UK financial services' "sludge" habit produces poor outcomes for all kinds of customers, even in crisis

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Rachel Wolcott, Regulatory Intelligence

Financial services firms' "sludge" habit continues to produce poor outcomes for the full spectrum of customers, and in some cases for firms themselves. In its July 2019 Feedback Statement 19/4 (FS 19/4), "Fair Pricing in Financial Services: Summary of Responses and Next Steps", the UK Financial Conduct Authority (FCA) defined sludge as practices that appear intentionally designed to discourage behaviour which is in the consumers' best interests. There are signs banks are at risk of practising sludge during the COVID-19 pandemic.

"[S]ludge can take two forms. It can discourage behaviour that is in a person's best interest such as claiming a rebate or tax credit, and it can encourage self-defeating behaviour such as investing in a deal that is too good to be true," Richard Thaler, professor of behavioral science and economics at the University of Chicago's Booth School of Business, said in an August 2018 article, " Nudge, not sludge".

Thaler is the co-author, with Cass Sunstein, of "Nudge" (2008) in which the concepts of behavioural economics are applied to some of society's more intractable problems. While "nudge" is meant to encourage beneficial behaviour, "sludge" is essentially an evil nudge, designed to encourage bad choices or prevent good ones, Thaler said.

Feedback Statement 19/4 provided examples of sludge the FCA and the Competition and Markets Authority (CMA) had found in some firms' product design:

"Sometimes we may see firm behaviours that are designed to influence consumers' price sensitivity without providing any additional value. The CMA considered this issue in detail in their response to the Citizens Advice super-complaint when they identified harmful business practices that firms use to hinder consumers from 'engaging, switching or getting better deals, such as making it hard to exit a contract or to find information about deals'. These practices, which are sometimes referred to as 'sludge', typically target consumers' preference for convenience, but the fact that firms are actively increasing friction means we may be more likely to find the practice unfair. In general, we would be concerned if we identified practices that are intentionally designed to discourage behaviour that is in the consumers' best interest."

COVID-19 sludge risk

HM Treasury has introduced the Coronavirus Business Interruption Loan Scheme (CBILS) for small and medium-sized enterprises (SMEs) and a mortgage "holiday" scheme for homeowners to help people in financial difficulty during the COVID-19 pandemic. Banks involved in these schemes will need to ensure they are not "actively increasing friction" which prevents customers from obtaining help while making a concerted effort to treat customers fairly in stressful times.

Regulators were quick to address sludge risk directly. On Wednesday, a joint letter from the UK's Chancellor of the Exchequer and heads of the Bank of England and the FCA outlined where regulators have moved to ease pressure on banks' operations and set out clear expectations for banks' treatment of SMEs and other customers. The letter also reminded banks to document carefully "flexibilities extended to customers" to "prevent an adverse impact on customer's credit file".

In addition, the FCA has published guidance for mortgage providers and for lenders taking part in the CBILS, again setting out clear expectations for customer treatment to prevent stressed businesses being denied access to loans.

Personal guarantees

Small and medium-sized enterprises looking into CBILS, however, found some banks require personal guarantees on loans that, according to the CBILS website: "provides the lender with a government-backed, partial guarantee (80%) against the outstanding facility balance, subject to an overall cap per lender". The government will cover the first 12 months of interest payments and any lender-levied fees to provide SMEs with no upfront costs and lower initial repayments.

Personal guarantees, moreover, may increase friction for SMEs which got their fingers burned by the same policy in 2008 and which consequently lost their homes and businesses. Critics have also said that the personal guarantee is, in effect, double security on a government-backed loan. Royal Bank of Scotland (RBS) has dropped personal guarantees for CBILS.

Barclays, however, is one bank which does require personal guarantees. "The Coronavirus Business Interruption Loan Scheme requires Barclays to lend according to normal credit policy terms and conditions, which includes, when appropriate, personal guarantees. Any guarantee taken excludes personal residence. We know that speed is important right now, and I promise that we're working as fast as we can to deliver the right support to businesses that need it," a Barclays spokeswoman said in an emailed statement.

Vulnerable mortgage customers have said they too are struggling to get relief from banks and other lenders.

Sludge is hallmark of banks' redress schemes

Sludge has long been a feature of banks' redress schemes.

The FCA is investigating Royal Bank of Scotland's (RBS) in-house review of investment advice, Project Amethyst. A group of whistleblowers has claimed that the project was designed to minimise redress paid to customers given unsuitable advice, and that that outcome was achieved through improper procedures and poor governance. There have also been allegations that staff working on the project are subject to bullying and harassment within the bank.

This example is another kind of sludge which Roger Miles, a behavioural and reputation risk specialist, calls systemic rule-gaming: that is, designing a remediation system such that it could not deliver a positive outcome for customers. This kind of sludge often includes the re-framing of definitions of the underlying offences and misconduct to reduce the number of eligible claimants.

Lloyds Banking Group and Clydesdale Bank were both fined for failing to treat their customers fairly when handling payment protection insurance (PPI) complaints. More recently, SME customers have said they fear the new Business Banking Resolution Scheme (BBRS) will end up being just more bank sludge that will deliver little compensation. SME customers have charged banks with trying to keep them out of the scheme by limiting eligibility criteria. Banks are seeking to keep out customers who have been through a review process before or who are bankrupt, for example.

"We are speaking to a range of stakeholders to develop the service and our eligibility criteria," a BBRS spokesman said. Further information will be available at the end of the scheme's pilot phase.

Customers also criticised the BBRS's lack of transparency and failure to publicise its existence. The spokesman said there would be an annual report and an information campaign "in due course" but could not give a precise publication date.

Best execution sludge

Retail customers are not the only victims of sludge. Inter-dealer brokers have in the past been accused of systemic rule-gaming to classify their customers as eligible counterparties as opposed to professional investors to whom investment firms owe best execution and a duty of care. Misclassification has long been a way for inter-dealer brokers to sidestep best execution obligations.

Inter-dealer brokers and some institutional brokers, as a rule, dislike best execution requirements and believe they do not apply to their businesses. As a result, some inter-dealer brokers have spent little time and effort on best execution compliance. Even though many have become organised trading facilities (OTF) under Markets in Financial Instruments Directive II rules, which brings greater regulatory obligations, their approach has changed little.

"[T]hese firms did not have robust business practices and supporting controls in place to deliver and monitor best execution in relation to those areas of their activities where best execution was owed because they were executing client orders," the FCA wrote in Thematic Review 14/13 (TR 14/13), "Best execution and Payment for Order Flow".

ESMA finds sludge in data pricing

Firms do not like sludge when it happens to them. The market data pricing controversy, where firms have said market data providers are overcharging and being opaque on pricing, is a good example.

"[The European Securities and Markets Authority] (ESMA) found that trading venues' market data policies could be made more accessible (not all venues publish all required information and for many it is difficult to find), shorter and less complex (an average full policy is 120 pages long) and more consistent (definitions are not identical across venues)," the FCA said in its recent call for input on accessing and using wholesale data.

Trading venues, then, are making it difficult for firms to make choices that are in their best interests. Banks and other market participants have argued that venues' behaviour is producing poor outcomes for them, as the venues' customers.

Complaints Procedure

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