



National Audit Office

Report

by the Comptroller
and Auditor General

Financial Conduct Authority and Financial Ombudsman Service

Financial services mis-selling: regulation and redress

Key facts

£22.2bn

compensation paid between April 2011 and November 2015 following mis-selling of payment protection insurance (PPI)

59%

of customer complaints to financial services firms related to mis-selling (including PPI) in 2014, compared to 25% in 2010

£3.8–£5bn

estimated amount of PPI compensation received by claims management companies between April 2011 and November 2015

£298 million fines issued by the Financial Conduct Authority for mis-selling activity since April 2013

£834 million total operating costs of the Financial Conduct Authority (£523 million), Financial Ombudsman Service (£240 million) and Financial Services Compensation Scheme (£71 million) in 2014-15¹

62% of mis-selling complaints have been upheld by the Financial Ombudsman Service since April 2013

17% of payment protection insurance cases at the Financial Ombudsman Service have been waiting over two years to be resolved (39,300 complaints)

£898 million amount of compensation received by consumers from the Financial Services Compensation Scheme related to mis-selling by defunct firms, between 2010-11 and 2014-15

¹ These include costs for many activities other than regulating and responding to mis-selling.

Summary

1 Mis-selling of financial services products can cause serious harm. Mis-selling can take many forms. In 2013, the Financial Services Authority defined it as “a failure to deliver fair outcomes for consumers”, including providing customers with misleading information or recommending that they purchase unsuitable products.¹ It has occurred across many different product areas, including bank accounts, consumer loans and insurance. Between April 2011 and November 2015, financial services institutions paid out at least £22.2 billion in compensation to people who had bought payment protection insurance, following complaints and regulatory action. The Bank of England has identified the consequences of misconduct by banks, including mis-selling, as a risk to financial stability. It views addressing misconduct as essential for rebuilding confidence in the financial system.

2 In 2013, the value of goods and services produced in the UK financial and insurance sectors was over £120 billion, about 7% of gross domestic product. Until 2013, most of the financial services sector by value was regulated by the Financial Services Authority. The Financial Services Act 2012 created the Financial Conduct Authority (FCA) and the Prudential Regulation Authority to replace the Financial Services Authority from April 2013. The FCA has a strategic objective to ensure that the relevant markets function well. The FCA's three statutory operational objectives are to secure an appropriate degree of protection for consumers, to protect and enhance the integrity of the UK financial system and to promote competition in the interest of consumers.

3 Several other bodies have a significant interest in mis-selling of financial services. The Financial Ombudsman Service (the Ombudsman) aims to resolve individual complaints between consumers and businesses. The decisions it makes can be binding on firms. The Financial Services Compensation Scheme (FSCS) pays compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it. The Money Advice Service aims to improve people's understanding and knowledge of financial matters and their ability to manage their financial affairs. HM Treasury sponsors all of these bodies, and has some powers over them, which vary according to the institution but include the ability to appoint or approve the appointment of some or all board members. In addition, the FCA oversees the budget of the FSCS, the Ombudsman and the Money Advice Service.

¹ Financial Services Authority, *Final guidance: Risks to customers from financial incentives*, January 2013.

4 In this report, we assess:

- how the bodies involved coordinate their activities with respect to mis-selling, and the costs involved (Part Two);
- how the FCA acts to prevent and detect mis-selling (Part Three); and
- how redress is provided to consumers (Part Four).

5 We focus on retail mis-selling by authorised financial services firms. We did not audit the Financial Services Authority, so do not evaluate actions taken before April 2013, though we do describe them to provide context. We do not evaluate efforts to improve the financial literacy of consumers, led by the Money Advice Service.

6 Domestic and EU legislation prohibits the FCA from providing the Comptroller and Auditor General with certain confidential information that the FCA holds about firms. This means that we were unable to carry out a full assessment of the effectiveness of the FCA's actions, as we could not see all of the evidence that the FCA holds. For instance, we have only limited evidence on how the FCA's actions have changed firm behaviour.

Key findings

Coordination and costs

7 **The FCA's strategic approach to managing the interventions it makes in response to mis-selling is still evolving.** Under the new strategy it launched in December 2014, the FCA is developing 'common views' to bring together data and intelligence, helping it to analyse what is happening across regulated sectors and to identify the right interventions. This should help to inform its decisions on what to prioritise and improve its understanding of risks. The FCA sets objectives for individual interventions and learns lessons from them. But it does not yet systematically draw together aims and success criteria for related interventions, evaluate how they fit together, or link the outcomes of interventions to their costs. This creates a risk that interventions may not be well coordinated, and means that the FCA cannot be sure that it has chosen the most cost-effective way of intervening (paragraph 2.2).

8 The FCA and the Ombudsman work hard to coordinate their activities, but haven't yet convinced firms that they have succeeded in doing this. Effective coordination between the FCA and the Ombudsman could help them both to carry out their different statutory roles. We saw examples of coordination at many levels, including strategic assessments of risks and operational discussions about particular firms. Industry representatives told us that they felt that a lack of coordination between the FCA and the Ombudsman can result in duplication of activities and extra costs to firms. Many examples they gave us seemed to reflect the differing remits of the FCA and the Ombudsman, but some seemed to reflect shortcomings in operational coordination. For example, the British Bankers Association told us that banks are sometimes asked to provide the Ombudsman with evidence demonstrating the appropriateness of products, services and charges, despite already having given this information to the FCA. Such duplications partly reflect legal restrictions on information sharing, but there is likely to be scope for some operational improvements (paragraphs 2.3 to 2.5).

9 The costs of regulatory responses to mis-selling, and of arranging for redress for consumers, are substantial, and some gaps in the FCA's understanding of the costs of its activities could hamper its decision-making (paragraphs 2.6 to 2.11):

- **Direct costs.** The 2014-15 operating costs of the FCA, the Ombudsman and FSCS were £523 million, £240 million and £71 million respectively. There is no complete estimate of the costs of their mis-selling work, partly because mis-selling issues cut across several areas of regulation. These costs are met by financial services firms in the first instance, but ultimately consumers pay too through firms' fees and charges. Firms also incur the costs of independent reviewers appointed by themselves or by the FCA, which can be substantial. The FCA reports that nine firms have paid £300 million to independent reviewers for work on the interest rate hedging products redress scheme.
- **Compliance costs.** Compliance costs are difficult to assess accurately because it is hard to determine what firms would do in the absence of regulation, and the FCA does not estimate the overall costs of complying with regulations. Smaller firms may face proportionately higher costs, since they are less able to develop in-house regulatory expertise. For proposed new rules, the FCA estimates benefits and costs in advance, including compliance costs. But it does not routinely undertake post-implementation reviews, which could improve its understanding of the actual impacts of regulatory interventions, including their effects on smaller firms. Of the 15 firms who responded to our information request, nine told us that their costs of complying with FCA conduct regulations were now 'much more' than in 2008. This could reflect the cost of strengthening compliance in response to past misconduct.
- **Wider costs.** Regulation aimed at preventing the sale of unsuitable products could have unintended consequences, such as discouraging innovations that could benefit consumers. For example, one firm told us that it considered that firms had become more reluctant to introduce new products, because they could subsequently be regarded as mis-sold if they prove to be unsuitable for some consumers. The FCA has established an innovation hub to allow firms to develop new services and products in an environment of regulatory support, advice and challenge.

Prevention and detection of mis-selling

10 Increased fines and redress payments appear to have substantially reduced financial incentives for firms to mis-sell products. Historically, firms and their sales staff had strong financial incentives to sell products such as payment protection insurance to their customers, even where the products were unsuitable, and many firms appear to have judged the immediate benefits of mis-selling to be greater than the later potential costs of compensation and fines. The FCA has made multiple interventions to affect incentives, including introducing restrictions on bonus structures through the remuneration code, and imposing mis-selling fines totalling £298 million from April 2013 to October 2015. Redress payments have been substantially larger, particularly for mis-selling of payment protection insurance. Most firms responding to our information request reported changes to their incentive structures to reduce the risk of mis-selling, in part because of the FCA's actions. The FCA has done valuable work to assess firms' incentive schemes for their retail sales staff, but it does not yet have an integrated picture of whether firms, and people working within them, could benefit financially from carrying out mis-selling activities (paragraphs 2.2 and 3.4 to 3.6).

11 The FCA is also acting to change other causes of mis-selling within firms. It has promoted changes to governance and internal controls, and launched campaigns aimed at helping people to avoid buying unsuitable products. The Senior Managers Regime, which is due to be introduced for banking sector firms in 2016, is expected to make individuals more accountable for their actions. In responding to our information request, several firms told us that they had made changes to their approaches, including devoting more senior management time to the risks of mis-selling and misconduct. However, both firms and the FCA acknowledge that changing the culture throughout firms is challenging, particularly at middle management level. Although the FCA undertakes several activities aimed at reaching smaller regulated firms, some smaller firms told us that they sometimes found it difficult to know how to comply with mis-selling regulations, as they had little interaction with the FCA (paragraphs 3.7 to 3.9).

12 The FCA lacks good evidence on whether its actions are reducing overall levels of mis-selling. Complaints data provide an imperfect indicator of current mis-selling levels because complaints may reflect past mis-selling rather than continued problems, and the FCA's information on complaints to firms does not identify when alleged mis-selling took place. The FCA does not yet draw together information that could show whether its actions are reducing mis-selling. In 2014, mis-selling accounted for 59% (2.7 million) of customer complaints to financial services firms. This compared with 25% (0.9 million) in 2010. Payment protection insurance alone accounted for 2.3 million complaints in 2014 – 51% of all complaints. There has been no clear trend in complaints about mis-selling of products other than payment protection insurance (paragraphs 3.10 and 3.11).

13 The FCA is taking a more active approach than its predecessor to identifying and responding to risks related to mis-selling, particularly for new products. It has developed information and analysis processes and techniques, which it told us helped it to detect potential mis-selling of self-invested personal pensions at an early stage. It has used its powers to stop the sale of unsuitable products, such as the sale of contingent convertible securities to retail customers; it expects this to prevent between £16 million and £235 million of detriment. The FCA has identified pension reforms as a possible trigger for future mass mis-selling, and is acting to prepare itself for the problems that may arise. It is also improving its understanding of the drivers of consumer behaviour. However, some consumer and firm representatives told us they thought the FCA's approach was based too much on monitoring and implementing detailed disclosure requirements, rather than assessing whether consumers truly understand what they are buying (paragraph 3.12).

Redress for consumers

14 Overall, banks' handling of complaints has been poor, requiring ongoing action from the FCA and the Ombudsman. Inadequate complaint handling by financial services firms has been a factor in many cases of alleged mis-selling going to the Ombudsman for adjudication, and in increased use of claims management companies by consumers. The FCA has tried to improve complaints handling by introducing new rules, conducting thematic reviews and taking enforcement action (including fining Lloyds Banking Group £117 million). The Ombudsman also provides guidance to firms based on the cases it adjudicates. The FCA and the Ombudsman told us that in their view complaints handling has improved over time. Seven out of 15 firms that responded to our information request reported changes in their approach, at least partly as a result of the FCA's or the Ombudsman's actions. However, there has been no noticeable fall in the level of complaints about mis-selling upheld by the Ombudsman in the past five years. It has found in favour of consumers in 62% of cases raised with it since April 2013 (paragraphs 4.2 to 4.4).

15 The FCA does not evaluate its chosen redress schemes formally, making it hard to assess whether schemes achieve their intended outcomes. The FCA has several informal and formal options for securing redress for consumers from firms. The type of redress mechanism chosen can affect outcomes, including speed of redress, the proportion of affected customers that receive redress, and the costs of providing redress. The FCA has set objectives, considered options, monitored progress and learned lessons for some larger, high-profile redress schemes. It decides on its approach to redress on a case-by-case basis, having regard to specific regulatory failings and consumer detriment. To date, it has not formally evaluated the factors that contribute to successful outcomes across different types of redress routes, including redress through complaints to the Ombudsman, but it has started work to identify common principles that should feature across its redress schemes (paragraphs 4.5 to 4.7).

16 The Ombudsman has continued to provide an effective service to complainants following a massive increase in complaints, but it has struggled with a backlog of older payment protection insurance cases. The Ombudsman opened around 400,000 new mis-selling cases in both 2012-13 and 2013-14, compared with around 120,000 in 2010-11, because of a rapid increase in complaints about payment protection insurance. The Ombudsman has trebled in size in response, without any evidence of a fall in the quality of its decision-making; in 2014-15, 74% of complainants agreed that the Ombudsman handled complaints efficiently and professionally. The Ombudsman received 1.49 million payment protection insurance complaints between 2001 and January 2016, 93% of these since 2010. Although the Ombudsman has reduced the number of open payment protection insurance cases from over 445,000 in May 2013 to 234,000 in November 2015, 17% of open cases (39,300) have now been outstanding for more than two years. Only 52% of complainants agreed that the Ombudsman settled disputes in an acceptable length of time (paragraphs 4.8 to 4.11).

17 Although complaining directly to the Ombudsman is straightforward and free, many consumers who have been mis-sold financial products fail to receive full compensation, because of lack of awareness or reliance on claims management companies. Lack of awareness can mean that consumers do not know that they were mis-sold a product, or that redress is available. The Ombudsman has found that many consumers don't pursue a complaint because they believe that it wouldn't achieve anything, or that it would be too stressful. The FCA, the Ombudsman and the FSCS have had some success in increasing awareness of mis-selling and redress, but the scale of the challenge is large. In 2014-15, 80% of survey respondents had some awareness of the Ombudsman, though only 24% could name it without prompting. The Ombudsman and the FCA have tried to encourage consumers to complain directly if they have problems, with little apparent impact so far; around 80% of payment protection insurance complaints to the Ombudsman come through claims management companies. We estimate that, between April 2011 and November 2015, claims management companies received between £3.8 billion and £5 billion of the £22.2 billion of compensation paid out to consumers of payment protection insurance (paragraphs 4.14 to 4.19).

Conclusion on value for money

18 The regulatory and redress bodies have carried out many activities to prevent and detect mis-selling and to ensure that consumers receive the redress to which they are entitled. These appear to have increased the prominence of mis-selling issues in financial services firms. But the complexity of products, continuing commercial incentives to achieve sales, and the difficulties in changing cultures within firms mean the risk of mis-selling remains. The FCA's strategic overview of these risks, and its understanding of the cost-effectiveness of different interventions and redress schemes, are currently limited, which makes it harder to respond effectively when problems emerge.

19 Legislative restrictions have prevented the FCA from sharing with us information it holds on firms. This makes it impossible for us to draw definitive conclusions on its approach. The information available to us, such as customer complaints, does not show any clear reduction in the extent of mis-selling. Despite some signs of progress, the FCA therefore has further to go to demonstrate that it is achieving value for money. The Ombudsman has dealt well with the unprecedented increase in its workload because of payment protection insurance cases, but there remains a substantial backlog of complaints.

Diagnosis and recommendations

20 The task of reducing mis-selling of financial services cost-effectively is a difficult one. Consumers often have limited information and exhibit behavioural biases, which can make mis-selling very profitable for firms. The FCA faces challenges in promoting good behaviour and cultures in firms, and in tackling the weaknesses that the Financial Services Authority and the FCA had identified in previous regulatory approaches. Our recommendations are designed to build on the FCA's current strategy and increase confidence that it is achieving its intended outcomes for consumers.

21 The FCA should:

- a** **Develop further its strategic view of the risks of mis-selling and its approach to tackling them.** It should communicate its expectations with regard to mis-selling clearly and consistently to firms, and work with the Ombudsman to assess regularly how it is affecting how firms and individuals weigh up the potential risks and rewards of mis-selling. It should ensure that it routinely defines the aims and success criteria of regulatory actions, monitoring and formally evaluating whether it has achieved them. The FCA should draw together indicators to help it and others to judge whether its actions on mis-selling are achieving their intended effects. These actions would help it to follow through on the impacts of its work and to judge the relative effectiveness of different interventions.
- b** **Develop a stronger understanding of the total costs and benefits of its work, and use cost and benefit information more routinely in its decision-making.** This should include detailed evaluations of how regulatory changes affect the costs of compliance. It should use a wide range of data sources to help it to assess how consumer behaviour responds to regulatory interventions. This would support its evaluations of the effectiveness of its work, and increase confidence that it is achieving value for money.

c Formalise its approach to evaluating redress mechanisms, including their costs, rates of uptake by consumers and how quickly they provide redress to consumers. It should set out clear success criteria and compare the effectiveness of different types of schemes. This would help it to identify more clearly the factors that contribute to successful scheme outcomes and to make more informed decisions between different approaches. It should work with the Ombudsman and financial services firms to evaluate tools for encouraging redress, including complaints-led approaches.

d Analyse alternative approaches to deciding whether products are mis-sold. At present, as well as undertaking a wide range of other regulatory activities, the FCA places detailed requirements on how firms describe and sell their products. It should assess whether an approach based on firms testing customer understanding directly, and the FCA assessing how they do so, would be more effective. It should consider whether its current rules prevent potentially valuable innovations.

22 The FCA and the Ombudsman should:

e Work together to improve firms' complaints handling, to develop better measures of the quality of complaints handling, and to publish the results. They should build on existing industry good practice in measuring complaints handling performance to facilitate comparisons between firms. This would enable them to assess whether complaints handling is improving, and help consumers and regulators to put pressure on poorly-performing firms.

f Work with financial services firms to help consumers to access redress without using claims management companies. They should test the effectiveness of different approaches to encouraging direct compensation claims, and implement any lessons that result in advance of a possible deadline for payment protection insurance complaints.

23 The Ombudsman should:

g Outline publicly how quickly it expects to clear the backlog of payment protection insurance cases on current assumptions about caseload, and report progress regularly. Given the likely increase in cases in the run-up to a possible deadline for claims, it is vital that it deals with the current backlog well before this date.

24 HM Treasury should:

h Strengthen the FCA's accountability by removing restrictions on the disclosure to the Comptroller and Auditor General of information that the FCA holds on firms, where this is permitted in EU law. Following the financial crisis, Parliament made the Comptroller and Auditor General the statutory auditor of the FCA, with the objective of improving accountability. But this is currently impeded by the impossibility of carrying out a full assessment of the effectiveness of the FCA's actions to influence firm behaviour. As a result, we cannot conclude on the economy, efficiency and effectiveness of its use of resources.

25 If HM Treasury and the Ministry of Justice propose any major changes to the regulation of claims management companies, they should:

i Establish an approach and timeline for evaluating the impacts of the changes on consumers and businesses. The Ministry of Justice should publish estimates of the effect of claims management companies on compensation received by consumers, before and after any cap on the amount that claims management companies can charge their customers.