KNOWLEDGE ORGANISER LIBF Unit 3 Topic 3 – The Impact of External Factors

What are external factors?

External factors are factors over which individuals have little or no control, but which nevertheless have significant effects on financial products and services, and therefore on people's economic well-being. The importance of these factors cannot be overstated, which is why this topic explores these factors in more detail and looks, in turn, at the impact that each can have on sustainable personal finances.

Examples of External Factors

The key external factors include:

- ◆ inflation;
- ◆ interest rates;
- ◆ house prices;
- ◆ economic growth or recession;
- ◆ unemployment;
- ◆ regulation;
- ◆ exchange rates;
- ◆ legislation and legal rights; and
- ◆ changes in state benefits, levels of taxation and exchange rates.

PESTEL

Political
Economy
Social
Technological
Enivronmental
Legal

Political Factors

This refers to the various ways in which the policies of a government affect the products and services offered by financial providers, and the impact that these policies have on individuals. These political factors generally derive from the legislation that has been introduced to govern the financial services industry – ie both the rules and regulations with which financial services providers have to comply, and the regulatory and consumer protection bodies that governments have set up to ensure that providers do comply with those regulations.

*Current Affairs Link

Conservatives winning the election, could lead to Britain leaving the EU, therefore financial providers do not have to follow EU regulation.

Regulation

The importance of having a comprehensive and effective system of regulation of the activities of financial services providers was clearly demonstrated by the 2007–08 global financial crisis. It has been widely accepted that failings in the regulation of banking and finance worldwide were a key factor among those that caused the crisis; at the very least, it is agreed that better regulation may have helped to prevent the crisis. The result was that governments in the many countries affected by the crisis undertook wide-ranging reviews of their regulation systems and followed this with reform, aiming to make the systems more effective in terms of maintaining a sustainable global financial services industry and properly protecting consumers' interests. Overall, the system of regulation sets out exactly what financial services providers are allowed to do – and what they are not allowed to do. It covers the way in which financial services organisations go about providing products and services.

EU Policy

When the effects of the financial crisis in the UK led to the creation of the Lloyds Banking Group (LBG) – comprising Lloyds TSB, the Bank of Scotland and the Halifax – EU regulators demanded that LBG reduce the size of Lloyds TSB. First, LBG proposed to sell off 631 of its branches to Co-operative Bank. Then, when this sale fell through, LBG complied with the EU regulations by making Lloyds and the TSB separate companies. The hundreds of branches are now operated by a stand-alone TSB bank.

Why regulate banking and finance?

◆ It protects consumers from dishonest, incompetent or financially unstable providers.
◆ A well-regulated financial system will be more sustainable, enhancing individual and corporate financial stability, and reducing the likelihood of any future financial crises.
◆ It gives people confidence in the financial system and encourages them to use the financial solutions that are available to them.
◆ It requires providers to run their businesses prudently (ie with care and foresight) and to manage their risks properly, particularly in terms of capital – ie the balance between the money that a provider holds and that owed to it.
◆ It requires providers to ensure that consumers are fully informed about, and have a good understanding of, the features, benefits, restrictions, and terms
and conditions of the financial products and services that they choose to buy.

Regulators

The present regulatory system was established in **April 2013** under the **Financial Services Act 2012**. The Act returned overall responsibility for regulating financial services and maintaining the long-term sustainability of the industry to the Bank of England.
The FSA was replaced by:
1.Bank of England's Financial Policy Committee (FPC) established in April 2013;
2. Financial Conduct Authority (FCA)
3. Prudential Regulation Authority (PRA)
They are responsible for enforcing the system of regulation ensures that providers conduct business fairly.

Mis-selling PPI

Payment protection insurance is designed to cover the monthly loan repayments of an employed person who stops working as a result of sickness or redundancy. Many banks, building societies and other lenders have been found to have persuaded borrowers to buy PPI even if they were not employed (eg people who were self-employed or retired) – and who were therefore not eligible to claim on the policy. These providers have since been forced to pay billions of pounds in compensation to the affected customers. In addition, the lenders involved have been sanctioned with large fines imposed first by the FSA and, more recently, by the FCA. Because of the risk of mis-selling and other problems, there are now several consumer protection agencies that help to protect financial services consumers.

Financial Ombudsman Service (FOS)

An independent body that is responsible for dealing with customer complaints against financial providers. It is funded by an annual levy on providers.

FSCS

The Financial Services Compensation Scheme provides a safety net for saves ensuring that up to £85,000 of their savings are protected. All businesses authorised by the FCA are covered. The FSCS is also, like the FOS, funded by the providers who are members of the scheme and this includes the cost of any compensation payouts. This is only when a bank fails and is unable to pay out savers.

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Competition & Markets Authority

The new Competition and Markets Authority (CMA), Citizens Advice and local authority trading standards offices also have powers and responsibilities for consumer protection more generally across all industries and businesses. These powers may not be specifically targeted towards financial services, but providers must nonetheless adhere to this more general system of consumer protection regulation.

Political Agenda

Regulation and consumer protection can be seen as measures that primarily try to prevent financial services providers from engaging in practices (such as mis-selling) that, if left unchecked, would adversely affect consumers' personal finances. There is, however, another set of government policies – known collectively as the political agenda – that is focused more directly on helping to ensure that every individual has access to the benefits that financial products and services can provide.

Social Inclusion

If certain groups of people or individuals in certain situations are denied access to the benefits enjoyed by most people in their society, they may be said to be 'socially excluded'. Those who are unemployed, for example, or those who do not have a permanent address, or those who have a poor credit history have often found it difficult to open a bank account or to take out a loan.

A society in which there is full social inclusion is therefore one in which all members of society can participate.

Social Exclusion

Social exclusion is a complex and multi-dimensional process. It involves the lack or denial of resources, rights, goods and services, and the inability to participate in the normal relationships and activities, available to the majority of people in a society . . . It affects both the quality of life of individuals and . . . society as a whole.

Financial Exclusion

The inability to get access to even the most basic financial services products and services. Financial exclusion can be caused by the same issues as social exclusion, such as mental health issues or being unable to afford financial products, but there is an additional factor: the individual's financial literacy. One measure of financial exclusion is the number of people who do not have a bank current account. Up until the early 2000s, almost one in four low-income families were in this situation – often, retired people, low-paid employees or self-employed workers being paid 'cash in hand', or those who, for some other reason (perhaps because they did not trust banks or understand how current accounts work), preferred to use cash to pay for all of their bills and spending.

Financial Literacy

The term 'financial literacy' refers to an individual's level of knowledge and understanding of financial matters. Those who have 'low financial literacy' may not know how to go about managing their personal finances, or may not be aware of the range of financial products and services that might help them to improve their financial well-being.

The impact on individuals' personal finances

Most of the decisions that politicians take in Parliament have the potential to affect individuals directly – and a political decision relating to financial services can have a particularly significant impact on an individual's personal finances. In an unregulated, 'free market' financial world, individual consumers would be exposed to unscrupulous, dishonest or incompetent providers whose only objective would be to maximise their short-term profits by selling as many products as they could at the highest prices possible. Many economists would say that little, if any, regulation of the way in which products are bought and sold is necessary if the market for those products is close to what is known as a 'perfect market'.

Interest Rates & Inflation

Interest rates can be described very simply as 'the price of money' – ie they are the price that banks charge borrowers for the money that they lend and the price that banks pay to savers for the use of the money that they have deposited with the bank. Interest rates are also used as a central tool of government and central bank economic policy. Historically, throughout most of the 1970s and 1980s, interest rates in the UK were high – generally more than 10% – falling to just over 5% only in 1994. From then until 2007, interest rates rose and fell regularly, but never drifted above 7.25% or below 3.75%. At the beginning of 2008, however, the financial crisis of 2007–08 and the economic recession that followed prompted the Bank of England's Monetary Policy Committee (MPC) to cut Bank rate an unprecedented 0.5%.

Interest Rates & House Prices

When interest rates are rising, some people will inevitably find it harder than others to meet their monthly mortgage payments and will begin to fall into arrears. Some will default on their mortgages and have their homes repossessed. The higher cost of mortgages will also reduce demand for houses and flats, because potential buyers may decide that they can no longer afford the mortgage they need to buy a property. Falling demand will then cause property prices to fall across the housing market and builders may decide to build fewer new properties. The housing market is such a large part of the national economy that changes in house prices and demand for housing have a significant impact on economic activity as a whole. This is as true in the UK as it is across most European countries, where it has been the ambition of many people, since the 1960s, to own their own homes

Impact on Personal Finances

If fewer people are buying or moving house, it not only reduces demand for new builds, but also for goods, such as new furniture, and for the services of builders, decorators, plumbers, electricians, estate agents, surveyors, solicitors, etc. People start to lose their jobs and others become afraid that their jobs may be under threat. Many people in this situation will reassess their personal finances in order to protect themselves against the prospect of losing their job and the income that they are used to having. A typical reaction among the majority of people in the face of the financial crisis was to try to reduce personal debts to increase regular savings.

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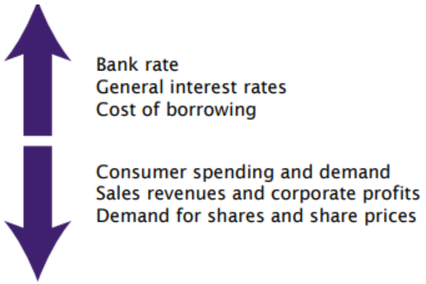
Interest rates and savings and investments

While rising interest rates causes problems for borrowers, it is a different story for savers. When Bank rate rises, banks and building societies can increase the interest rates that they charge to borrowers and increase the interest rates that they pay to those who have deposited savings without having to narrow profit margins. The main beneficiaries will be retired people and others who rely on their savings to provide an income. The majority of retired people have paid off their mortgages and tend not to have many other debts, so they will rarely be as badly affected by interest rates going up on borrowing. Paying higher interest rates to savers may also affect people's attitudes to saving and borrowing – encouraging them to save more of their income rather than to spend it – which further adds to the downward pressure on demand and prices.



A fall in the stock market generally affects the wealth of many people and businesses. Those who have invested directly in the stock market – by buying shares in particular companies or by putting money into collective investments, such as unit trusts or OEICs – will suffer an immediate reduction in wealth; many other individuals are also indirectly exposed to what happens in the market as a result of the effects on pension fund and insurance company fund investments.

Economic Activity

A healthy, balanced economy is one in which demand for goods and services is high enough to keep unemployment at an acceptably low level but is not so high that it causes unacceptable levels of inflation. Economic activity in the UK is fuelled by demand for the goods and services from four main sources:

◆ consumer demand refers to the amount that individuals are spending on the goods and services that they are consuming, spending that is funded by consumers' incomes, savings and borrowings;

◆ corporate demand is the amount that businesses are spending on the goods and services that they are consuming, spending that is funded by a business's revenue, savings and borrowing, and by capital injections from its investors;

◆ government spending is the amount that national and local government departments and agencies are spending on the goods and services that they are consuming, which spending is funded by tax revenues and government borrowings; and

◆ demand for exports refers to the goods and services produced in the UK, but sold overseas.

One of the government's key roles and objectives is to use the economic tools available to it to achieve and maintain full employment and low inflation. We have seen already that, on the one hand, when inflation goes above the government's 2 per cent target, interest rates are increased to reduce consumer and corporate spending, putting downward pressure on prices. On the other hand, when prices are stable and unemployment is growing because of a lack of demand, interest rates may be reduced to make it to borrow.

Government Spending

As well as using monetary policy, it is equally important for the government to manage the amount of money that it raises in taxation, the amount that it borrows on the financial markets, and the overall amount that it spends. This is known as 'fiscal policy'. Whenever the government changes its policies on taxation, borrowing and / or spending, this has the potential to affect economic activity. There are different opinions among economists, politicians and political parties as to what should be the 'correct', or 'optimum', levels of government spending and how much of it should be financed by taxation or borrowing. Put simply, if the amount spent by the government each year is more than the amount raised through taxation, then the government's budget is said to be running a deficit, which has to be financed by government borrowing. (Government borrowing is largely funded by means of gilt edged securities, or 'gilts', which are bonds sold to investors and guarantee a set return on a set date.) Any borrowing that is not immediately repaid is added to the overall government debt. The aim of most governments is to 'balance' the budget (ie for spending to be equal to tax revenue) or to achieve an annual surplus (ie revenue greater than spending). Most people accept, however, that many governments – like consumers – were encouraged by low interest rates and easily available credit to borrow more and more in the years running up to the financial crisis (leading to increasing budget deficits and outstanding debt). They used these borrowings to finance significant expansion in government spending – especially on education, public transport and the health service.

Unemployment

The level of unemployment can undoubtedly have an impact on individuals' personal finances, and on their choice of products and services. High employment can lock people into a high-consuming lifestyle and it encourages a consumer culture. It also enables people to save money if they earn enough to have a surplus after they have satisfied their needs and everyday wants. People feel confident because they are earning money, and as a consequence their needs, wants and aspirations are probably less influenced by fears for the future than they might otherwise be. High unemployment makes for a very different market. The long-term unemployed–defined as those who have been continuously unemployed for more than 12 months – have to rely on state benefits for their income and do not have the resources to buy financial products, even though they may still need them. At times of high unemployment, even those who have a job probably feel uncertain about the future.

Global Economy & Exchange Rates

The effect on personal financial planning are changes in exchange rates (ie the purchasing power
of the pound sterling against other currencies) and changes in the global economy.
These factors are considerably more important now than they were 100 years ago
because of the effect of 'globalisation' – ie the integration of the economies of individual countries around the world.

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Global Economy

The 2007–08 global financial crisis, yet again, illustrates clearly the impact of globalisation. A hundred years ago, the collapse of the US sub-prime market in mortgage lending might have affected only banks and investors in the United States; in the present day, globalisation has resulted in an international financial services industry comprising many multinational banks, insurance companies and other providers with offices scattered across the globe providing services and selling financial products to an enormous customer base.

Exchange Rates

Further factors that illustrate globalisation are the extent to which people regularly travel abroad, either on holiday or on business, and the growth of imports and exports of raw materials, components, and semi-finished and finished goods. All of this activity has an impact on foreign currency exchange rates – particularly the value of the pound sterling (£) against the euro (€) and the US dollar ($). In today's globalised economy, for example, a UK manufacturer might buy raw materials from France, paying its French supplier in euros, and export what it makes to the United States, getting paid in US dollars. At the same time, it pays its UK costs, such as wages and rent, in pounds sterling.

Social Factors

When we refer to social factors in the context of financial services, we are referring to a wide range of cultural aspects, including changes in demographics, levels of employment and home ownership.

Cultural Issues

Refers not only to people's ethnic and religious backgrounds, but also more generally to the social groups to which they belong or in which they were brought up. Our cultural backgrounds tend to determine what ideas, beliefs, values and attitudes were instilled into us as children, the overriding ideas of our peer groups and what is important to us in our lives generally. Cultural factors affect people's approaches to financial services, helping to determine which products they will buy and from which suppliers they will purchase them. They affect people's needs, wants and aspirations, and ultimately their behaviour, including their financial behaviour.

Multiculturism

Large sections of the UK population have family origins elsewhere in the world. Their values, attitudes and beliefs may be very different from those of people with other cultural backgrounds. Some people with family origins elsewhere may not be able to identify with the traditional ways of doing things in the UK – and this means that there is a risk that they will be excluded from using certain financial products and services unless providers take cultural differences into account when they are designing, marketing and delivering those products and services.

Religion

In many religions, lending and borrowing money is seen as an acceptable activity provided that lenders treat borrowers fairly and borrowers do not build up unsustainable levels of debt.

Complying with Sharia Law

Under Islamic law, known as Sharia, it is forbidden to charge or pay interest (Riba). If an urgent need arises for someone to pay for something and they do not have enough money to do so, the options available to them are to borrow only from members of their own family group or to use a Sharia-compliant financial product.

Youth Culture

'Youth culture' is the term used to describe the values shared by people in their teens and early 20s. It embraces everything from what you believe in to how you spend your leisure time and money. Changes in youth culture can affect how young adults manage their finances, and the kind of financial products and services that they use.

Grey Culture

Grey culture' refers to the older section of the population – ie those in late middle age and older stages in the financial life cycle – which has been getting bigger year by year across the world's industrialised countries in recent decades and will continue to do so for the foreseeable future.

Consumer Culture

In the latter half of the twentieth century, as standards of living rose and people in the industrialised world found themselves with more disposable income, a consumer culture emerged. A consumer culture, or consumer society, is '[a] society in which the buying and selling of goods and services is the most important social and economic activity'.

Demographics

Demographics involve analysing a population in terms of age, sex, ethnicity, culture, social status and geography – ie its demography. The demographic structure of a population and changes in that structure play a key role in the way in which providers design and market their products, because the individuals who can be grouped under a particular demographic heading may have very different needs, wants and aspirations from those in another.

Technological Factors

Technological factors include matters such as increased automation, the rate of technological change and the influence of technology on outsourcing decisions. Technological shifts can affect costs and quality of service, and can lead to product innovation. The financial services industry is directly affected by change in information and communication technologies (ICT). One feature has been increased automation – ie a computer doing something automatically that a person would formerly have done. The processes that lend themselves to automation are those that are rules-based. The computer is given a set of rules via a software program and processes information or carries out tasks in accordance with those rules. Generally, these are jobs that need no judgement or discretion, although the following points are worth noting. A computer that works to a set of rules can make straightforward decisions based on those rules and it can put borderline cases in a separate list, to be referred to someone who can exercise judgement and make a decision. Credit scoring is an example of an automated way of making decisions.

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Environmental Factors

Although there are some scientists and politicians who take a different view, the vast majority of environmental experts believe that the things we do and use every day – the products that we make, the raw materials that we dig out of the ground, the energy that we use in our homes, factories, offices, vehicles, etc – are causing serious problems for the long-term sustainability of the environment. Waste products from production processes and from the consumption of goods can cause pollution; waste heat and 'greenhouse gas' emissions contribute to global warming, which causes damaging climate change including melting ice caps and rising sea levels; rain forests are being destroyed, and we are using up non-renewable sources of energy and other natural resources. These environmental factors must be considered in relation to sustainable personal finances because, whether or not individual consumers are themselves concerned about the environment, the financial products and services that they buy will inevitably have an environmental impact. Financial services providers are being encouraged by regulators, government and non-government agencies, environmental campaigners and pressure groups, among others, to make their products more environmentally friendly. Banks, for example, are under pressure to make loans available on favourable terms to companies that invest in developing green technology and not to lend money to those companies whose products or production processes are non-sustainable. Insurance companies, similarly, can make a difference by charging lower premiums to people with more fuel-efficient cars and / or cars with lower carbon emissions.

Legal Factors

Financial providers wanting to set up in business need to ensure that they can comply with all applicable laws before they do so and, in particular, with financial legislation, such as the Financial Services and Markets Act 2000, the Consumer Credit Acts 1974 and 2006, the Banking Act 2009 and the Financial Services Act 2012. The Banking Act 2009 established a permanent statutory regime for dealing with failing banks and makes new provisions for the governance of the Bank of England. The Financial Services Act 2012 amends the Bank of England Act 1998, the Financial Services and Markets Act 2000, and the Banking Act 2009. It also includes other provisions about financial services and markets.

Company Law

This covers many aspects of how companies are set up and run, and how they report on their affairs. There is also partnership law for those businesses that operate as partnerships.

Employment Legislation

This sets out rules on how employers must treat their workers and what rights the workers have.

Tax Laws

These govern the taxes that individuals and businesses must pay, and how they are calculated.

Proceeds of crime and anti-terrorism legislation

These laws aim to stop criminals from laundering money (ie from using financial services to hide the proceeds of crimes), and to stop terrorists from using financial services to collect and move their funds around.

Accounting Standards

Financial services providers must draw up their annual financial statements in accordance with International Accounting Standards (IASs).

As consumers of financial products and services, individuals are also protected by more generic consumer protection laws that give them rights, for example, to return faulty goods to the shop from which they bought them and get a full refund.

Primary and Secondary Legislation

The primary and secondary legislation (Acts and regulations, respectively) that are relevant in the context of financial services include:

- ◆ the Courts and Legal Services Act 1990;
- ◆ the Competition Act 1998;
- ◆ the Consumer Credit Acts 1974 and 2006;
- ◆ the Consumer Protection from Unfair Trading Regulations 2008;
- ◆ the Consumer Protection (Distance Selling) Regulations 2000 (known simply as the 'Distance Selling Regulations');
- ◆ the Enterprise Act 2002;
- ◆ the Estate Agents Act 1979;

Primary and Secondary Legislation - continued

- ◆ the Financial Services and Markets Act 2000;
- ◆ the Sale of Goods Acts 1979 and 2002;
- ◆ the Transport Acts 2000 and 2001;
- ◆ the Unfair Terms in Consumer Contracts Regulations 1999 (often abbreviated as the UTCCR 1999);
- ◆ the Consumer Rights Act 2015; and
- ◆ the Finance Act 2016.

Until April 2014, the Office of Fair Trading (OFT) and the Competition Commission were the government agencies responsible for enforcing the relevant consumer protection provisions. On 31 March 2014, both of these bodies closed and their responsibilities in this regard were divided between the Financial Conduct Authority FCA) and a new agency: the Competition and Markets Authority (CMA). This change was brought about under the Enterprise and Regulatory Reform Act 2013. [The CMA is] responsible for:

- ◆ investigating mergers which could restrict competition;
- ◆ conducting market studies and investigations where there may be competition and consumer problems;
- ◆ investigating where there may be breaches of UK or EU [competition laws];
- ◆ bringing criminal proceedings against individuals who commit [an offence];
- ◆ enforcing consumer protection legislation to tackle practices and market conditions that make it difficult for consumers to exercise choice;

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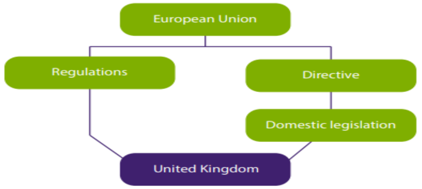
European Legislation

Membership of the European Union also has implications for a country's legislation, because the institution itself makes laws. These take the form of either regulations or directives, and they have to be applied in all of the member countries.

◆ Regulations are directly applicable in member countries, including the UK. This means that they become law in all EU member countries as soon as they come into force, and that people and businesses must comply with them immediately. Such regulations apply to all EU members equally, with no variation of the law from one country to another.

◆ Directives can be seen as instructions issued by the European Commission to the governments of the EU member countries. Each member has to enact its own laws to meet the requirements of the directive within a set period (usually two years). The exact rules can differ from one member country to another, as long as they fulfil the requirements of the directive. In other words, the directive sets out what is to be achieved and the member country can decide for itself how to achieve it. There can be differences in how quickly each member country brings a directive into force, but they should result in a set of minimum standards being established across all EU member states.

Implementation of EU legislation in the UK



Analysing Data Sources

Many of the PESTEL factors that we have discussed in this topic are quantifiable – ie their values can be measured, and differences or changes in those values can be recorded and analysed. Data on interest rates, levels of inflation or unemployment, house ownership, budget deficits and debts are just some of the social and economic variables that can be measured and presented in tables, graphs, histograms, bar charts and pie charts, etc. In the UK, huge amounts of these statistical facts and figures are collected and collated every day by the Office for National Statistics (ONS).

Key ideas in this topic

◆ Changes in external financial factors – things over which neither consumers nor providers have control – and their impact on both consumers and providers of financial services

◆ Analysis of external factors using the PESTEL framework ('political', 'economic', 'social', 'technological', 'environmental' and 'legal')

◆ The effect of international influences – particularly the impact of globalisation

◆ The presentation of the impact of external financial factors in the form of statistical tables, graphs and charts, to aid easy understanding and accurate analysis