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A model of protecting financial service clients in the UK[1]

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Abstract:

Aim: The purpose of the paper is to describe changes occurring in the UK in consequence of the financial crisis with regard to protecting financial service customers, which prompts towards the answer to the question about the optimum protection model when it comes to protecting financial market customers. The author analyses whether regulations in use in the UK are sufficient to ensure cohesion between the public supervision of the financial market and customer protection. In practice, these value may be in opposition.

Design / Research methods: The basic research method used in the paper is analysing sources of law and the literature of the subject.

Conclusions: The most recent financial market crises undermined the assumption that public and legal supervision is a sufficient tool preventing market turbulences. The financial market supervision should expand beyond professional financial service providers. At the same time, it is also necessary to ensure customer protection. Having conducted the research, the Author recognises that the model used to supervise the financial market and protect financial service customers adopted in the UK deserves to be multiplied on the basis of Polish law, with a particular focus on transferring the supervisory function to the central bank.

Originality / value of the article: The topic is pertinent and important as, in the EU member states, adaptation of new legal solutions in the area of financial supervision is considered. However, the problem tackled in the paper has not received any wider coverage in the literature of the subject. The UK regulations may and, according to the author - should serve as a model for the Polish legislator who is planning to challenge the issue of organising supervision over the Polish financial market in the near future.

Keywords: consumer protection, financial services, the UK, Prudential Regulatory Authority (PRA), Financial Conduc Authority (FCA)

JEL: K21, K23

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1. Introduction

Joseph E. Stiglitz, an American economist and a professor awarded with the Nobel Memorial Prize in Economic Sciences (2001), said that the role of financial regulations was to correct market failures (Stiglitz 1994: 14334). One of the key challenges faced by countries in response to the first wave of the financial crises was revision of their legal regulations in terms of correctness of their financial supervision model and the need to protect financial services. As it happened, the financial crises undermined the assumption that a public and legal supervision is a sufficient tool preventing market turbulences. This paper has been written to present changes embraced in the UK, introduced in consequence of the financial crises to protect clients buying financial services.

2. The need to change the existing supervision model in the UK

In 1985, the Bank of England appointed the Securities and Investment Board which, on the basis of the Financial Services Act of 1986 (1986 c. 60), became the regulator (i.e. "the delegated body") on the financial market. This board was appointed by the Treasury although it was operated independently of government. In October 1997, it was transformed into *Financial Services Authority* – FSA) (Ellinger, Lomnicka, Hare 2011: 28; Ferran, 2011: 455–480). The FSA was a quasi-judicial body in charge of regulation of the financial services industry in the United Kingdom until 2013.

The next stage for creating the supervisory architecture was set up by the Bank of England Law of 1998 (1998 c. 11) which served as the basis for transferring supervisory authority over banks to the FSA. In the literature, it is also emphasised that the Bank of England Law of 1998, while taking its supervisory competences from the central bank, at the same time reinforced its independence (particularly in the area of monetary policy) (Pilbeam 2010: 469).

Starting from 1990, the EU member states saw a departure from the sectoral supervision model in favour of an integrated supervision (Jurkowska-Zeidler 2008: 250–251).[2] Between 1997

[2] It is worth mentioning that a twin peaks model was introduced in the Netherlands, dividing supervisory competences among the central bank and the integrated supervision body.

and 2000, the FSA's competences were extended. Pursuant to the Financial Services and Market Act of 2000 (Financial Services and Markets Act 2000, 2000 c. 8, http://www.legislation.gov.uk/ukpga/2000/8/pdfs/ukpga_20000008_en.pdf; hereinafter: FSMA 2000), the FSA was carrying out an integrated supervision which included supervision over banking business (previously with the Bank of England), the securities market (previously with the Securities and Investment Council) and the insurance business (previously with a Department at the Ministry of Commerce and Industry). In addition, the FSA took over tasks in supervising the Building Societies Commission and Friendly Societies Commission. December 2001 saw the abolishment of the Securities and Futures Authority, Investment Management Regulatory Organisation and Personal Investment Authority. The above-listed entities were sectorial self-regulatory organisations, therefore, there were regulations of non-binding, non-compulsory nature for different sectors of the financial market. Competences of the three organisations were taken over by the FSA as "the super-supervisor".

A legal regulation intended at bringing close the Tripartite Authorities, ensuring stability of the financial market and integral solution of potential issues was *Memorandum of Understanding* (Ellinger, Lomnicka, Hare 2011: 28). It was signed between the Bank of England (responsible for the monetary policy), the FSA (as the regulator and supervisor of the banking sector) and the Treasury (the ultimate payer in the fiscal policy). The Memorandum led to the formation of the Standing Committee on Financial Stability as a permanent forum holding monthly meetings, a forum for agreements, coordination of activities and exchange of information on stability of the financial system (cf. item 10 and 11 *Memorandum of Understanding between HM Treasury, the Bank of England and the Financial Services Authority*, http://www.bankofengland.co.uk/about/Documents/legislation/ mou.pdf).

Moreover, FSMA 2000 set up the Financial Services and Markets Tribunal awarded with the right to give judgements in quasi-judiciary proceedings falling under the FSA supervision (cf. Articles 55, 58 and 132 of FSMA 2000). The Tribunal was given the right to make decisions, impose penalties, withdraw licenses, bank listing securities of a specific type as well as imposing a ban when it came to acting in some specific capacities by some specified persons.

The FSA has been much maligned for its perceived lack of supervision in the run-up to and during the financial crisis (Dhama, Taylor, Proctor 2010: 236). Lord Turner was obligated to coordinate works on analysing reasons which led to the crisis on the British market and develop

proposals for changes in connection with the situation at the time. One may conclude that, during the financial crisis of 2008–2009, the UK regulatory authorities did not have sufficient powers and instruments to eliminate reasons for the issues which emerged on the financial market.

The Treasury Select Committee working with the Central Bank and the FSA also published a report on the UK financial regulation on February 3, 2011. The Government published a summary report in November 2011 (*A new approach to financial regulation: summary of consultation responses*). The Government identified five key themes in its summary response:

- the need for the regulatory authorities' core statutory objectives to be balanced and supplemented with other factors,
- the importance of accountability and transparency for the PRA, the FCA, and the FPC;
- the need for a strong, coherent markets regulation function within the FCA, including the functions of the UK Listing Authority,
- the importance of the European and international agenda, both during the transition phase and in steady state, and
- the importance of effective coordination between the new regulatory authorities (*A new approach to financial regulation: building a stronger system* 2011: 6).

The main proposals in the UK came from the following sources: The HM Treasury Review ("Reforming financial markets" dated July 2009), the Turner Review for the Financial Services Authority (FSA; "Regulatory response to the global banking crisis" dated March 2009), the Banking Act 2009 and the Walker Review ("A review of corporate governance in UK banks and other financial industry entities" dated July 16, 2009) (Dhama, Taylor, Proctor 2010: 235).

A new structure of financial regulation was introduced in the UK on April 1, 2013 under the Financial Services Act 2012 (2012 c. 21; hereinafter: FS Act 2012). This regulation has largely amended the core legal regulation for the financial service market in the UK, i.e. the Financial Services and Markets Act 2000 (FSMA). Further reforms were introduced by the Financial Services (Banking Reform) Act 2013 (2013 c. 33).

3. Current supervision model in the UK

The crisis on the financial market of early 21st century prompted the UK to restructure its financial regulations, including liquidation of the financial supervision. By 2013, the Bank of England was responsible for stability of the entire UK financial system while supervision of financial institutions was the responsibility of the FSA. To a limited extent, the responsibility was also on the Treasury. On December 19, 2012, the Financial Services Act 2012 (FSA 2012) received royal acceptance. The Act abolished the FSA on April 1, 2013. The Financial Services Authority was blamed for irregularities which occurred in the first phase of the financial crisis, i.e. 2007–2008. In particular, it was blamed for not responding to banking malpractices such as selling term loans and credits. The new institutional structure which took a formal shape in 2012 seriously dented the FSA's reputation as a word-class regulator (Ferran, 2011: 479). This was a dramatic fall from grace for the FSA and a remarkable phoenix-like re-emergence for the Bank of England as a financial supervision (Ferran, 2011: 456).

The British Parliament divided the competences of then-existing supervisory body between two supervisory bodies: Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA). The PRA works to ensure security and reliability of the financial market. The FCA has a task to defend consumers and investors as well as the infrastructure of the financial market. Financial Conduct Authority is a new regulatory body for the UK financial services industry that was established in April 2013. This is an independent administrative authority. The FCA is responsible for regulating conduct in both retail and wholesale financial markets and the infrastructure that supports them (Law 2016: 245). The new body is intended to be more robust regulator than the FSA. It has been said that it will intervene more quickly to ban risky financial products and enforce its rulings with tougher penalties (Law 2016: 245). The FCA also assumes the responsibility for consumer credit regulation that was exercised by the Office of Fair Trading.

Several important consumer protection concepts were aptly raised and these should be fulfilled *de lege lata*. Including: system of financial regulation must provide a universal degree of protection in order to foster the overall trust and confidence that are critical to successful financial markets. It is essential to allow (and require) the FCA to take note of the principle that consumers should take the responsibility for their decisions because a regulator needs to be able to draw the line somewhere (Ferran 2012: 447–448).

According to the assumptions, the FCA would play a key role in maintaining the UK's regulatory standing and influence on the new European Securities and Markets Authority (ESMA). It would use its knowledge and expertise to play an important role in developing and shaping rules and standards as they affect the UK, not only at the EU level, but also at the level of international authorities (*A new approach to financial regulation: building a stronger system* 2011: 61).

Under the FSMA, the PRA and FCA share overall responsibility for the key aspects of banking regulation, namely: authorisation, prudential and conduct-of-business supervision, enforcement, and rule-making and regulatory policy with respect to these areas (Penn, Ko 2014: 405–406). A similar proposal to set up the Consumer Financial Protection Agency (CFPA), which should be independent as the FRB, FDIC and the SEC was also submitted in the US (Patrikis 2010: 212).

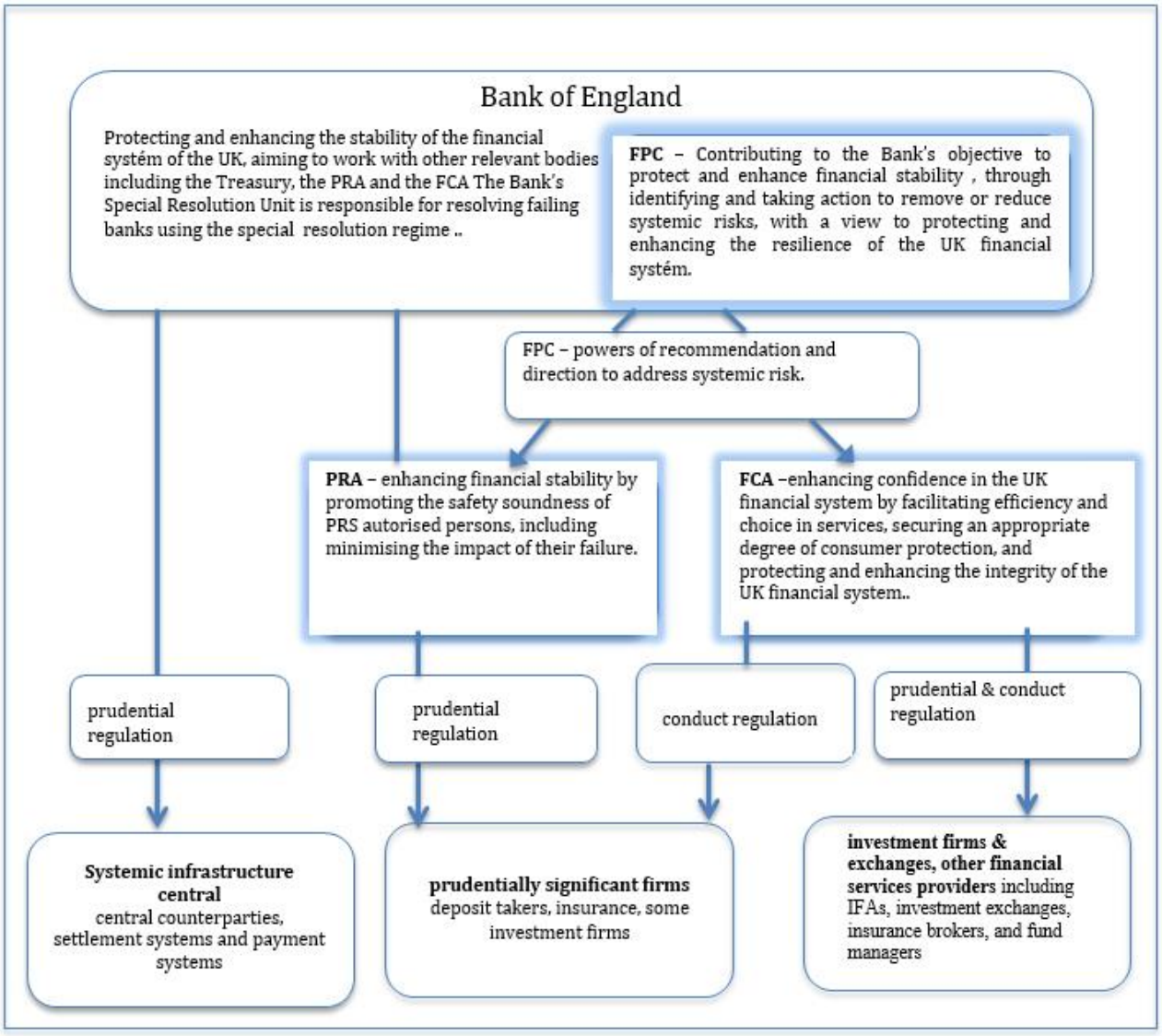
Both supervisory bodies operate with the purpose of taking *ex ante* actions to ensure protection of the financial market against unfavourable phenomena. For this reason, the "twin peaks" model was introduced. Such type of the financial supervision model is popular in the Anglo-American law system. Australia, Canada and the US can serve as examples here.

The PRA is an entity separated within the central bank and reporting directly to the central bank. As the name indicates, the PRA's activity is focused on prudential regulations for banks,[3] insurers and investment enterprises to guarantee the security and good standing of each financial institution. Therefore, the PRA is essentially responsible for macro-conservative supervision.[4] It supervises nearly 1,700 entities, including banks, insurers and credit societies (cf. http://www.bankofengland.co.uk/pra/Pages/default.aspx).

[3] While writing on the recommendations of the banking supervision authority as a source of banking prudential standards, M. Olszak points out that "the prototype of a recommendation in practice of the Polish banking supervision bodies may be found in general recommendation issued for the purpose of having a positive impact on the formation of a good banking practice" (Olszak 2011: 161)

[4] The macro-prudential supervision is "interpreted as long-term monitoring and assessment of risks to the financial stability at the national or supranational level, in each sector of the financial market and going beyond these sectors" (Fedorowicz 2013: 44). The macro-prudential supervision may be defined as "respecting and sanctioning non-observance of prudential standards which should be regarded by each individual financial institution operating on the EU financial market" (Fedorowicz 2013: 44).

Figure 1. A roles of the bodies in the new regulatory architecture



Source: *A new approach to financial regulation : building a stronger system* 2011: 5.

The objective of FCA, which was created on the basis of the dissolved FSA, is to protect and build a stronger trust in the financial services and market, also by protecting consumers and promoting competition (cf. Article 1A item 1, part 1A, the regulators – chapter 1: the Financial Conduct Authority, Financial Services Act 2012). The scope of its activities includes currency exchange, multi-lateral trading platforms (MTF) and consumer credit. The above indicates that, in essence, the FCA supervises financial services to verify whether clients of the broadly understood financial institutions are properly treated. The FCA controls operation of enterprises supervised by the PRA as well as other participants of the financial market, including brokers,

investment advisors and fund managers. The Financial Conduct Authority is the conduct regulator for 56,000 financial services firms and financial markets in the UK and the prudential regulator for over 24,000 of those firms (https://www.fca.org.uk/about/the-fca).

Table 1. Main functions of FCA

protecting consumers	protecting financial markets	promoting competition
– ensuring that a firm applies a pro-consumers policy during its conduct.	– conducting supervision, – enhancing cooperation, – sharing best practice, – discussing issues of common interest.	– promoting effective competition in consumers' interests in regulated financial services, – identifying and addressing competition problems and adopting a more pro-competition approach to regulation.
– monitoring which firms and individuals are able to enter the financial markets, – making sure that they meet standards before they are going to be authorise by FCA.		– investigating a range of markets, – identifying concerns and taking steps to address features which could inhibit effective competition.
– imposing penalties, – encourage consumers to report to FCA where they see potential harm or bad conduct, – working with a network of consumer organisations to raise awareness of the FCA's campaigns and helping inform FCA's approach to regulation, – keep a warning list of entrepreneurs breaching law.	Enforcement powers: – withdrawing a firm's authorisation, – prohibiting individuals from carrying on regulated activities, – suspending firms or individuals from undertaking regulated activities (in the case of certain infringements), – issuing fines against firms or individuals who breach the rules or commit market abuse, – issuing fines against firms breaching competition laws, – making a public announcement in the cases of disciplinary action and publishing details of warning, decision and final notices, – applying to the courts for injunctions, restitution orders, winding-up and other insolvency orders, – bringing criminal prosecutions to tackle financial crime, such as insider dealing, unauthorised business and false claims to be FCA authorized, – issuing warnings and alerts about unauthorised firms or individuals and requesting that web hosts deactivate associated websites.	– helping consumers get the information they need, – empowering consumers to assess the best choice for them, – helping consumers to act on their decisions, – seeking to ensure that firms compete fairly, – making it easier for new competitors to launch, – encouraging innovation in financial services, (In April 2015, the FCA was given powers to enforce against breaches of competition law, alongside the Competition and Markets Authority, for the provision of financial services generally).

Source: own study based on https://www.fca.org.uk.

The strategic objective of FCA is to ensure that the relevant markets function well. Especially its operational objectives are to:

- secure an appropriate degree of protection for consumers;
- protect financial markets by protecting and enhancing the integrity of the UK financial system;
- promote effective competition in the interests of consumers (https://www.fca.org.uk/about/the-fca).

From April 1, 2015 to March 31, 2016 the FCA issued 105 final notices: 75 against firms and 30 against individuals, secured 151 outcomes using its enforcement powers (138 regulatory or civil and 13 criminal ones) and imposed 34 financial penalties totalling £884.6m (Table 2) (*Annual Report and Accounts 2015/16*: 55).

Table 2. Financial penalties imposed

	2015/16	2014	2013/14
Number of financial penalties imposed	34	43	46
Total value of financial penalties	£884.6m	£1,409.8m	£425m
Number of financial penalties imposed against firms	17	23	27
Total value of financial penalties imposed against firms	£880.4m	£1,403.1m	£421.1m
Number of financial penalties imposed against individuals	17	20	19
Total value of financial penalties imposed against individuals	£4.2	£6.7m	£3.9m

Source: *Annual Report ...2016*, 55.

Moreover, it is worth noting that "in crisis management and crisis-solving actions, the very supervision is insufficient as it does not have sufficiently high financial resources to help directly the financial institution in danger. For this reason, its co-existence with the central bank and a guaranteed deposit system, within a well-designed security network, are so important […]" (Jurkowska-Zeidler 2008: 254). Another important function of a supervisory body is taking into account the interest of clients of broadly understood financial institutions, i.e. entities of non-professional character on the financial market. According to the literature on the subject, "the creation of a single regulator should be enable more appropriate regulation of an increasingly

cross-functional industry while eliminating (or at least dramatically reducing) potential boundary disputes between different regulatory functions" (Fawcett 2001: 56). As practice showed, the solution did not work. Thus, now, in many countries, a twin peaks model has been introduced as the predominant supervision model.

The Financial Services Compensation Scheme (FSCS), the Financial Ombudsman Service (FOS) and the Money Advice Service provide important functions that underpin consumer and market confidence in financial services and which, thereby, help to secure better consumer outcomes. The FOS and the FSCS help to protect consumers by giving consumers access to independent adjudication in the cases of disputes with a provider and offering compensation or pay-out if a firm goes into default (*A new approach to financial regulation: building a stronger system* 2011: 99).

The FSCS is a scheme established by the FSMA 2000 to provide compensation for private investors who stand to lose money as a result of the default or bankruptcy of an authorized investment firm. The FOS is an UK body set up to deal with complaints in relation to financial services and products, which was established also by the FSMA 2000 to replace the separate complaint schemes for banks, building societies, insurance, investment and pensions companies (Law 2016: 246).

The Money Advice Service is an organisation that provides free-of-charge advice on money and financial decisions to people in the United Kingdom. Before April 4, 2011 it was called the Consumer Financial Education Body (CFEB) which was set up under the Financial Services Authority as required by the FSMA 2000.

4. Conclusions

In 2008 and 2009 the world experienced the worst economic and financial crisis since the 1930s. As a result of a debate on the reasons for the financial crisis of the early 21st century, in some EU states, the rationale behind introducing a twin peaks type of supervision model was questioned. At present, in the UK, the Bank of England has the right to exercise a direct supervision over the banking system but only via the FPC which sets the rules for the PRA – as a part of the Bank of England which supervises the financial condition and stability of companies

providing financial services. In response to the financial crisis, the role of the Bank of England as a multi-platform institution responsible for proper operation of the financial system has been strengthened.

According to the twin peaks model, supervision over the prudential market and protection of financial services customers should be entrusted to separate, independent entities (while leaving the macro-prudential supervision in the hands of central bank). It was the crisis that proved that the financial market supervision should not be focused on professional financial service providers only but also include customer protection. The above should lead to recognition that, in practice, supervision and customer protection are values which may often contradict. The financial market supervision model and financial service customer protection model in the UK deserve to be received with full approval. In particular, it should be approved that the FCA has been entrusted with a wide range of enforcement powers – including criminal, civil and regulatory measures – to protect consumers and to take action against firms or individuals that do not meet standards. It would be worthwhile to introduce similar legal solutions in other legal systems. However, the question whether two supervisory bodies would have an insight into the full spectrum of the legal aspects of the financial market must be raised.

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Model ochrony klientów usług finansowych w Wielkiej Brytanii

Streszczenie:

Cel: Celem artykułu jest przedstawienie zmian w zakresie ochrony klientów usług finansowych, jakie zaszły w Wielkiej Brytanii w następstwie kryzysu finansowego, co skłania do odpowiedzi na pytanie o optymalny model w tym zakresie. Autorka analizuje, czy regulacje stosowane w Wielkiej Brytanii są wystarczające, w ramach dążenia do zapewnienia spójności między publicznym nadzorem rynku finansowego a ochroną klienta. W praktyce wartości te mogą pozostawać w sprzeczności.

Metody badawcze: Podstawową metodą badawczą zastosowaną w opracowaniu jest analiza źródeł prawa i literatury przedmiotu.

Wnioski: Ostatni kryzys na rynku finansowym zakwestionował założenie, że nadzór publiczny oraz regulacje prawne z tego zakresu stanowią wystarczające narzędzie zapobiegające "zawirowaniom" rynkowym. Nadzór nad rynkiem finansowym powinien mieć szerszy zakres obejmując nie tylko profesjonalnych pośredników finansowych. Konieczne jest bowiem jednoczesne zapewnienie ochrony klienta. W oparciu o przeprowadzone badania, Autorka uznaje, że model nadzoru rynku finansowego i ochrony klientów usług finansowych przyjęty w Wielkiej Brytanii zasługuje na powielenie na gruncie prawa polskiego, ze szczególnym uwzględnieniem przeniesienia niektórych funkcji nadzorczych do banku centralnego.

Oryginalność / wartość artykułu: Temat jest istotny i ważny, ponieważ w państwach członkowskich UE rozważa się wprowadzenie nowych rozwiązań prawnych w zakresie nadzoru finansowego. Problem poruszony w artykule nie doczekał się dotychczas szerszego odzewu w literaturze przedmiotu. Przepisy brytyjskie mogą – i zdaniem autorki – powinny służyć za wzór dla polskiego ustawodawcy, który w najbliższej przyszłości planuje dokonać zmian w zakresie organizacji nadzoru nad polskim rynkiem finansowym.

Słowa kluczowe: ochrona konsumentów, usługi finansowe, Wielka Brytania, Prudential Regulatory Authority (PRA), Financial Conduct Authority (FCA)
JEL: K21, K23