

## **FairPensions' response to the FSA's 'Journey to the FCA' document**

FairPensions welcomes this opportunity to respond to the FSA's 'Journey to the FCA' document. FairPensions is the leading NGO scrutinising and challenging the investment sector. Our core mission is to promote responsible ownership by pension funds and other institutional investors. We seek responsible behaviour from both the companies in which pension funds invest and from companies in the financial services sector which act on behalf of savers and pensioners. FairPensions aims to influence the policies and practices of institutional investors with a view to making responsible investment mainstream and ensuring that pension providers and commercial investors operate with integrity towards their members and customers.

We welcome the general approach proposed in the Journey document and look forward to continuing engagement with the FCA in the development of specific objectives consistent with the stated aims.

### **1. Wholesale markets**

We are pleased to see the emphasis placed by the FCA on tackling the shortcomings in wholesale markets since this is where savers' and pensioners' funds are aggregated and transacted. We agree that no general presumption should be made about the supposed sophistication of the parties that would justify turning a blind eye to misconduct. Asymmetry of information and expertise is likely to be the rule in wholesale transactions rather than the exception.

In relation to occupational pension schemes, it is now over a decade since the Myners Report identified lack of trustee expertise as a major governance issue. This is particularly true of smaller pension funds, but remains a wider problem across the occupational pensions landscape. Pension funds are obliged by law to take professional advice before making certain key decisions: this reflects a recognition that the relevant expertise may not be available in-house. As such, most pension funds are vulnerable not only in relation to the asset managers and others with whom they contract, but also in relation to the consultants who advise them on these decisions. It is somewhat perverse that these entities are less well protected by the regulatory regime because they are regarded as 'sophisticated' investors. It is also concerning that those who advise them continue to be entirely unregulated. We therefore welcome the FCA's general declaration of intent as regards wholesale market activity.

In general, we believe a thorough examination of wholesale markets is now needed, given the many instances of poor conduct that have come to light recently. The previous light



touch regime has not succeeded in protecting consumers and ensuring market integrity. The FSA has achieved considerable progress in improving conduct through the Retail Distribution Review, the Mortgage Market Review and the Turner Review. What is now needed is a Wholesale Markets Review.

### ***1.1 Fiduciary standards of care***

FairPensions has argued that adoption of fiduciary principles would go a considerable way to putting relationships between investors and intermediaries on a sound basis. We welcome the challenge in Martin Wheatley's speech of 25 September when he said: 'I am particularly interested in how asset managers respond to the idea of adopting a fiduciary duty to their investors.' We would note that, as most lawyers agree, asset managers will generally already owe their clients a fiduciary duty under common law. Thus the question is not only whether they are willing to adopt fiduciary obligations but whether they are making active efforts to evade the obligations they already owe. We have heard evidence from several lawyers that clauses to restrict the application of common law fiduciary duties are standard practice in, for example, investment management agreements. The FCA could take steps to tighten up its rulebook in relation to such practices.

We welcome the Kay Review's emphasis on the promotion of fiduciary standards of care, and the government's indication that the FSA has agreed to review the extent to which its rules are compatible with these standards. We note the government's decision to avoid explicitly using the term 'fiduciary', preferring to spell out the detailed standards which it understands to be implied by it. Caution is needed to ensure that this approach does not inadvertently water down the standards in question – for example, in relation to the avoidance of conflicts of interest. Fiduciary obligation has the advantage of being an overarching concept which asserts the appropriate nature of the relationship between principal and agent. It therefore has an important role to play in reshaping culture from the top down, making the most of the "opportunity to reset conduct standards for the financial services industry" which the FCA's establishment represents.

FCA-authorized businesses that provide investment management services or investment advice are in general likely to be more expert than their clients, in wholesale as well as retail markets. It would therefore be appropriate for such businesses to be subject to a duty of care to their clients in general. We believe that caveat emptor is never an appropriate principle for the activities of authorized firms in whom clients are entitled to repose trust.

The FCA rightly recognizes that activities in retail and wholesale markets are connected and that risks caused by poor wholesale conduct can be transmitted between them. Accordingly, the general principle, stated in the legislation, that those providing regulated financial services should be expected to provide consumers with a level of care that is appropriate having regard to the degree of risk involved, is applicable to wholesale markets. As was argued during debates on the Financial Services Bill, the legislation leaves unresolved the vital question of what constitutes an 'appropriate' level of care. The FCA has an important task ahead in articulating its views on this question and making clear its expectations for conduct towards consumers.

### ***1.2 Conflicts of interest***

The FCA recognizes that failure to properly manage the often inherent conflicts of interest in wholesale markets is a root cause of risk to both market integrity and consumer protection. The Retail Distribution Review has been a valuable exercise in addressing and

mitigating conflicts of interest in retail markets. We believe that the same principles should apply in wholesale markets. We welcome the FSA's recent work on conflicts of interest in asset management which highlighted the extent of the problem and the considerable need for further work. Areas which we believe deserve particular attention include:

- Asset management firms should have robust processes in place to manage the conflicts inherent in their business models in relation to investment decision-making: for example, where investee companies are actual or potential clients, either of the asset management firm itself or of the parent company's investment banking arm. We are aware of considerable anecdotal evidence that these conflicts result in investment decisions that are suboptimal for beneficiaries.
- Charges made by intermediaries and market makers should be transparent and agreed with clients, whether fee for service or the difference between buying and selling prices. We welcome the expectation that the FCA is likely to go further than the FSA has previously done in challenging providers on the value-for-money of their products and checking that charging structures can still ensure good outcomes for consumers. This is relevant for wholesale markets as well as for retail.
- Proprietary trading that takes advantage of knowledge gained from client's business gives rise to conflicts of interest that are likely to be detrimental to the client. In general, the proceeds of ancillary transactions such as stock lending by asset managers should be credited to clients, as should any net proceeds from trading to facilitate market-making activity.

## **2. Investment models**

The Kay Review of UK Equity Markets has highlighted important deficiencies in the investment models prevailing in the UK asset management industry. FairPensions largely accepts Kay's analysis regarding the dominance of 'trading' over 'investment', with pension funds and others judging asset managers by short-term, benchmark-relative performance measures, and few players in the investment chain incentivised to nurture or even assess the fundamental value of companies. (In our view, this analysis is not limited to equities but can be applied to institutional investment portfolios across asset classes.)

Short-termist investment strategies and herding behaviours have clear implications for financial stability. But as Kay notes, they also have clear potential for consumer detriment, since ultimately only the creation of wealth in the real economy can produce long-term investment returns for savers. With the advent of auto-enrolment and the increasing reliance on DC pension products to provide for UK citizens in old age, the implications of these issues are ever growing. If not resolved, they could lead to catastrophically inadequate retirement incomes for a generation of pensioners.

The substance of asset managers' investment strategies is therefore not just a legitimate subject for the FCA to take an interest in, but a vital one for delivering its consumer protection objective. Working with other regulators where appropriate, the FCA must address issues such as ineffective stewardship of investee companies, excessive portfolio churn and the resulting transaction costs, or inattention to drivers of fundamental value, such as sustainability. The FSA's recognition that it must go beyond 'point of sale' is welcome. It now needs to build on this by extending its reach not just backwards (i.e. by focussing on product development), but forwards (i.e. by focussing on ongoing investment governance).

We welcome the FCA's declared intent to devote more resources to thematic work (as opposed to focussing on specific instances of misconduct), since this approach lends itself to these fundamental sector-wide issues.

### **3. Competition**

We agree that promoting competition in wholesale markets is likely to benefit consumers. But competition needs to be effective, as regards both quality and price. We also welcome the FCA's recognition of the limits of competition and consumer choice in the financial services arena.

#### **3.1 Choice**

The existence of large numbers of managed funds does not mean that competition is working to improve consumer outcomes, whether through better returns to investments or lower transaction costs. Indeed, evidence suggests that beyond a certain point, large numbers of funds actually lead consumers to make worse choices.

In addition, we have found that a desire to expand the choice of products offered through investment platforms can come at the expense of governance and oversight. For instance, our research has found that most insurance companies do not monitor the investment governance of the funds they offer to pension savers. The most common defence of this position is that such oversight is simply impossible given the sheer number of external fund managers whose products they offer. It is difficult to see how this state of affairs benefits consumers: effective oversight is not a 'nice-to-have' but is essential. If providers do not have the resources to oversee all the products they offer to consumers then they should not be offering them.

The FCA must therefore focus its efforts on promoting *meaningful* competition. One helpful approach would be for the FCA to publish authoritative comparative tables of performance and charges in wholesale markets, as previously issued for retail products by the FSA (now by the Money Advice Service). This would help pension funds make sound decisions and would stimulate competition amongst providers and advisors.

The FCA should also critically appraise on a case-by-case basis any industry arguments against enhanced regulation on grounds that it might hamper choice and innovation. While innovative products that are socially or economically useful are welcome, those that serve mainly to enrich the innovators are not desirable and should be the focus of regulatory attention. We therefore welcome the FCA's intentions as regards product governance, including early intervention to prevent harm. Given the risks to consumers caused by poor wholesale conduct, it would be right to scrutinise innovative wholesale products to ensure that they are unlikely to be a source of detriment.

#### **3.2 The limits of competition**

We welcome the FCA's recognition that financial services are different from other consumer products due to the information asymmetries between provider and customer. Such asymmetries cannot be resolved fully through disclosure, since the vast majority of consumers will struggle to interpret the information disclosed, or to use it to make informed decisions. Although financial education may help to reduce this problem, it would be naïve to assume that it can ever entirely resolve it. Long-term investment products such as pensions suffer from additional barriers to effective competition, due to

the absence of repeat business and the fact that poor performance may not become apparent until it is too late for consumers to act.

If the established approaches to promoting effective competition do not succeed, it would be necessary to recognise the existence of what in effect is a natural monopoly, a source of potential consumer detriment. In such circumstances, it would be wrong to leave authorised firms in a position where they could exploit market failure. Accordingly, recourse would need to be had to mitigating measures, including rate of return regulation via price caps, as applied to monopolistic elements of the utility businesses. It might also be necessary to set higher minimum standards in areas which are unlikely to become a source of effective competition due to consumers' lack of expertise: this could include aspects of stewardship and investment governance.

As well as promoting choice, the aim of promoting competition is to ensure that economic rents are competed away, as happens in the generality of markets. This reduces costs to consumers. The industry might object that measures to foster competition and suppress rents would constrain remuneration, which would result in firms moving to more permissive regulatory jurisdictions. On the other hand, such intervention would enhance the attractions to investors of the UK market by reducing transaction costs.

#### **4. Market analysis**

The FCA recognizes that, to fulfil its competition objective, it will need to expand its analysis of markets, and that when this raises concerns about whether competition is effective in delivering value or quality or whether consumers are getting a fair deal, it will conduct a sound and thorough study of the market and, where possible, design pro-competitive remedies. We welcome this intention.

Market analysis has not been a feature of the FSA's approach in the past. This has been a source of the disappointing outcomes of the regulatory regime. For instance, it was the Competition Commission, not the FSA, that reported that the twelve largest distributors of payment protection insurance made profits that yielded a Return on Equity of 490%, clear evidence of market failure, ineffective competition, failure of consumer protection, and a source of excessive remuneration.

The financial services sector is subject to many kinds of market failure, more so than other sectors of the economy. There is also a culture of exploiting market failures and inefficiencies for gain, some of which is legitimate (arbitrage), some illegitimate (insider dealing, retail mis-selling), and some inappropriate (proprietary trading based on private knowledge gained from clients). The FCA needs to equip itself to carry out in depth analysis of wholesale markets to address possible market failure. It will be important to have a strong team of economists headed by a Chief Economic Advisor – the absence of which at the FSA has been a symptomatic anomaly.

A crucial feature of market failure in the financial services sector is the generation and extraction of economic rents, resulting in high levels of remuneration unrelated to wealth-creating functions. Another feature with similar consequences is excessive intermediation and 'hyper-activity' which perpetuates this intermediation but does not deliver any clear benefit to consumers - such as portfolio churn. It must be the aim of market analysis to identify rent extraction and excessive intermediation, as the starting point for mitigation measures.

It is important that the FCA's desire not to damage 'innovation and growth', and to support the industry in creating jobs, does not allow the industry's interests to continue to prevail over those of consumers. If the Kay Review is right to allege that the UK investment industry is characterised by excessive intermediation, then resolving this will unavoidably involve a loss of jobs in the financial services industry. If it is concluded that these jobs are effectively extracting rent from consumers, the interests of the industry should not prevent the regulator from acting.

Forensic accountancy is another relevant approach to identifying market failure, starting both from excessive charges born by savers and pensioners, as well as from excessive remuneration.

It would be desirable for the FCA to commission and publish analyses of sectors of the wholesale market, to improve understanding and as an aid to identifying measures that may be needed to remedy misconduct. An example from the retail side is the analysis commissioned by the FSA from Deloitte of the platform market, published in February 2012.

## **5. Consumer representation and regulatory capture**

While most organisations representing consumers will focus on deficiencies in retail markets, we believe that wholesale market shortcomings also need attention. We welcome the intention that consumer organisations should be able to make 'super-complaints' to the FCA. The range of organisations eligible to make such complaints should be drawn as widely as possible. FairPensions would wish to be a designated organisation for this purpose.

Wholesale markets are far less transparent than retail markets, which means that consumer detriment is much harder to identify. Nevertheless, there is a growing interest among academic economists and others in dysfunction in capital markets that could be cultivated in the interests of better regulation and consumer outcomes. We suggest that the FCA should consider how such public interest perspectives might be supported.

We welcome the FCA's attempts to make its consultation processes more accessible and transparent for stakeholders, but would caution that replacing written consultations with informal face-to-face discussions may have the reverse effect, by entrenching the dominance of a few large stakeholders and making consultation processes even more opaque and inaccessible for those outside this loop.

The FCA must do much more to reach out to smaller and specialist consumer groups (for instance, the UK Shareholders Association, the Association of Member Nominated Trustees, and others representing the beneficiaries of particular types of financial services), for example by establishing working groups representing consumers in particular sectors, and by better publicising relevant consultations among consumer groups with a potential interest. Any such processes should be fully transparent and publicised through a revamped FCA website, rather than relying on organisations having personal contact with the FCA. The FCA should also reach out to a wider range of civil society organisations who may not be consumer groups in the traditional sense, but may have expertise on financial services issues with implications for consumers.

In addition, we believe the FCA must be far more alert to the dangers of regulatory capture. We are somewhat concerned that the focus on improving consultation with regulated firms

risks entrenching the influence of the finance industry over its own regulation, which in our view is already excessive and which is widely acknowledged to have been a contributing factor in the global financial crisis. The FCA's priority should not be to improve its already extensive links with regulated firms but to urgently address the imbalance of power between consumers and industry. Symptomatic of this is the existence of three Practitioner Panels as against only one Consumer Panel.

The FCA should also seek to safeguard against regulatory capture through its recruitment policies. Whilst recruiting from the financial services sector will clearly always be necessary in order to maintain the necessary level of industry expertise, the FCA should also seek to recruit more widely among economists, consumer and competition specialists, those with a policymaking or regulatory background, etc.

## **Conclusion**

Wholesale markets need to function competitively and with integrity if consumers' interests are to be safeguarded. Market failure due to ineffective competition is detrimental to consumers. The approach developed by the FSA for retail markets should be extended to wholesale markets. Authorised firms providing advice should be presumed to have more knowledge and expertise than their clients and should therefore have a duty of care towards them. Charges for services should be transparent and agreed with clients. Where charges are excessive, the regulator needs to act to constrain returns to shareholders and employees to that which would be achieved by efficient firms in effectively competitive markets.

In order to advance its consumer protection objective – as well as its role in contributing financial stability – the FCA must also take far more interest in the content of asset managers' investment strategies and the extent to which investment products, taken as a whole, are capable of delivering sustainable long-term returns to consumers such as pension savers. The Kay Review has identified an important agenda in this respect which we very much hope the FCA will embrace.

Given the past lack of focus on wholesale markets by the FSA, as well as the emerging evidence of poor conduct, it would be timely for the FCA to initiate a Wholesale Markets Review exercise.