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20 November 2017

Jim Shannon MP
House of Commons
London
SW1A 0AA

Our Ref: SA170922A

Dear Mr Shannon

Re: (A) TSC: March 2015 – Conduct and competition in SME lending

Thank you for your letter of 19 September 2017, on our approach to small and medium sized enterprises (SMEs) as users of financial services.

I apologise for the long delay in responding to you. I understand that a member of my Public Affairs team has been in touch with your office directly. Please continue to liaise with them or get in touch with my office if you have any further questions.

You asked for a detailed list of concrete actions the Financial Conduct Authority (FCA) has taken or committed to for SMEs, since the financial crisis; including any taken after considering the feedback received to our Discussion Paper on SMEs as users of financial services (DP15/7).

You also asked for a detailed list of concrete actions taken by Government (including, but not limited to, legislation) since 10 March 2015, and any actions we believe still require action by Government and Parliament.

I provide a list of these actions below, organised into relevant themes. I also address separately your question as to whether there are areas that we believe still require action by Government and Parliament.

It is possible to time the onset of the financial crisis in different ways; for the purposes of this response I take September 2007 and the failure of Northern Rock as the beginning of the crisis. Financial regulation usually applies on the basis of the activities carried on, as opposed to the type of client (that is, whether a customer is an SME does not normally dictate how regulation applies). So I have included interventions that I believe offered, or will offer, significant new protections to SMEs regardless of whether they were the only or main target of the intervention.

Ring-fencing and structural reform

In response to recommendations made by the Independent Commission on Banking in 2011, the Government, in 2013, inserted provisions into the Financial Services and Markets Act 2000 (FSMA) that will establish a ring-fencing regime for the UK's largest banks from 1 January 2019. The legislation aims to isolate retail banking from investment banking and so reduce the likelihood of disruption to key retail services (including for example payments services or overdrafts used by small businesses).

Certain larger SMEs are able to opt out of ring-fencing of their deposits. In 2015 we provided guidance on our approach to supervising firms' ring-fencing arrangements¹ and consulted on how firms should communicate to their clients, including SMEs, the potential risks arising from not being ring-fenced.² Our work should help ensure that SMEs only decide to opt out of ring-fencing where they understand properly the implications of this.

Senior Managers and Certification Regime

In response to the recommendations of the Parliamentary Commission for Banking Standards (PCBS) HM Treasury legislated to implement a new Senior Managers and Certification Regime (SMCR) for all deposit takers. This regime has been in force since March 2016. HM Treasury has since legislated to extend this regime further to cover all authorised persons from 2018. Among other things the SMCR incorporates high-level Conduct Rules reflecting the core standards expected of all staff. These focus on employees acting with integrity; skill, care and diligence; and with regard to the interest of customers – as well as being open and cooperative with regulators; and observing proper standards of market conduct.

For most firms the Conduct Rules will apply only to regulated activities (and any activities necessary to carry these out). However, under the banking regime the Conduct Rules apply to everything someone does on behalf of their firm, whether it's regulated or unregulated or linked to financial services at all. In practice this means that we can hold bank senior management to account for breaches of the conduct rules in relation to activities, such as lending to small companies, which are otherwise unregulated.

We are currently consulting on how we propose to apply the SMCR³ to firms outside of the banking sector. Once we have reviewed the feedback to our consultations we will confirm our final package of rules and intend to publish a policy statement in the summer.

Conduct in retail banking

In 2008 the FSA consulted on the implementation of the Payment Services Directive (PSD), implemented in the UK through the Payment Services Regulations 2009 (the PSRs). The PSD and the PSRs set out conduct of business requirements on the information that must be provided to customers (including micro-enterprises)⁴ and the respective rights and obligations of payment services users and providers. These requirements came into effect in early 2009. As a result SMEs gained important protections when making payments. For example the rights to claim refunds for unauthorised transactions were made clearer and liability for these payments was capped. Micro-enterprises were also given rights to take complaints about payments services to the Financial Ombudsman Service (the Ombudsman).

Alongside PSD implementation the FSA consulted on creating a conduct regime for retail banking, including banking services to micro-enterprises. This regime replaced previous industry self-regulatory codes and applied our core Principles for Business to retail banking. The Principles are the core planks of regulation setting out high level obligations such as the requirement for firms to conduct their business with integrity. It also introduced high level requirements in relation to, among other things, the provision of information about banking services, and the fair treatment of customers in financial difficulty.⁵

¹ <https://www.fca.org.uk/publication/guidance-consultation/gc15-05.pdf>

² <https://www.fca.org.uk/publication/consultation/cp15-23.pdf>

³ <https://www.fca.org.uk/publication/consultation/cp17-25.pdf> and <https://www.fca.org.uk/publication/consultation/cp17-26.pdf>

⁴ Micro-enterprises are businesses with fewer than 10 employees, and either turnover or gross assets not exceeding EUR2m

⁵ http://www.fsa.gov.uk/pubs/policy/ps09_06.pdf

From 2018 the implementation of the revised Payment Services Directive (PSD2) will further enhance the rights of micro-enterprises and, subject to opt-out, larger businesses when they are using payment services. It also aims to give banking customers, including SMEs, greater control over their banking by requiring banks to give certain regulated firms access to customers payment accounts information, subject to the customers consent. This could in future enable provision of tailored switching services and price comparison for customers, including SMEs. HM Treasury has already legislated to implement the Directive and earlier this year we published our final rules and guidance on the subject.⁶

Regulation of consumer credit, access to finance and expansion of the FOS jurisdiction to unregulated lending

Following a Government consultation in 2013, we took over regulation of consumer credit from the Office of Fair Trading (OFT) in 2014. The regulatory perimeter for the Consumer Credit Act (CCA) includes some business lending, namely loans up to £25,000 to sole traders, small partnerships and other unincorporated bodies (but not limited companies). This means regulated businesses lending and broking are subject to our high-level Principles together with detailed conduct of business rules in our Consumer Credit sourcebook (CONC). These include rules on assessing creditworthiness (including affordability) and the provision of adequate pre-contractual explanations to customers.

Regulated loans are within the compulsory jurisdiction of the Ombudsman, and we have subsequently extended this to include "lending money" more generally. This means that micro-enterprises can bring complaints about loans to the Ombudsman even if the loans in question are outside our regulatory perimeter.⁷

Alongside this, we worked with HM Treasury to create a bespoke regulatory regime for loan-based crowdfunding (also known as 'peer to peer' pending).⁸ Since we published our rules in 2014 crowdfunding has grown to become a significant source of funding for small businesses; we estimate that it provided almost 7% of all gross lending to UK SMEs in 2016.

Competition and market function in retail banking and retail lending

In 2013 the Government launched the Current Account Switch Service (CASS). The CASS, which today is owned and managed by Bacs, allowed consumers to safely and reliably switch their accounts between banks in 7 days, with a guarantee that they would be fully protected against any financial loss in the event a problem occurs during the switch. We reviewed the effectiveness to date of the CASS in 2015 and gave feedback to the newly-created Payment Services Regulator (PSR) as well as the Competition and Markets Authority (CMA).⁹

In 2014 the CMA provisionally decided to make a Market Investigation Referral in relation to the provision of retail banking services to SMEs and to the provision of Personal Current Accounts. The CMA's decision built on evidence from our joint market study into competition in SME banking, published in July 2014.¹⁰

⁶ <https://www.fca.org.uk/publication/policy/ps17-19.pdf>

⁷ <https://www.fca.org.uk/publication/consultation/fsa-cp13-07.pdf>

⁸ <https://www.fca.org.uk/publication/policy/ps14-04.pdf>

⁹ <https://www.fca.org.uk/publication/research/making-current-account-switching-easier.pdf>

¹⁰ https://assets.publishing.service.gov.uk/media/53eb6b73ed915d188800000c/SME-report_final.pdf

The CMA reported on the findings of its full investigation in August 2016¹¹, setting out a package of remedies. The CMA recommended that we take a role in implementing some of these, including some directly relevant to SMEs:

- The CMA has compelled banks to assess and publish specific indicators of their service quality, to help SMEs think about their choice of business account provider. We have consulted¹² on service quality indicators that might be added to make this choice easier, and we will provide feedback later this year.
- We are also considering what (if any) prompts might encourage business customers to review how they use their account and who they choose to have an account with.
- We will sit as an observer on the industry-led group which aims to standardise the process for opening a business current account across the banks.
- We are also engaging with the Implementation Entity established under the CMA's Order to implement the CMA's open banking remedy, which will create a shared standard across the largest banks to share account data (similarly to the requirements under PSD2), helping innovative and SME-friendly services to develop.

We are also currently conducting a strategic review of retail banking business models – a programme of work to examine the business models used in the retail banking sector and evaluate the impact of changes on competition and conduct. We will look across the retail banking balance sheet and consider the full range of personal banking products/services including SME banking. We expect to produce a project update in Q2 2018, explaining our preliminary analysis and conclusions from phase 1 of this work.¹³

Insurance distribution and insurance claims management

The Insurance Act 2015 changed how disputes about insurance contracts work. This means that an insurer can avoid an insurance contract only where the breach by the insured party (for example leaving out relevant information) was deliberate or reckless or where the insurer would not have entered into the contract on any terms had the breach not occurred. The Act also abolished the law that meant a breach of a warranty in a contract of insurance resulted in the discharge of the insurer's liability under the contract. Instead, the insurer's liability will be suspended in such circumstances until the breach is remedied. This brings the treatment of commercial claims, including those by SMEs, closer to that of retail consumer complaints. Insured parties can now claim damages for late payment of a valid claim, which can be an important issue for SMEs. We consulted on changes to our rules to align with the requirements of the Act in 2016¹⁴ and the changes came into effect in August this year.

In May 2014 and May 2015 we reported on the findings of our thematic review into conflicts of interest among commercial insurance intermediaries¹⁵ and our thematic review into the handling of insurance claims for SMEs, respectively.¹⁶ In summary we found that there was a gap between SMEs expectations and the service they received when they try to make a claim. We have actively engaged with firms, senior figures in the industry, and relevant trade bodies to discuss the findings of the reviews, with a key focus on the changes that may be required to improve outcomes for SMEs.

¹¹ <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>

¹² <https://www.fca.org.uk/publication/consultation/cp17-24.pdf>

¹³ <https://www.fca.org.uk/publications/multi-firm-reviews/strategic-review-retail-banking-business-models>

¹⁴ <https://www.fca.org.uk/publication/consultation/cp16-17.pdf>

¹⁵ <https://www.fca.org.uk/publication/thematic-reviews/tr14-09.pdf>

¹⁶ <https://www.fca.org.uk/publication/thematic-reviews/tr15-06.pdf>

We have also provided feedback to the specific firms included in the reviews. The industry has responded to our findings, including for example publishing industry guidance aimed at preventing under-insurance for SMEs.

In relation to Insurance Based Investment Products (IBIPs), the Insurance Distribution Directive (IDD) requires that firms provide appropriate information to customers and act honestly, fairly and professionally in the best interests of customers. As part of this, firms must avoid pay and performance management practices that would conflict with the customer's best interests.

HMT consulted on the transposition of the IDD in early 2017 and we are currently consulting¹⁷ on rules changes to implement these IDD provisions, but we are proposing to apply them to all insurance products, including commercial insurance, that fall under the Directive.

The new requirements will come into effect in early 2018 and should help reduce the risk of firms distributing to SMEs insurance products that are poor value for money or unsuitable for the SMEs' needs.

Product governance

From 2018 new product governance provisions will apply to products and services that are in scope of the second Markets in Financial Instruments Directive (MiFID II) and insurance products under the IDD – between them the Directives cover a broad range of investment and insurance products. These will oblige providers to maintain, operate and review a product approval process to identify a target market for each product and ensure that products meet the needs of the target market. These protections will help ensure that firms reflect on the needs of their SME clients and what products might be appropriate for them, and could help prevent the mis-selling to SMEs.

Conduct of business in relation to investments

Once MiFID II has been implemented, some protections that at the moment only apply to retail clients will be extended to professional clients (a more sophisticated category of client) and, in some cases, to eligible counterparties (the most sophisticated clients). This is likely to benefit a small percentage of SMEs, usually larger ones, who may have chosen to "opt up" into professional client status. MiFID II also expands the range of products classified as 'complex', meaning that for a wider range of products firms will have to assess whether sales of these are appropriate, regardless of whether or not they are giving their clients formal advice on what to purchase.

These changes are likely to benefit SMEs purchasing more complex investment products, and avoid non-advised sales to SMEs that do not have the knowledge, experience and expertise to understand the risks involved in using the relevant products. We consulted on rule changes to implement these requirements in 2016 and published feedback and final rules earlier this year.¹⁸

Improvements to complaints handling and access to the ombudsman service

In 2008 the FSA consulted on changes to the rules that cover who can complain to the Ombudsman, making micro-enterprises *eligible complainants*. Eligible complainant status is important to SMEs because a firm dealing with an eligible complainant has to follow our complaints handling and reporting requirements and an eligible complainant can refer their complaint to the Ombudsman if it cannot be resolved by the firm.

¹⁷ <https://www.fca.org.uk/publication/consultation/cp17-33.pdf>

¹⁸ *ibid*

Between 2010 and 2011, the FSA consulted on a number of further changes to DISP.¹⁹ These included increasing the ombudsman service's award limit from £100,000 to its current value of £150,000 and requiring firms to identify a senior individual responsible for complaints handling. The rules came into effect from early 2012, and should result in more meaningful compensation for SMEs with higher-value disputes, where firms might have a lesser incentive to provide redress informally.

In late 2014 we consulted on measures to improve complaints handling by retail financial services firms, including an obligation to notify eligible complainants that they can refer their complaints to the Ombudsman. All of these changes have been in force since June 2016 and should, taken together, result in greater awareness of the ombudsman service among SMEs.

We have committed to further changes to the scope of the Ombudsman to help small business which I discuss below.

Next steps: Matters for Government and Parliament

Questions around the Government's policies in support of SMEs as users of financial services, or in support of SMEs more generally are, rightly, matters for the Government to comment on directly. We are working closely with the Government on SME issues as my summary above shows.

As you know, we published a review of the protections available to SMEs as users of financial services in November 2015, in a Discussion Paper²⁰ which asked what more could be done to improve outcomes for this sector. In that paper we set out in some detail the limited grounds on which SMEs can take action compared to individuals, for example because they are not private persons for the purposes of s. 138D of the Financial Services and Markets Act 2000 (FSMA) and limits to our rule-making, supervisory and enforcement powers in FSMA where services are unregulated (for example in the case of corporate lending) or where the consumer is not a private person

We will publish our feedback to that paper in the near future, including a summary of the responses we received. The FCA is taking these issues seriously. It has taken us some time to reflect on the feedback we received, in order to make sure we get this right. In the meantime, however, we have committed publicly to specific work to improve SMEs' access to redress. When we consulted on our future Mission in October 2016 we explored the boundaries of our powers in relation to SMEs, and how we should approach this. In April 2017, we published a Feedback Statement (FS17/1)²¹ to this consultation. In that publication we acknowledged that overseeing redress schemes outside our regulatory perimeter or where our powers are more limited is 'clearly unusual'. We committed to address this, specifically in relation to SMEs, in an upcoming consultation to expand the remit of the Ombudsman. Giving more SMEs access to the Ombudsman will ensure a greater range of small business have access to quick, informal redress when things have gone wrong.

¹⁹ See for example http://www.fsa.gov.uk/pubs/cp/cp10_21.pdf

²⁰ <https://www.fca.org.uk/publication/discussion/dp15-07.pdf>

²¹ <https://www.fca.org.uk/publication/feedback/fs17-01.pdf>

HM Treasury stated in December 2016²² that they were willing to review SMEs' access to redress if our feedback to DP15/7 indicates that there is a case for them to do so. However, legislative change is, rightly, a matter for Parliament and Government.

I hope that this is helpful.

Yours Sincerely
Andrew Bailey

Andrew Bailey
Chief Executive

Cc Rt Hon Nicky Morgan MP

²² <http://hansard.parliament.uk/Commons/2016-12-15/debates/6783C8F6-7370-4CD0-B607-7834A68AD2A7/CommercialFinancialDisputeResolutionPlatform#contribution-64A29091-B860-45A6-9F6A-D692BC2A9D63>