their door.

Consumers will only start to regain trust in banks once they see better deals and better customer service. Promoting effective competition can help in this regard if it makes banks and the

46 Robert Peston, Evidence to Future of Banking Commission, 18th March 2010. http://www.which.co.uk/documents/pdf/future-of-banking-commission---evidence-session-18th-march---robert-peston-209921.pdf.

system as a whole more responsive to their needs and works more in the interests of consumers. In short, we should all be working towards a virtuous triangle. We need a different approach to regulation, effective competition and better-educated consumers. Only then will we have a banking system we're truly proud of. The banks have spent the last two years charging consumers extra in an attempt to rebuild their battered balance sheets (whilst at the same time paying high bonuses). We believe now is the time to start rebuilding their equally bruised relationships with customers too.

2: HOW CAN FINANCIAL EDUCATION BOOST TRUST?

Chris Pond[47]

Is lack of trust in financial services discouraging people from taking up the opportunities that financial products – bank accounts, insurance or pensions – might offer? Much effort and resources have been devoted by policymakers in recent years to tackle financial exclusion.

According to the Treasury's Financial Inclusion Taskforce, the number of adults living in households without a transactional bank account fell from 3.57 million in 2002/03 to 1.54 million in 2008/09. The number of adults living in unbanked households has fallen by over a half and now represents 3% of the population, compared to 8% in 2002/03.[48]

In part, this is the result of the Department of Work and Pensions' (DWP) 'Payment Modernisation' programme, transferring millions of claimants from pension books and giros into bank accounts and the (non-transactional) Post Office Card Accounts.

Yet, in addition to the 1.5 million adults who do not even have access to a bank account; 7.8 million people are unable to access mainstream credit, being forced into the hands of doorstep lenders, loan sharks or the generosity of friends and family. It has been estimated that people on benefits borrow £330 million a year on home credit, paying £140 million in interest.[49]

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47 Chris Pond is Head of Consumer Affairs and former Director of Financial Capability at the Financial Services Authority. He is a Trustee of the charities Credit Action and of the Family and Parenting Institute. He was previously MP for Gravesham and a Work and Pensions minister, responsible amongst other things for the DWP Payment Modernisation programme and the Social Fund. This paper is written in a personal capacity.

48 Financial Inclusion Task Force, 'Banking services and poorer households', (December 2010).

49 National Consumer Council, 'Affordable credit: a model that recognises real needs', (August 2005).

Without access to financial services, people's lives are inevitably diminished: as well as paying high rates of interest when they need credit, people are left vulnerable to the unexpected (unemployment, ill-health, relationship breakdown or natural or domestic disasters). They cannot take advantage of the security that insurance or decent pensions can provide. Despite widespread scepticism about banks and other financial institutions, to misquote Erasmus: "Banks: can't live with them, can't live without them".

The drift of public policy under successive governments towards promotion of personal responsibility and away from state provision increases the need for people to purchase or invest in financial products. Those without an adequate private pension can no longer rely on the state to provide a comfortable retirement; those who lose their jobs can no longer expect the DWP to step in to meet their mortgage commitments; and there is increasing emphasis on the need to insure against sudden drops in personal income, arising from unemployment, illness, relationship breakdown or, indeed, natural disasters.

The FSA's Financial Capability survey suggests that much of the UK population is ill-equipped to make such provision: 70% had made no personal provision to cover an unexpected drop in income, and that this was true of people of all income levels. Nearly half of the population have no savings at all. [50]

There is still a good deal more that the conventional financial services industry can do to extend access to bank accounts, as well as new sources of affordable credit and other products to those currently outside the system. Yet the early emphasis on promoting the supply of such services, for instance through ensuring that ATM machines are available in even the most deprived areas, has more

50 Financial Services Authority, *Financial capability in the UK: establishing a baseline*, (London: Financial Services Authority, 2006).

recently switched to a focus on constraints on the demand side: how do we persuade people to purchase or invest in such products?

Engagement with the financial services industry, whether through a bank account, insurance policy or pension, is critically dependent on the extent to which the providers of these products are perceived as trustworthy. This is particularly important in the case of long-term investments, such as life policies and pensions, where the individual has to trust the provider to make the right decisions on his or her behalf. Yet the FSA's Consumer Awareness Survey (based on almost 2000 face-to-face interviews) shows that little more than half (54%) of consumers are confident that firms treat customers fairly, while 15% are not at all confident that this is the case (a quarter didn't express a view). The proportion confident that the firms with which they personally have dealings had treated them fairly increased to nearer 60%.[51] But for those taking up products for the first time, whether the industry as a whole is trustworthy may make the difference between taking it up and staying excluded.

Many groups continue to resist engagement with financial services through lack of trust and the costs – to them as individuals, to the wider economy and to the industry– are considerable.

What then is to be done?

Over time, the greater emphasis of the FSA as regulator on conduct issues, backed by more intrusive supervision and the creation of the new Financial Conduct Authority, will help to improve consumers' experience of financial services, their perception of the trustworthiness of the industry as a whole and their confidence that things will be put right when they go wrong. But trust in financial services and consequent increased financial inclusion will depend also on an improvement in consumers' own confidence in financial

51 FSA , 'Consumer awareness of the FSA and financial regulation', (September 2010).

management. This is where investment in financial education and financial capability is so important.

Individuals who lack the confidence or knowledge to manage their financial affairs are more vulnerable to a lack of trust in financial providers and are less likely to behave as active participants in the market for financial services. They will be more reticent to purchase products and less likely to shop around for the most appropriate product to suit their circumstances.

Financially capable and confident consumers are necessary for an effective market. They are more likely to engage, firms are more able to develop practices that better suit the needs of their customers and the need for regulatory intervention is reduced.

The state can help to improve financial capability. In 2009 and 2010, the FSA ran a pilot to test how best to provide a money guidance service – either via telephone, face-to-face or on a website. Over the 12 months of the pilot, the service delivered over 570,000 Money Guidance sessions to approximately 220,000 people. The independent evaluation of the pilot, which has subsequently been rolled-out nationally, indicated that the financial capability of those attending the sessions had improved as a result. Moreover, a fifth (21%) subsequently went on to apply for, buy or change a financial product (including opening an account).[52] Thus, improved financial capability can itself assist financial inclusion.

Behavioural economics has been used to explore the most effective ways of improving financial capability. The first lesson is that people will tend to act only if they trust the person or organisation encouraging them to do so. Research suggests that sometimes the perceived expertise of the person delivering the message is more important than communication skill. The perception of expertise may

52 FSA , 'Consumer awareness of the FSA and financial regulation', (September 2010).

be linked with trust. Evidence suggests that people in lower socio-economic groups are more sensitive to the messenger being someone like them (in age, gender, ethnicity, social class/status, culture, profession, etc.). 'Word of mouth' messages seem to be particularly effective for young people and those with financial difficulties. It may be possible to encourage this effect, by interventions relating to social norms. Interviewees said that trust and rapport are crucial.[53]

The FSA built on this approach in developing the National Strategy for Financial Capability by ensuring that its financial education was delivered through 'trusted intermediaries'. Midwives handed copies of the *Parents Guide to Money* to new parents; Macmillan Cancer professionals provided information to patients and carers; youth workers were the principle channel for getting information to young people neither in education, training or employment.

At a local level, community organisations, sometimes operating as Credit Unions, may provide the focus for the delivery of financial services in a way that people trust. Financial providers themselves could do much to work with trusted partners to overcome the lack of confidence that many have in the industry itself.

But the most important lesson is that people need the confidence themselves to participate in financial dealings: to manage a bank account, to insure they have adequate and appropriate insurance to protect themselves against unexpected life events, to provide themselves with security in retirement. Lack of financial capability amongst the UK population, profound though it is, cannot be blamed for the financial meltdown. But financial education could help people to protect themselves against the worst effects of the next crisis, whenever it comes. And it could be one way in which trust and confidence in financial services, so badly damaged by recent events, could be rebuilt.

53 Consumer Financial Education Body, 'Transforming financial behaviour', (July 2010).

3: TRUST AND FINANCIAL EXCLUSION

Brian Pomeroy

Introduction

Many people harbour negative feelings towards the financial services industry. These sentiments pre-date the recent crisis but have been magnified by it. Generally, they do not prevent existing customers of banks, insurance companies and investment firms from continuing to use their products. However, there is a group of people who are disconnected from financial services and whose mistrust of the industry significantly deters them from taking up those basic financial products, such as bank accounts and insurance, that most people would regard as essential for life in the twenty-first century.

Financial inclusion and why we need to tackle it

The 'financially excluded' suffer from a lack of access to mainstream financial services. Those without a bank account can struggle to find work, since an employer can insist on paying an employee through a bank account. The 'unbanked', as they are known, may also have to pay more for basic services such as energy, water and telecommunications because they cannot pay by direct debit. Your money is obviously less safe physically if you keep it at home rather than in a bank. And there are some services that the unbanked cannot buy at all. For example, they cannot get mobile phone contracts and have to use more expensive 'pay as you go' instead. Often, too, insurance is only available if regular premiums are paid though a bank account. And people who do not have access to mainstream financial services, but need to borrow money – often small amounts of unsecured credit necessary to smooth fluctuations in household income and expenditure – have no alternative but to pay high charges to sub-prime lenders or, in some cases, be forced into the hands of extortionate illegal moneylenders.

Financially excluded people are mainly in the lowest income groups and among the most deprived in society. Financial services can be compared to utilities such as energy and telecommunications, – basic infrastructure to which *everyone* needs to be connected, or at least have the opportunity to be connected in to our society and economy.

During the last six years, the Financial Inclusion Task Force has overseen a series of measures to bring the excluded into financial services. That does not mean that everybody must have a bank account, a savings account or an insurance policy, but it does mean that everyone should have the opportunity to do so if they believe they could benefit from it. A central part of this initiative was an agreement, reached between the Government and the major banks in 2004, to halve the number of people who are unbanked (defined as adults in households where there is no bank account). At that time, there were 3.75 million adults in this situation. The goal was met two years ago and credit should go to many people and organisations, including the banks themselves, who helped achieve this. But even now, there are still over one and a half million unbanked people in Britain and, even taking account of the substantial progress that has been made in bringing the number down, this is still far too many. There are still obstacles to be overcome in promoting measures to reduce financial inclusion – and one of them is a lack of trust in the financial services industry itself.

Barriers to inclusion

When the current initiative to reduce financial exclusion began, it was clear that the industry itself had erected barriers to inclusion. For example, the banks required potential customers to produce documents such as passports and driving licences in order to verify their identities as new account-holders – documents that many financially excluded people, who are generally in the lowest income groups, often do not have. Many staff in bank branches were

anything but welcoming to people on low incomes who did not look as if they fitted an assumed profile of their customers. Branches did not make information about suitable products for people on low incomes readily available and there was no guarantee that a customer would be offered a product that was suitable for them. Much of the progress that has been made in reducing the number of unbanked has been the result of tackling and bringing down these 'supply side' barriers, and the banks themselves have played a major and constructive role in achieving this.

Why trust matters in financial services

Why do we make so much of the need for "trust" in financial services? After all, we have to trust many other firms that supply us with goods and services, like those that produce and distribute food, for example.

Apart from the obvious fact that financial firms have possession of your money and you expect them to look after it, there are features of the industry that distinguish it from many others. First and foremost, when someone opens a bank account, they do so in the expectation (shared by the bank) that there will be an enduring and probably long-term relationship between supplier and customer. During that time the customer will be subject to the terms, conditions and business practices of the bank. Ending the relationship is not as simple as switching supermarkets. Changing one's bank is perceived to contain risks – for example that transactions will not be properly rerouted. Although it is now much easier to move to another bank than it used to be, most people are extremely hesitant to do so: the amount of switching that actually takes place is relatively small. In pensions and other long-term savings, it may be many years before the customer learns whether what they bought actually performed as claimed or expected – and throughout this period they need to trust their provider to make the right investments. There is therefore a special need for trust and confidence in whomever provides them with financial services.

Alongside supply side barriers, however, there have also been severe obstacles on the demand side, and it is these that are most relevant to the theme of this paper. Many people outside

the financial services fence do not readily come forward to take up products, even when supply side barriers have been removed. There are many reasons for this. Some people are simply unaware of the existence of financial products and of how they might be useful to them (underlining the importance of increasing financial capability). Even if they are aware of mainstream financial products, low income groups often see them as being "not for people like us – banks are for rich people, aren't they?". Sometimes they do not feel sufficiently self-confident to go into a bank branch. But often they simply hold a mistrust of financial services firms, to the point where they will not feel comfortable engaging with them at all.

Experience of trying to reduce the number of unbanked is illuminating in understanding how a lack of trust prevents people from taking up services even when they could benefit from them. Last year, the Financial Inclusion Task Force undertook research to establish what proportion of the remaining unbanked recognised the benefits of having a bank account and could therefore potentially be brought in. It appears that about half of them would open a bank account if the right product were available from an acceptable supplier. The research also makes it clear, however, that there is considerable reluctance to doing so through one of the mainstream banks. Many people who are outside or on the margins of banking have heard accounts of difficulties experienced by friends and relatives who have opened bank accounts. In some cases they will have experienced problems themselves. A striking fact to emerge is that six of every ten people who are currently unbanked have at some time held a bank account, but abandoned it because of a poor experience, very often in the form of unexpected charges imposed when, for example, there was insufficient money in their account to discharge a direct debit payment.[54] They are also strongly influenced by what they read in the press. People who have become used to managing their money in cash have a justifiable fear that they may lose control of their finances

54 Financial Inclusion Task Force, 'Banking services and poorer households', December 2010.

when they open a bank account and are resentful when such loss of control leads to financial penalties that, while bearable by middle income groups, are sufficient to throw their own tight household budgets seriously out of kilter.

Thus, when financially excluded people say that they do not trust the banks, they do not necessarily mean that they think the banks are fundamentally dishonest. They mean that they do not trust the banks to deal fairly with them and to take account of the particular vulnerability that goes with moving from managing cash to more formal ways of managing money. The implication of this is that it is not sufficient for financial institutions to overcome some generalised perception of untrustworthiness, but that it also requires a change in the way they treat these customers in practice and ensuring that the products they offer are suitable for the customers' circumstances.

Overcoming lack of trust

How can this lack of trust be overcome? It is often simply said that the industry "must rebuild trust". It is hard to argue with this as an abstract proposition, but few people who are in close contact with financially excluded groups believe that this is something that can be achieved either easily or soon. Moreover, *re*building trust is a difficult concept to apply in the case of a group of people who have never in the past felt comfortable dealing with mainstream financial institutions. Ultimately, trust will only be built or restored after a period – possibly quite a long one – in which there are few perceived consumer "scandals" and in which regulation of consumer financial services is seen to be effective. Much of this task will of course fall to the new Financial Conduct Authority, whose role in improving confidence in financial services, for all groups including the financially excluded, will be critical.

However, all the signs are that, for many people on low incomes, resistance to the financial services sector is deeply ingrained. A

substantial proportion of them will always be reluctant to engage with mainstream providers. For this reason, there is a pressing need to develop alternative products and channels that can serve low income, financially excluded groups. That does not mean that the banks should relax the steps they have already taken to make banking more available, but it does mean that we need to look at other measures at the same time.

First, where financially excluded people may not trust financial institutions, they will often trust someone whom they know well and who they are confident will advise or signpost them fairly and objectively. Such "trusted intermediaries" may include social landlords (since a large proportion of financially excluded people are tenants of housing associations or of local authorities), advice agencies or any of a wide range of NGOs working with deprived groups. While the financially excluded will view advice from the industry itself with extreme suspicion, they will often accept it from people with whom they have a positive relationship, particularly if the intermediary is a not-for-profit body. As for the intermediaries themselves, they often have a clear interest in making sure that their clients are financially included and financially capable and therefore have an incentive to provide them with advice or refer them to advisors. For several years now, initiatives have been in place to engage trusted intermediaries to provide information and practical help. In a few cases, banks have themselves formed partnerships directly with trusted intermediaries as a way of bridging the divide between them and potential customers – something that all banks should be encouraged to do. The greater use of trusted intermediaries would be a powerful way of helping reduce resistance to taking up financial products among excluded groups.

However, we need to recognise that a significant proportion of the financially excluded will never wish to be customers of the financial services mainstream, however much trusted intermediation is available. The only way to connect them to

essential basic financial services will be to find alternative sources of supply. Much of the effort to promote financial inclusion has so far focused on third sector institutions such as Credit Unions and Community Development Finance Institutions, both of which have important and valuable roles to play in the future. The Post Office already provides a limited range of financial services for people on low incomes, but could do a great deal more. Successive governments have considered allowing Post Offices to provide a range of simple, trusted products for people on low incomes but little has materialised. The single most effective step to boost financial inclusion that Government could take would be to permit the Post Office to provide a wider range of basic financial products.

The major supermarket chains (two of which already hold banking licences) are also potentially valuable suppliers of financial services for people who are reluctant to approach the established financial services sector. They are not only trusted – people buy food and other goods regularly from them – but also geographically accessible in a way that many banks are not. They can play a vital role in reducing financial exclusion.

Finally, technology provides opportunities for developing new models for providing services to financially excluded people without the need to open a conventional bank account. It is easy to conceive of a simple, basic banking service making use of mobile phone or plastic card technology. As an example – but just one example of a wide range of possibilities – wages (or benefit) could be loaded onto a prepaid debit card which could be used to withdraw cash from ATMs or make purchases. If the cardholder wished, it could also be used to initiate direct debits in order to take advantage of discounts. Such a service could be provided without requiring the customer to use either a branch banking institution or an online service (to which many financially excluded people do not have access). A whole range of options of this kind can be envisaged, using technology that is already available to provide basic banking functions in a new way.

In summary, lack of trust – and, in particular, a lack of trust that financial institutions will treat their customers fairly – is a significant barrier that separates people who are financially excluded from access to the basic financial services that ought to be available to them. As well as encouraging banks and other financial institutions services to continue to open their doors to people on low incomes who have not previously used their services, we should seek new and trusted channels through which to offer such services and should exploit technology that is already available to develop acceptable new models for delivering them.

ADVICE
4: TRUST, ADVICE AND FINANCIAL SERVICES
David Lipsey

In financial services, trust is all. If you are to put your money in the bank, you have to be sure you will get it back. Otherwise, you will stuff it under the mattress. That trust is also herdlike. If you thought everyone else was going to take their money out, then you would do the same, as banks borrow short and lend long. Hence the queues outside Northern Rock.

Deep confidence is required to enter into some financial transactions. If you invest in a pension fund, you won't know for many years what the return will be, and by the time you do, you won't be able to do much if it disappoints. Ask the former pensioners of Robert Maxwell or the customers of Equitable Life.

If you buy long term care insurance, and it doesn't provide what it says it will provide when you need it, you won't be able to go back to work to make up a shortfall. Indeed, if you have dementia like an increasing number of people receiving care, you may not even know you have been let down.

So trust is all. But trust is not very high. The Financial Services Trust Index, prepared by the University of Nottingham, regularly measures its level. On a scale of 0 – 100, it gives a value of about 47 for the financial services sector as a whole, though people have rather higher trust in the institutions they themselves use. An Insight Survey from YouGov in June 2010 found that only 30% of respondents were prepared to identify a financial services brand as "most trustworthy". There is an underlying sense in the surveys that people are not convinced that the financial services sector puts their interests ahead of its own profit.

This is not surprising. The banking crisis will have had an impact. Equity markets tumbled though they have since recovered. Investors in some banks were more or less wiped out.

But even before the crisis there has been a long list of scandals where the financial services sector was found to have ripped people off. Home income plans left people with negative equity. There was the huge pensions mis-selling scandal of the late 1990s. There have been problem with endowment mortgages. The shameless flogging of expensive, unnecessary payment protection insurance is only now being properly tackled.

Such episodes have been frequent. So, inevitably a systemic explanation is sought. What is it that causes the financial services sector, dependent on trust as it is, to repeatedly do things which destroy that trust?

First, the usual factors that stoke bubbles are often present. Lenders and investors see new markets offering glittering prizes. Short-term prices rise higher than long term values as bidding wars rage over these markets' future profitability. Prices collapse as exuberance gives way to despair.

And as with the banking sector in the run-up to the crisis, incentives go wrong. Those who sell the products get paid, and paid handsomely, up front: such was the case with pensions, where advisors got large commissions for selling. But the company may not have made the revenues needed if customers decided that the products they had bought were not delivering the right service at the right price. Salespeople can develop short run mentalities which mean they pay too little attention to what the long term performance of the product will be.

Third, regulation has been weak. The Financial Services Authority too often plays catch-up. Gordon Brown made an error

in subsuming the old consumer protection remit of the Personal Investment Authority (on whose board I sat) into the Financial Services Authority. The FSA has as a result suffered from tensions between protecting consumers, at the expense of company profits, and protecting the viability of financial institutions, at the cost of customers. Past performance, of course, is no indicator of future performance, and it is to be hoped that the new Financial Conduct Authority will do better by customers.

However, there may be a more fundamental reason for consumer mistrust. It goes like this. First, as any financial advisor will tell you, financial services products do not exactly fly off the shelf. For consumers are human and, like most human beings, they heavily discount the future: "hyperbolic discounting" in the jargon. They would rather have one apple today than two apples tomorrow.

People don't like paying for advice either. Commissions to advisors have therefore come from the providers of the products they sell. Of course, the cost is just the same as if the customer paid but it is hidden.

An example is the almost complete failure of policies designed to provide for the costs of long-term care. Care costs can swiftly run through a person's assets. Hence the sad stories that appear in our newspapers about people having to sell their homes to pay for care. Yet there are only some 36,000 care policies extant.[55] People resent paying for them. So, they persuade themselves that needing care won't happen to them, or if it does happen to them that the state will pay, or that if the state won't pay it ought to pay so they won't insure.

55 MoneyMarketing, 'Look beyond insurance for LTC, says think tank', 15th March 2011.

For the same reason, provision for pensions is inadequate. People are living longer. They can work a bit longer, but they are also going to have to live off their pensions for longer. Pensions will pay less as annuity rates decline. So we all need to be saving more, yet any excuse is good enough not to. We will live off selling our house, or our kids will provide – and who knows? We may die young. It remains to be seen if auto-enrolment will indeed mean that most people have a sufficient pension, or whether in fact contracting-out rates will be high.

So, consumers do not seek out financial services products. They have to be sold to them, in the face of consumer reluctance. The consumer often finds ingenious reasons why they should not take out the protection they need.

It follows that financial advisors, however incentivised, find themselves playing a dual role. Yes, hopefully, they will act as objective advisors. But giving the right advice is not enough. They also need to nudge and nudge hard, as salespeople. Salespeople do not generally understate the virtues of the products that they are selling.

The investment markets have become produced fewer easy wins over the last decade. It is increasingly hard to make high returns on investments. The supply of funds was great, largely from the huge payments surpluses being run up by China and others. However, the supply of productive investment opportunities was much less great. In order to produce attractive returns, the financial institutions either had to resort to more and more leverage (often disguised in complex derivative products) or to dodgy investment (such as sub-prime loans).

The same sort of thing goes on in the retail financial services markets. For example, you will often see unit trusts advertised on the back of impressive past returns. But, of course, you do

not hear of all the trusts run by the same operators which have produced unimpressive returns. Racing tipsters base their claimed profits on tipping different horses to different customers and then choosing whichever wins. Something similar goes on in financial services.

The search for 'alpha' returns, investments (or advisors) who consistently produce returns over the average continues. Few, if any, achieve it. Certainly, such returns are not available to 'Joe Public'. So, products are routinely sold on the basis of returns which are unlikely to be realised.

The FSA has not acted decisively to stop this. It allows, for example, pensions providers to base projections on high returns. These returns can only be achieved if there is substantial inflation in future – which reduces the real value of those returns.

There are failures on both sides of the market, which reinforce each other. Customers may not buy products they need even if they are told the full unvarnished truth about them. Is it better that they go without them at all? Or should we be happy that sales/advisors gild the lily, because it boosts take-up, even if the consumer doesn't get all the gains they could?

However, this process – mis-selling to inert and confused consumers – has a serious effect on trust, and one that is likely to become more serious as time goes by. Expectations are raised that will almost certainly be disappointed in practice. Trust is all, but trust is constantly being eroded.

One way forward would be to carry on with the unsatisfactory status quo. Salespeople would continue to gild the lily; consumers would continue to resist buying; society would continue to live with a low savings ratio, low returns on saving and thus low incomes in old age. Few would regard this as an optimal outcome.

There is another way forward however. It is based on the liberal belief that people are educable. If they are fully informed as to the likely costs and benefits of their actions, they will behave appropriately – particularly if society constructs the right system of 'nudges' to bias them towards doing the right thing.

This has important implications for the way financial advice is provided.

Many people have a relatively modest need for advice. In particular, the less well-off simply cannot afford to invest heavily in financial services products. They will continue to rely primarily on what the state provides: either through taxation or through National Insurance; either through universal or through means-tested benefits.

For such people the cost of personalised advice will usually exceed the benefits. They are therefore going to rely on generic money advice services or websites such as Money Advice Service. Following the Thorenson report, the FSA itself is very actively promoting money advice.

For those who have more to spend on financial services, personalised services will be appropriate. On this point the FSA is now entering the last stages of a reform that is potentially revolutionary. Under the Retail Distribution Review, the regulatory regime governing financial advice is being transformed.

A full description of the RDR would take up many pages in this essay. Indeed it takes up many, many pages on the FSA website. However, it has three central features:

First, the qualifications required of advisors are being raised. They are still not as high as they should be. Financial advisors do not, and will not yet at any rate, require degree level knowledge.

But the old-style financial advisor working off a few half-baked homilies and his golf club contacts will finally become a thing of the past.

Second, a clearer distinction is being drawn between advisors who offer products drawn from a wider market and the sales staff of particular institutions selling their institutions' products. This distinction, which escapes many customers now, will mean a more demanding role for independent advisors, but should also mean better outcomes for customers.

Third, hidden commissions are being outlawed. In future, it will have to be made clear to customers exactly what they are paying for the advice they are getting and, as a result, they will be in a position to negotiate about the price.

The result of all this, if it works, can be summed up in a single phrase: professionalisation.

The characteristic of a profession is that it puts the interests of the customer first. Doctors are supposed to serve their patients, not their pockets. Lawyers work for their clients, and so on. Doubtless professionalisation, even in these long established professions, is imperfect. It would be naïve to suppose that some lawyers do not advise with half an eye on future fees. But the principle of professionalisation is clear and well-understood. In future it will apply to financial advisors.

It should be understood that this is a risky course. We do not yet know that customers will be willing to pay the price for proper advice. Many may blanch at the cost, and instead busk it, using websites and their own knowledge.

The current financial advisor population is ageing. Some will not feel able, or indeed be able, to cope with upgrading their

skills. Others may find that the market is not a strong enough one to provide them with an adequate living. Already over the past few years there has been something of a flight from advising: for example, many mortgage brokers have turned to debt advisors as the mortgage market declines. That could intensify under the RDR regime.

There have been some signs recently of a belated backlash against the RDR from advisors. MPs queued up to express their concerns in a recent parliamentary debate on the subject. But, to their credit, the government and the FSA have held firm.

It is now possible to envisage a future where financial advice, at least to the better off, is professionalised. It is possible to envisage a future where recommendations reflect a wise assessment of people's needs and the best ways to fulfil them. It is possible to envisage a much higher standard of advice reflecting investment realities. So advisors would be recommending clients to save sufficiently; to have an appropriate spread of investments; to use tax breaks available to them; to make sure their plans are proof against inflation, both expected and unexpected; and to use to the full, newer products which meet their needs such as equity release.

All this will only come about on two conditions. First, that advisors, encouraged by their regulators, take on board that a new ethos is required in this new world. Secondly, that customers do not penny-pinch and see that appropriate professional advice comes at a price well worth paying. It is too soon to be confident, but it is possible to be optimistic: and if that optimism is justified, to envisage a future in which people's financial needs are much better met.

5: THE ROLE OF PROFESSIONALISM

Adam Phillips[56]

There are at least two meanings of the word professional.

The first is the use of the term as an adjective, to describe behaviour which is responsible and conducted in a timely and ethical fashion. The second is the use of the term as a noun to describe an individual. This use implies that the professional has a recognised level of competence and a requirement to provide an honest service to clients. This latter meaning of the term has developed as professions have evolved. It is this latter meaning of professionalism which is relevant to rebuilding trust in financial services.

Originally, membership of a craft guild provided assurance that the craftsman had served an apprenticeship and met an acceptable standard of skill in the opinion of his peers. As the demand for legal, financial and medical services grew, good practitioners needed to differentiate themselves as individuals from practitioners who were less competent and trustworthy. Membership of the professional society provided a way for potential clients to identify those qualified to give expert advice and, just as important, who had also agreed to behave honestly and ethically and to keep their knowledge up to date.

In order to defend the reputation of the profession some form of examination by established members was usually required to demonstrate knowledge, together with practical experience. In the event that a member fell below the standard of behaviour expected by the society, they could be reprimanded or thrown out in order to protect the authority and reputation of the institution

56 Adam Phillips is Chair of the Financial Services Consumer Panel. The views expressed here are his own and not those of the Consumer Panel.

and its members. Institutions like the General Medical Council, the Law Society and the Institute of Chartered Accountants emerged in the first half of the nineteenth century and have become increasingly involved in raising and maintaining standards of their members. In the process, the public has come to trust the advice that they give, helping the general public to avoid "quacks, vipers and pettifoggers" and thus build trust in the competence and honesty of members of the profession.

These first professional bodies were successful for two main reasons. First, new members were able to charge a higher price for their services because of the reputation of their professional body. They did not need to spend a lifetime building a personal reputation. Second, society has benefitted because the self-regulation of the profession has delivered a higher quality of service and made it much more difficult for people with no training to exploit the ignorance of the general public. As a result, professional societies have been attractive to legislators as an effective means of ensuring good minimum levels of service quality in sectors which are highly technical and where the law will always lag behind innovation. For this reason many of the leading professions possess a Royal Charter.

The success of the major professions in creating value for their members inevitably led to the development of other professional bodies. In financial services there are professional bodies for all sectors, including accountancy, banking, insurance, consumer advice, asset managers and actuaries. Part of the problem is that the financial services market covers a very broad range of products and services. It has its own special language and culture. This makes it difficult for consumers to engage with the industry, even to the extent of understanding who to ask for advice. Most people outside the industry do not understand the roles of different types of sales people and advisors or their qualifications. People have to learn how to do this. It is to be hoped that the creation of the Consumer Financial Education Body and the discussions around

the need for money advice services will begin to meet this need for general information and education.

For the average member of the public the financial services industry provides four essential services:

- A mechanism for facilitating financial transactions – getting paid, buying things and paying bills.
- Insurance to reduce the impact of unexpected costly events.
- Consumer credit and short term saving.
- Savings and investments, mortgages and health and life insurance, which insure and smooth payments over the long term.

As the customer moves from the first to the fourth service, the cost of making a bad decision rises and consumers have an increasing need for professional advice about what to buy. For transactional banking, trust is about confidence that the service will operate smoothly and efficiently. Professionalism in this area is mainly about efficient delivery of the service on time and without any problems or mistakes. When choosing an organisation to provide such a service from a list of untried suppliers, accessibility, a suitable range of products, price and reputation are all important to varying degrees. In this area, it is the reputation of the organisation that provides the reassurance about quality of service, rather than the professional expertise of the individual serving the client. In this respect, it is more like purchasing grocery or an airline ticket than booking a holiday.

The second and third types of service, the provision of insurance, credit and short or medium term saving, are more complex and the client's individual circumstances, expectations and history are important, both for the client and for the service provider. There is a plethora of products available, only some of which will be suitable for the customer. However, in most cases

the scale of risks created for the customer by imperfect, rather than bad advice, are not enormous. In many respects this transaction is more like buying a controlled pharmaceutical product from a pharmacist; the reputation of the organisation providing the product is important, but so is the training and experience of the individual dealing with the customer. One of the major problems that has emerged in the recent past is the extent to which banks and insurance companies have failed to strike the correct balance between product design and the experience of the intermediary. Rather than copying the pharmaceutical industry and producing products which deal with known conditions where any negative side effects or risks are clearly identified, the industry has tended to try to get the customer to take the responsibility by providing long and complex documents explaining the product and service they provide, reducing as far as they can any liability for its failure to perform.

The lack of public understanding about the qualification and status of intermediaries means that customers often believe that they are dealing with an advisor when in fact it is a sales person. This model is a parody of the commonly accepted role of professional advice. Under the circumstances, it is not surprising that consumer trust in the organisations they are dealing with is low. For most consumers the cost of employing a professional advisor, given the cost in relation to the risks involved, will be hard to justify. The real need is to improve these products by regulation and the type of incentive schemes and training for sales staff.

The fourth essential service provided by the financial services industry is access to ways of saving and investing money for later life and to more complex kinds of insurance. This is the service where the average person has to rely on advice, the range of choices is enormous and the cost of a bad decision can be very large. This is the sector of the industry where a professional advisor is essential for most people. The training and experience of the

advisor is central to providing the best chance of a good outcome. In many respects the financial advisor here is playing a role like a doctor in general practice or a medical consultant. As surveys regularly demonstrate, people with an IFA relationship have a high degree of trust in their own financial advisor unless they have had a recent bad experience. However, most people don't have a financial advisor and there is a lot of evidence that people have a problem choosing one. This appears to be an ideal area for professional self-regulation. The key question is whether it is a lack of professionalism that has destroyed trust in financial services or some other factor.

In 2009 the FSA commissioned a report to investigate the link between increased professional standards among investment advisors and the levels of consumer trust and engagement with the industry. The report concluded that generalised trust in the investment advice sector as a whole is low, but that established client-advisor relationships show a high level of trust. It follows, therefore, that improving generalised trust is critical to encouraging initial engagement, and the fact that it is low at present means that many are not taking up advice that could be helpful.[57]

The causes of this low level of generalised trust, according to the report, are mis-selling scandals, commission-based remuneration, poor professional qualifications and a perceived lack of ethical standards.

One of the critical issues in building trust between the intermediary and their customer is the extent to which the intermediary is working for the customer, for the provider, or for themselves. In the last fifty years most retail businesses have come to the view that a strong relationship with their customers strengthens their negotiating position with product providers

57 FSA, 'Professional standards and consumer trust: a summary of existing research,' November 2009.

when it comes to obtaining the best products at the best price. In financial services this has not happened to the same extent, partly because advisors have worked as independent individuals and, to a large extent, earned their income by selling products which pay commission. This might work when selling soup or toothpaste, but no one would expect a doctor to work in this way. Without high professional standards, generic pharmaceuticals would never be prescribed, just as low margin financial products like low cost trackers, investment trusts, and national savings are not widely promoted by IFAs now. The FSA's Retail Distribution Review (RDR) is an attempt to change the relationship and make the advisor the agent of the customer. Like all change it is experiencing a great deal of resistance from established interests, but it is the single biggest improvement that could be made to the distribution of advice and investment products to improve confidence and ultimately consumers' trust.

Many advisors are unhappy, to say the least, that they should be suspected of not working in their clients' best interests, but it is only reasonable to expect that, if income can only be derived from products which pay commission, those products that do not pay much, or any, commission will not be promoted to the exclusion of those that do. The Association of British Insurers has shown that there is a clear link between commission and the level of sales of some types of financial product.[58] The move to transparent charging proposed in the RDR will do a great deal to improve trust in the advice sector as a whole. Making it possible for the advisor to work as the agent of the customer not the provider, creates an ideal environment for membership of a professional body to add real value.

Many people are concerned that making the cost of advice clear to the client, which is what the RDR requires, will stop people

58 Transcript for Money Box programme, 'The sins of commission,' 17th May 2005. http://news.bbc.co.uk/1/hi/programmes/moneybox/4532867.stm

getting advice. There is no doubt that this is a risk. Less people are going to the dentist than in the past and they are foregoing, or buying less costly, treatments as the cost rises. It is not possible for dentists to conceal their charges in the same way as financial intermediaries, so the pressure is on for the sector to create more cost effective solutions, as well as to find ways to extract more value from high net worth individuals with cosmetic treatments and implants. In a world where advice is paid for by commission, the demand from customers to get the best possible return for their money and the need for advisors to make money will tend to encourage advisors who are working on commission to sell riskier and more opaque structured products because they generate more income for the advisor.

Someone with £100,000 to invest can afford a good deal of advice about how to invest it. Someone who only has £200 a month to save after paying into their NEST pension fund and no history of saving cannot afford to pay much without the cost of advice far outweighing the benefit they will gain from it. In this situation, the solution is not to conceal the cost but, as with healthcare, to find a lower cost solution which will provide an appropriate product for most people with a given set of requirements. At present there is a very unfortunate nexus between the product providers, the intermediaries and the regulators which is obstructing the development of innovative solutions to these problems.

Professional standards can help to create a market in which the cost of providing advice is transparent and easy to compare, but also where individuals' different circumstances and needs are taken into account. As with doctors and pharmacists, qualifications based on a mixture of examination and practical experience can provide both the practitioner and the client with better of service quality and value. The ethical requirements of a professional code ensure that the practitioner keeps the client's best interests at heart. The self-regulation of a profession allows regulation to keep up to date

with innovation and maintain a high basic level of quality of advice. If this can be delivered, generalised consumer confidence and trust will improve.

How close is the financial advice sector to having such a professional structure? In both banking and financial advice there are a number of bodies which provide professional training. However, one of the challenges for such bodies is to ensure that they cover the majority of the good practitioners in their sector, that they are well-governed, that they have effective means of ensuring members adhere to the agreed standards, and that consumers recognise the professional body. Without the first it is difficult for the non-expert to decide on the relative merits of individuals with qualifications from different professional bodies and without the last three there is little reputational benefit for members. A proliferation of professional associations and qualifications can make it difficult to establish a clear image of a profession among the general public. In the accountancy sector this appears to have been reasonably well managed by accountants, but in the area of providing financial advice to consumers the situation has been much less straightforward: a proliferation of different professional bodies and standards has indeed occurred.

The FSA has made an attempt to improve the situation by setting up a Professional Standards Board (PSB) which is aimed at bringing together the various professional associations in the advisory space and harmonising and raising standards. Unfortunately, the PSB will not be an independent professional body with a chairman and governing council, but an administrative operation within the FSA. It is to be hoped that once established the PSB can be spun off from the regulator as a truly independent body which can lead the future development of the profession driven by the needs of its members and their clients. For this to happen, it is desirable that it has lay members in its governing body and continues to be overseen by a statutory body such as the FSA, or FCA in the future.

I have argued that the best way to improve the trust of the general public in financial services is to ensure that the people who are advising them on long term savings, mortgages and complex insurance products should be members of a recognised professional body. However, the problems of the last few years have highlighted a general weakness in the other professional bodies operating in the financial services area. The role played by accountants auditing banks and other companies has not been acceptable in a number of cases and so, there is a serious need for all the professional bodies working in the financial sector to review their codes of standards and their disciplinary procedures in much the same way, and for the same reasons, that the GMC and the Law Society have reviewed theirs. In addition, many top bankers were not members of any professional association at all, making a strong case for all professional bodies in the financial services area to be established on a statutory, or quasi-statutory footing, as for doctors or accountants.

To sum up, the experience of the last few years has made it clear that there is a relationship between trust in financial services and the professionalism of people working in the industry. The benefit of requiring more widespread membership of stronger professional associations in the financial services sector is that the rules apply to the individual, not the organisation they work for. Also, a professional society can ensure that its rules are kept up to date with innovation in a way that is difficult for regulators or legislators, because the society relies on judgement exercised by professional peers rather than legal experts. It is a very effective way of encouraging good behaviour among members because of the very damaging impact of an individual's poor behaviour on the reputation of all the members. However, in order to be effective the enforcement process must be transparent, not solely under the control of members of the association, and the results must be publicised.

SUPPLY
6: BANKERS, PAY AND TRUST

Michael Skapinker

In his preliminary review of the corporate governance of financial institutions, Sir David Walker, a City of London grandee, observed that British taxpayers had, in the wake of the financial crisis, provided banks with support equivalent to some 90% of the country's gross domestic product. As a result, he said, people's tolerance of "unsafe remuneration policies, which led to this calamitous state, is understandably low".[59]

This was putting it mildly. Stephen Green, then chairman of HSBC, one of the world's leading banks, and later UK trade minister, was more damming. Banks, he told the British Bankers' Association in June 2009, "have been at the epicentre of a storm of rage". Remuneration was a principal cause of the anger. "The perception that some have taken pay and bonuses in vast multiples of the remuneration of ordinary hard-working and socially valuable people – for indulging in an alchemy which has blown up in their faces and required huge bailouts at prodigious cost to the taxpayer – has ignited fury around the world," he said.

He added that bankers' compensation "lights the blue touch paper in the public mind". Reforming remuneration, was essential if banks were to win back public respect. "Nothing is more important for the rebuilding of public confidence than demonstrable, consistent and sustained evidence of greater responsibility by employers in regard to compensation," Mr Green said.[60]

59 A review of corporate governance in UK banks and other financial industry entities, http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf

60 Restoring Governance and Trust, http://www.hsbc.com/1/PA_1_1_S5/content/assets/newsroom/090630_speech_bba.pdf

Top executive pay has been a neuralgic theme in British life for a quarter of a century, but it has involved business leaders of all sorts, not just bankers. The first celebrated lighter of the blue touch paper was a clothing retailer. Sir Ralph Halpern, then chairman of the Burton Group, set off a torrent of comment and criticism when, in 1986, he became the first British chief executive to take home over £1 million in salary and performance-related pay. When, as a recent *Financial Times* recruit, I went to interview him in January 1987, he told me other British chief executives had telephoned to congratulate him and tell him it was about time.[61]

With his pay cheque, he hoped to break a taboo – that there was something unseemly and un-British about earning large amounts of money from business. Far from being greedy, he was setting set an example to ambitious young people. "If I can show that I earn a million pounds then hundreds more will want to get to the top. I want someone who's earning £8,000 a year now to want to get to the top. The guy who doesn't want to get to my level – I'm not particularly concerned about him. I'm interested in those who do. They're the people the country needs. That's the spirit we need in this country," he said.

Other company leaders needed little urging. Within nine months of my interview with Sir Ralph, three other British chief executives were earning more than he was. Top of the pile was a banker – Christopher Heath, then managing director of Baring Securities, the subsidiary of Baring Brothers, whose remuneration totalled £2.5 million. Second place was held by a property boss – Michael Slade, managing director of Helical Bar, with £1.1 million. A third millionaire, coming in just ahead of Sir Ralph, was Peter Stormouth Darling, chairman of Mercury Asset Management.[62]

61 *Financial Times,* 'Now cash is clean again', 20th January 1987

62 *Financial Times,* 'Top executive is paid £2.5 million', 7th October 1987

They were soon joined by industrialists such as Lord Hanson.[63] The taboo had been shattered.

The defence of high pay for business leaders was repeated frequently over the years: if British business were to prosper it had to attract the best. British executives were poorly paid compared with their counterparts elsewhere. According to a study at the time by Hay Management Consultants, the base salary of a managing director was lower in the UK than in any other European country apart from Spain and Portugal.[64] British company leaders earned far less than chief executive officers earned in the US.

It wasn't enough to attract talent, the argument for high pay went. British attitudes to business needed to change. Why did company leaders earn less than pop stars or golfers? What did that say about the country's attitude to commerce?

It was odd that it had taken this long for the argument to be made this forcefully. Britain was by then almost a decade into Margaret Thatcher's administration, a government dedicated to freeing business from crusty attitudes and releasing its animal spirits. Mrs Thatcher's election in 1979, following by Ronald Reagan's entry into the White House a year later, signalled the beginning of three decades of overwhelming belief in the power of free enterprise – and, along with it, the argument that it was for the market to determine pay. President Reagan's quip that the nine most terrifying words in the English language were "I'm from the government and I'm here to help" summed up the view that the best thing any administration could do for business was to get out of its way. It was private enterprise that could deliver.

63 *Financial Times*, 'Burton chief regains title of highest paid chief executive', 5th October 1988

64 *Hay Group*, 'Executive compensation report', 1987.

This philosophy had immense historical consequences – the sweeping away of the bankrupt Communist empire being its greatest achievement. For almost 30 years, privatisation and deregulation seemed to work. Not everyone benefited, but Britain became noticeably more prosperous. There was a time after the fall of the Berlin Wall when some predicted that Frankfurt, being closer, both physically and philosophically, to the centre of Europe, would become the continent's financial capital. Within a few years, the idea seemed risible. The City of London had no peer in Europe and few in the world. Britain was no longer Europe's sick man. And if top business people earned mighty amounts of money (Sir Ralph Halpern's single million seemed quaint by now), well, that was just the market weaving its magic.

Even then, however, some were asking questions about whether highly-paid CEOs were worth it. The questioning was not confined to the UK. It came from the US, the home of free market economics and the country that served as the role model for UK business.

The criticism came from people who could hardly be described as anti-business. In a column in the *Wall Street Journal* in 1992, commentator Paul Gigot observed that liberal critics, such as the then-Democratic presidential hopeful Bill Clinton, were sniping at chief executives' earnings. "So naturally," Mr Gigot wrote, "all good free-marketeers should rise in response to defend the right of CEOs to earn whatever … hold on a minute. Grab that jerking knee. There are good reasons other than class envy for disliking the runaway salaries of many chief executives."[65] Mr Gigot voiced persistent criticisms of top executive pay: that it went up even when company performance went down. Levels of CEO pay, Mr Gigot wrote, "are outrageous enough to make even a capitalist blush. Steven Ross, the Time Warner boss, raked in $74.8 million

65 *Wall Street Journal*, 'Executive pay – an embarrassment to free-marketeers', 10t1243 January 1992

in bonuses in 1990 (on top of his $3.3 million salary), even as *Time* magazine discards employees. Good work if you can get it. General Motors's former chairman, Roger Smith, receives a $1.2 million annual pension – presumably his reward for a decade of losing market share … Windfalls might be justified when companies do well; Bill Gates of wealth-creating Microsoft deserves his billion in stock. But the trouble is the bonuses keep coming even for CEOs in sinking companies."

The attacks, even from traditionally pro-capitalist publications, continued over the next decade. In 2001, *Fortune* magazine carried an article entitled "The Great CEO Pay Heist". In 2003, the magazine pictured a pig on its cover dressed in a business suit, along with the headline "Oink! CEO Pay Is Still Out of Control."

These criticisms did not imply disillusionment with the free market. Rather there was a sense that the market in chief executives' compensation wasn't working. In the Wall Street Journal, Mr Gigot said that corporate leaders had too cosy a relationship with the board members who determined their rewards.

These views were mirrored by generally pro-business commentators in Britain. In *The Times*, Patience Wheatcroft said of the earnings of chief executives of FTSE 100 companies: "Despite all the loud demands for rewards to be linked to performance, bonuses and other variable parts of the remuneration package provided only the icing on the very generous slice of cake. Basic salaries soared at a rate that leaves ordinary workers understandably feeling that the rules that apply on the shopfloor, or even in the ranks of middle management, vanish once they hit the boardroom door."[66] Corporate scandals in the US surrounding companies such as Enron and WorldCom further soured attitudes towards high paid chief executives.

66 *The Times,* 'Is it really that tough at the top?', 31st October 2001

It was in this atmosphere that the financial crisis of 2008, the most severe since the Great Depression, erupted. One early consequence was shock by business leaders that markets had failed to work in the way they were supposed to. Instead of rewarding winners and eliminating losers, the entire system seemed to have crashed.

Josef Ackermann, chief executive of Deutsche Bank, said: "I no longer believe in the market's self-healing power."[67] More remarkably, Alan Greenspan, former chairman of the US Federal Reserve, told a Congressional hearing: "I made a mistake in presuming that the self-interest of organisations, specifically banks and others, was such that they were best capable of protecting their own shareholders."[68] In other words, rather than looking after their shareholders, bankers had looked after themselves.

Why had bankers looked after themselves? Many pointed to their remuneration as the key to what had gone wrong. Bankers themselves appeared to accept this. Like Mr Green of HSBC, Lloyd Blankfein, chief executive of Goldman Sachs, said: "[C]ompensation continues to generate controversy and anger. And, in many respects, much of it is understandable and appropriate. There is little justification for the payment of outsized discretionary compensation when a financial institution lost money for the year."[69]

Public anger occasionally spilled over into violence. Vandals attacked the home and car of Sir Fred Goodwin, the former chief executive of the Royal Bank of Scotland. They objected to the large pension Sir Fred was drawing, particularly as the bank had had to

67 'Deutsche Bank head calls for government help', Spiegel Online International, 18th March 2008, http://www.spiegel.de/international/business/0,1518,542140,00.html

68 *Financial Times,* 'I made a mistake, admits Greenspan', 24th October 2008

69 Remarks by Lloyd Blankfein at Handelsblatt Banking Conference, http://www2.goldmansachs.com/our-firm/on-the-issues/compensation/handelsblatt.print.html

be saved from collapse with taxpayers' money. Law-abiding people might have condemned the vandals' methods, but many agreed with the criticism.

The same objections were extended to other bankers, even if they weren't subject to criminal attacks. The central justification for high pay – that it was necessary to attract the most talented people – had been exposed as an absurdity. Many leading bankers were revealed as anything but talented: through their imprudent lending and construction of over-complicated financial instruments, they had almost brought the world's financial system crashing down. And when their reckless risks went wrong, governments were there to clear up the mess. As Richard Lambert, director general of the CBI, the UK employers' organisation, put it: "The bankers had been bailed out by the taxpayer and were … receiving payments beyond most people's wildest dreams."[70]

So what should be done? Much official discussion focused on the structure of bankers' pay rather than the total amounts they received. The make-up of remuneration packages – particularly the size of bonuses relative to basic pay – was blamed for bankers' excessively short-term outlook. Once they had hit their targets for the year and pocketed their bonuses, why should they worry about what happened to the bank, its shareholders or employees years from now?

European and UK regulators began constructing a remuneration system that would force bankers to concentrate on the longer-term and to ensure that they retained an interest in what happened to their institutions. By the end of 2010, regulators were set on limiting immediate cash bonuses to as little as 20 per cent of total pay, with payment of the rest being deferred and a proportion having to be paid in equity.[71]

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70 http://cbi.org.uk/pdf/20100330-cbi-richard-lambert-rsa-business-reputation.pdf

71 *Financial Times*, 'Banks to overhaul global pay structures', 20th December 2010

All of this, however, was aimed at ensuring that bankers chasing annual bonuses didn't cause another crash. It seemed unlikely, however, to assuage the anger of the public, for whom these rules would seem arcane and irrelevant. What made the news were the headline amounts that bankers were paid and polls suggested that the public wanted them capped.

In a *Financial Times*/Harris poll in the UK, 74% of those asked wanted a ceiling imposed on bankers' pay. (It should be said that even more – 80% – wanted a cap on all executive pay. Forty-eight per cent thought sportspeople's pay should be capped and 42% thought the same should happen to musicians.)[72]

Capping any high earner's pay has long proved an elusive goal, however. What would the maximum be? A multiple of the average or of the lowest-paid worker's wage? And how would it be enforced? Through higher tax rates? In the past, the highest earners have either sucked those up, threatened to move to lower-tax jurisdictions or employed accountants to find ways of avoiding tax.

What about using shame and embarrassment? If bankers' pay was made public, would this provide an incentive to keep it down? The pay of directors in publicly-quoted companies has long been public and it has not stopped remuneration from increasing. On the contrary, publishing directors' pay has led to lower-paid executives demanding more.

In his governance report, Sir David Walker accepted that this "signalling effect" was a problem; he referred to "the view that disclosure of board level remuneration has probably exerted upward ratcheting influence". But he did think there was benefit in disclosing how much banks were paying not just their directors but other top earners too. He rejected the idea of naming these

72 *Financial Times,* 'Poll finds solid support for tougher action', 25th January 2010

high-earning non-directors. Instead, in his final report, he proposed that institutions say how many of their most highly-paid people's remuneration fell within certain bands above £1 million.[73]

By the end of 2010, Sir David was rowing back from that. Disclosing the bands of pay for UK banking executives would not work unless other countries did the same, he said in an opinion piece in the *FT* – and they weren't. "[W]hile the European Union's new capital requirements directive is highly prescriptive on other areas of bank remuneration, it does not require disclosure of high-end salary bands. In the US neither the Federal Reserve nor the Securities and Exchange Commission has given any sign of plans to do the same," he wrote. It would be damaging for the UK to act alone. "Specifically, any attempt to require banded disclosure for UK banks in isolation would be commercially sensitive vis à vis their non-disclosing competitors elsewhere. It could also stimulate higher executive turnover, and (as a perverse unintended consequence) lead to higher remuneration as a defensive retention measure. For these reasons, it would be mistaken for the British government to act in the absence of closely aligned similar initiatives elsewhere in Europe and, above all, in the US."[74]

Would bankers limit their pay anyway out of a desire to avoid public opprobrium? At the very top, some did so. In 2009, several bank leaders waived their bonuses or donated them to charity, but by 2011 the desire to take their bonuses returned.

This meant that one of the principal arguments used to justify high pay had returned: everyone else is doing it. If our bank doesn't, we will lose our best people to those who do. And even if every bank in the UK does it, we will lose our best people to the banks in the US, Switzerland or Hong Kong who pay more.

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73 http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

74 *Financial Times*, 'Britain must call for more open bank pay rules', 21st November 2010

Some believe that higher regulatory capital requirements will lower bank profits and that bonuses will fall as a result.[75] However, it is unclear how long-lasting such an effect would be or if the fall in bonuses would be sufficient to soothe public anger.

Some in the industry held out hope for Project Merlin, a bank-led effort to reach agreement with the government over pay and lending. The banks involved – HSBC, Barclays, Lloyds Banking Group and Royal Bank of Scotland – said that they "understand the public mood" and would "show responsibility on pay". They undertook to lend significantly more, especially to small and medium-sized businesses, but this was a goal rather than a cast-iron commitment – and bonuses subsequently announced were still of a size to enrage critics.[76]

How much of an effect has the pay controversy had on the public's willingness to engage with banks and the financial services industry? Consumers have little choice but to engage with banks and the financial services industry. They have to keep their savings somewhere, borrow from someone to buy their homes and purchase insurance to safeguard their possessions. Public anger may be a trial for bankers, but it is one they seem prepared to endure. In January 2011, Bob Diamond, chief executive of Barclays, declared the period of "remorse and apology" over.[77]

75 *Financial Times*, Tony Jackson 'Investment banks are victims of their footloose culture', 26th January 2011

76 *Financial Times*, 'Banking: ahead in the clouds', 15th March 2011

77 *The Economist*, 'Round Three', 15th January 2011

7: MUTUAL FINANCIAL FIRMS

Jonathan Michie[78]

Introduction

Co-operatives and mutuals – that is, companies that are owned by either their employees or their customers – form only a small part of the UK economy. Most companies are owned by private individuals or other entities, or by external shareholders. The common assumption amongst the media, politicians, civil servants, regulators and the public at large is that the shareholder-owned model is the 'natural' form of corporate ownership and control. This assumption has important consequences: regulation tends to be devised with that ownership and governance structure in mind, and is imposed in a blanket fashion on all companies, regardless of their actual ownership structure. Almost inevitably, this will be inappropriate for and damaging to companies with 'alternative' ownership structures, such as co-operatives and mutuals.

In the financial sector, the demutualisation of lending has not been a success. All building societies that demutualised are now either bankrupt and in state ownership, or merged with or acquired by another bank. Yet mutuals and co-operatives are highly rated for customer service and security by consumers. Can government promote trust in financial services by mutualising state owned banks and encouraging others to mutualise?

To answer this question it is worth reflecting on why these 'alternative' corporate forms exist, alongside the bulk of companies that are owned by private individuals, families or other entities (such as hedge funds), or by external shareholders (either privately, or quoted on one of the stock exchanges).

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Why do co-operatives and mutuals exist and persist?

If co-operatives and mutuals were a recent invention then they might be thought to have been an interesting idea but not one worth supporting, given that they have failed to take significant market share. They could indeed be allowed to go to the wall, with their small market shares being taken back by normal companies. But this is not the case. What is strange – a puzzle that deserves to be solved – is that despite having been absolutely dominant for more than a century, shareholder-owned firm (plus privately owned) have failed to displace these co-operatives and mutuals. Why?

To answer this question, it may be worth considering why these alternative corporate forms developed in the first place. The answer, largely, lay in one word, in a single concept: namely, *trust*. At the time of the industrial revolution and subsequent spread of capitalist production, with companies owned by private industrialists and subsequently by external shareholders, consumers did not trust those owners to supply good quality food. Co-operatives emerged largely because consumers felt they could have more trust in the company if it was owned by them – the customers – and if its corporate objective was thus to provide them with good quality, safe food, as opposed to a company whose purpose was to make financial returns to private or external shareholders.[79]

The puzzle of the continued existence of these 'alternative' forms is perhaps particularly striking in the case of mutual building societies. Our economy is absolutely dominated by privately owned companies (owned individually or by external shareholders). These are the type of organisations we do business with for the vast majority of our transactions, on a day-to-day basis, and in life. We clearly trust them to some extent, as we hand over our money in exchange for the goods

79 For a review of the economic literature on the concept of 'trust', see Russell Mannion and Huw Davies, 'The economics of trust' in Jonathan Michie (ed.), *The Reader's Guide to the Social Sciences*, (London and Chicago: Fitzroy Dearborn and Routledge, 2000).

and services they provide, so we must have some degree of trust that these goods and services will be of a satisfactory quality – or, at least that if they prove not to be, then we will be able to exchange them or get our money back. One might think, therefore, that we would only be prepared to deal with 'alternative' companies – those with quirky ownership and business models – for peripheral transactions that were not of great consequence. What is odd is that this is not the case at all. By far the largest market transaction that most of us will make in our lives is to purchase a house. Yet in such transactions, the proportion of customers who choose to contract with 'standard' shareholder organisations is lower than is the case than for other, less important trades. Conversely, this most important transaction is made with co-operative or mutual organisations to a far greater extent than is the case for the other transactions we make.

Why should this be the case?

Again, the answer lies largely in the realm of trust. We trust these mutual building societies – owned by us, their customers – to prioritise the interests of us, their savers and borrowers.

But is this trust deserved, or conversely, are customers right to be less trustful of privately owned banks? It is rare in economics to be able to answer such questions, as we aren't able to conduct experiments to test the hypothesis in the same way as natural scientists can. In this case, though, we are fortunate in having had the experiment conducted for us as a result of legislative changes in the UK that paved the way for the demutualisation of these consumer-owned building societies. It was argued by those in favour of such demutualisation that the injection of shareholder capital and the introduction of the governance and incentive structures of the shareholder owned banks would promote greater efficiency, with the gains in turn passed on to the customers.

Of the building societies that demutualised, not a single one remains in business today as an independent entity. All of

them either failed, were taken over, or had to be rescued by us, the taxpayer. The most striking case was Northern Rock, as the pictures of its customers queuing up all night to reclaim their money appeared on television screens and newspapers across the globe. This was a bank run. The sort of thing that happened – or at least was threatened – at the time of the development of capitalism and the banking system, when there was not yet sufficient trust that the banks would actually be able to repay their customers' money should they all seek to withdraw their savings simultaneously. Such bank runs had indeed been largely banished thanks to bank regulation requiring minimum reserve holdings, the role of the central bank as the bank of last resort, and so forth. But Northern Rock managed to undermine more than a century of such confidence. Its customers did not have sufficient trust that it would be able to return their money. And so it proved.

Northern Rock is, at the time of writing, a nationalised firm. The Government will, of course, want to sell it back to the private sector, both for ideological reasons (of private sector being good and public sector being bad) and for financial reasons, to reduce the enormous deficit that was created by the failures of the private banking system in creating the 2007 to 2008 credit crunch and subsequent recession. The question is, should they return Northern Rock to the mutual sector, where it operated successfully for decades, or should they return it to the privately owned sector, where it engaged in the short-term speculative behaviour of the other private banks that created the disaster of the credit crunch? As argued elsewhere[80] the case for selling it back to the mutual sector, whereby the government could receive the sale proceeds over time from the surpluses generated by the mutually-owned entity, are good and indeed compelling. The Government is likely, though, to choose the alternative option of maximising the short-

80 Jonathan Michie, and David Llewellyn, 'Converting failed financial institutions into mutual organisations', *Journal of Social Entrepreneurship* (2010)1:1, 146-170.

term sale price to receive the proceeds before the next General Election. Such a short-sighted decision would leave the financial services sector even weaker than it already is and even more biased in favour of the privately owned banks that created the credit crunch. This will only serve to create a further such financial crisis in the future unless action is taken to avoid it.

International comparisons

The above discussion has focussed on the UK, but a similar picture emerges globally. In all the advanced capitalist countries, whose economies are dominated by privately owned companies – owned by individuals or by external shareholders – there exists alongside such companies co-operatives and mutuals, owned by their employees or customers. Indeed, the UK is only an exception in having allowed this co-operative and mutual sector to become so weak, as a result of the demutualisation and the general bias of the regulatory system in favour of privately owned companies. In Germany, for example, the strong financial services sector is made up of only about a third of companies being owned by external shareholders, with around a third being publicly owned, and roughly a third being co-operative or mutual.

Not only are co-operative and mutual companies well suited to deliver the vitally important ingredient of trust into financial services transactions, but they provide effective competition to privately owned banks; the evidence demonstrates that this really does force these privately owned banks to provide better service to customers than would otherwise be the case. And even more important, the diversity of corporate forms creates a far stronger 'eco-system': companies with different ownership structures, business models and governance arrangements will act differently, and will react differently to economic 'shocks' to the system. Thereby the danger of a lemming-like rush towards the cliff, with all players reacting in the same way and creating self-fulfilling prophesies and unsustainable bubbles will be reduced. A system

characterised by corporate diversity will thus be more resilient. The Coalition Government could and should take positive action to promote such diversity of corporate forms.[81]

Conclusion

Needless to say, an ownership model in itself is not enough – it is always possible to do a bad job of something, whatever the structure. There is always a danger of incompetence or dishonesty. But the fact that the purpose of a mutual is to deliver benefit to their owners, namely the customers, does at least provide an environment conducive to developing the structures and culture required to deliver to that agenda. It certainly cuts off the damaging short-term pressure to maximise private financial gains for external shareholders that bears down on managers and directors of shareholder-owned companies.

So, the founding and guiding principles of mutuals are to be more trustworthy and responsive to customers than companies with external shareholders whose goal is financial gain are. But can and do they deliver on that promise? Do they actually realise this latent mutual advantage?

These questions were researched in detail by Jacqueline Cook *et al*, who surveyed the members of mutual organisations and found a remarkably high level of trust.[82] Mutuality did indeed appear to play a part in generating these high levels of trust. The fact that there were no external shareholders was found to be of particular appeal. In a separate survey, they found that even among a random sample of the general population, a higher proportion trusted building societies than banks – and this was before the credit crunch, where so many banks and bankers were exposed as being entirely untrustworthy, both in terms of morality and

81 Jonathan Michie, 'Promoting corporate diversity in the financial services sector', (2010).

82 Jacqueline Cook et al, Trust Rewards: realising the mutual advantage, (London: Mutuo, 2003).

competence. Cook *et al* thus concluded from their survey evidence and subsequent case study work that:

> *"... there is a mutual advantage that PLCs simply cannot enjoy. PLCs can benefit from ethical behaviour, and this should certainly be encouraged. But PLCs are constrained by the overriding need to maintain shareholder value. They are not able to prioritise customer interests in the way mutuals can."*[83]

Since that was written, the godfather of the 'shareholder value' ethos – Jack Welch – has recognised it to be "the dumbest idea in the world".[84] Successful businesses need to prioritise the interests of their customers, communities and employees. The surest way to do so is to give such stakeholders a genuine stake – an ownership stake. Organisations owned by their customers have a different purpose, business model, governance arrangements, behaviours and outcomes than organisations owned by external shareholders do. These differences allow – and indeed encourage – mutuals to take a long-term view in the interests of their customers. There is thus a material basis for them to be more trusted. A strengthened mutual sector also provides competition which improves the performance – and trustworthiness – of shareholder-owned companies. In addition, the financial services sector as a whole will be more robust and resilient if there is a greater degree of corporate diversity than that which pertains in the UK at present. To achieve that diversity will require a strengthening of the mutual sector. It would not be hard to do, but Government does need to take positive action to make it happen.

83 Ibid., 9.

84 Financial Times, 'Welch rues short term profit "obsession"', 9th March 2009.

How does trust interact with financial services markets? What impact did the financial crisis really have on trust? And what more long-term, endemic problems in the market have driven distrust? With a major Social Market Foundation analysis of financial services markets combined with expert essays, *A Confidence Crisis? Restoring Trust in Financial Services* answers these questions and proposes a set of radical policy solutions to correct market failures.

The report recommends government intervention to improve the quality of financial services, shifting competition onto the price of improved services, while maintaining consumer choice. It lays down a challenge to policymakers: stop tinkering at the fringes of the financial market, and make the market work better across the board by cutting through the inherent and unavoidable information asymmetries between consumers and firms, and by making shopping around easier. Only then will consumer trust in the consumer finance market be rebuilt, to the benefit of all.

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