Summary

On 25 January the FSA released a Discussion Paper outlining the regulator’s **new approach to consumer protection** as it evolves into the new regulator: the Consumer Protection and Markets Authority (CPMA – working title).

Historically the FSA has mainly focused on point of sale regulation – but this is set to change as this Discussion Paper sets out a more interventionist approach which considers intervening in the development stage of the product lifecycle, as part of the new culture of regulation.

**Some possible options for product intervention include:**
- Banning products
- Price caps
- Additional competence requirements for advisers
- Product health warnings

**Next Steps:**
- The consultation period ends on **21 April 2011**


Background

Since the financial crisis the Government and the FSA have been reviewing their tools to oversee financial markets in order to improve the chances of anticipating and preventing systemic risks to economic stability. The key objective is to avoid a repeat of the financial crisis, but alongside comprehensive reforms to macroprudential regulation, methods for enhancing consumer protection are also being considered.

In this context the Government is overseeing the creation of two new regulators¹ including the **Consumer Protection and Markets Authority (CPMA)**, due to come into force in 2012. The CPMA is intended to be a “consumer champion” with a more “interventionist mandate” to prevent consumer detriment in the retail investment market.

The FSA’s previous regulatory approach focused primarily on point of sales and post sales supervision – penalising firms where evidence of significant mis-selling emerged. The FSA’s current Discussion Paper on product intervention demonstrates the regulator’s intent to do more for consumers by turning its focus to the product development stage of the product lifecycle.

The Treasury has also declared its interest in intervening in the retail investment market by publishing a consultation on introducing **simple financial products**² which it argues could “help promote personal responsibility, enable consumers to compare products and understand product features more clearly”. The FSA will be keeping a close eye on developments in this area as it is likely to have implications for how the regulator implements its new, more interventionist agenda.

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¹ We published a briefing in December summarising the responses to the Government’s consultation paper on reforming the UK’s regulatory architecture. It can be accessed via: [http://www.knowledge.cii.co.uk/system/files/private/Briefing_Responses_to_HMT_CP_Dec2010_0.pdf](http://www.knowledge.cii.co.uk/system/files/private/Briefing_Responses_to_HMT_CP_Dec2010_0.pdf)

Why regulate the product development stage?

The product lifecycle is made up of four stages:

1. Development: The earliest stage of the lifecycle – where the product is designed and developed
2. Distribution strategies: How the firm plans to get the product to market
3. Point of sale: How the product is actually sold to the consumer
4. Post-sales handling: How the product performs over the long term and whether there is continuing customer care after sale.

At each of the stages of the lifecycle problems can emerge:

Figure 1. Where problems can arise in the product lifecycle


The FSA takes the view that it is inherently more difficult for competition in retail financial services than in other sectors primarily because consumer understanding of financial products is relatively low. Many consumers are therefore not able to recognise that there has been a problem with their investment for many years.

The Discussion Paper argues that the primary type of regulation enforced at the moment - point of sale regulation - only discovers problems in the market after consumers have already suffered the ill effects of inappropriate behaviours from firms and advisers or bad product design. And, the FSA asserts, once problems have gained traction, they are more difficult to handle and more consumers will be affected. Identifying and dealing with problems earlier in the product lifecycle may therefore reduce the chances and length of consumer detriment and be less costly for firms and the regulator than if the regulator was to focus on purely after the event redress.

Ultimately, by adopting a more interventionist approach, the FSA believes that consumers will be more confident about the performance of an investment product and therefore more likely to purchase those products in the future.
A new approach to regulating the retail investment market

The Discussion Paper sets out the framework for future regulation of the retail financial market – noting that the FSA will bring together the existing rules on “product governance” with what the FSA labels “additional product intervention”.

The strategy consists of the following elements:

- comprehensive risk analysis and research to identify earlier the sources and nature of risks to consumers;
- sector-wide intervention to change incentives in the markets where necessary (either in a pre-emptive manner or where other interventions have failed);
- **intervention earlier in the value chain, in scrutinising products and ensuring firms embed robust product governance arrangements**;
- using intensive supervision in firms to identify and mitigate emerging risks to consumers;
- more aggressive use of enforcement tools to create credible deterrence in firms;
- improvement of the framework and delivery of redress to consumers; and
- early and effective influence on conduct issues at the EU level.

Will increased intervention be detrimental to choice?

The FSA argues that a more intrusive approach may have the downside of reducing the number of products available to consumers. However, the FSA argue that “limiting consumer choice may be acceptable when the resulting benefits to the majority of consumers from not being mis-sold a product outweigh the costs to the minority who might benefit from being able to access it”.

The FSA clearly wants to have a debate about how the new regulatory process will work in terms of consumer protection. Much of the proposed could be construed as controversial but it is in line with recent regulatory activity, noticeably in the Mortgage Market Review. As Sheila Nicoll Director of Conduct Policy at the FSA put it:

“...we realised that in certain circumstances, we would need to intervene in markets in a more intensive way. We needed to change incentives, relationships or structures to address particular intractable problems, and we needed to do this across the whole value chain.

We recognise that this will have significant implications for firms and their business models, and we will only do it where we believe other measures will not achieve the outcomes we want.

**Our Mortgage Market Review and Retail Distribution Review are two high-profile examples of this.**

In both markets, after thorough analysis, we concluded that a sector-wide intervention would be required in the face of powerful incentives for existing market participants. We could not simply tackle the problems we observed by imposing rules on providers or intermediaries in isolation.

A very important element of our review of the distribution of retail investments, was our decision to ban commission payable by product providers to advisers. From 2013, we will align the incentives of the advisers to the consumers by asking consumers to agree what they will pay for the advice rather than it being decided by the product provider.

We also want to make investment advisers more professional and to require them to be very clear with investors about the service they will be providing. If they describe themselves as ‘independent’, they must look across the entire market for the most suitable product for their client. Otherwise, they must make it clear that they are offering ‘restricted’ advice.”

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What are the possible “additional” product intervention options?

**Product pre-approval:** The FSA favours the option whereby firms would be required to notify the regulator some time before the issuance of a new product or changes to an existing offering. This would give the FSA time to react if it thinks there is a high risk product about to enter the market. The regulator does not, however, favour being a pre-approver of all products.

**Banning products:** The FSA believes that banning products would prevent consumer detriment by stopping a problem from growing and reaching more customers. However, they note that adequately defining the product on which to enact a ban will be a challenge – open to regulatory arbitrage.

**Mandating or banning product features:** This could involve setting the criteria that products must meet in order to be sold in the market. For example, the FSA argues, “there is scope for firms to exploit consumer behaviour in general insurance sales by reducing the scope of the cover to below the typical market standard (such as focusing too narrowly on price when comparing products). The Treasury’s simple financial products initiative aims in part to tackle similar concerns.”

**Preventing non-advised sales:** For products that are particularly complicated, or where there is high risk of consumer detriment, the FSA has previously specified that it is generally inappropriate to sell certain products using non-advised distribution methods. The FSA will continue to keep this option open.

**Additional competence requirements for advisers:** This approach would ensure that consumers are only exposed to complex products under the advice of financial advisers who can demonstrate a higher level of knowledge and skill in that market by attaining a relevant additional qualification and carrying out appropriate additional CPD.

**Price interventions:** This approach could include ensuring firms design appropriate charging structures, benchmark advice against a low charged substitutable product or even introducing price caps.

**Increasing prudential requirements on advisers:** Firms would have to hold higher capital so that they could offset the costs associated with increased redress payments. The FSA argues that this would need to be implemented alongside other possible options.

**Consumer and industry warnings:** FSA would publish a list of products that they regard as being generally unsuitable for the mainstream, retail market. The list would not ban products but inform consumers.

**Mandated risk warnings:** This would be like health warnings on cigarettes – only ‘wealth warnings’. The FSA notes that this will only work if consumers read and act on the warnings.

Sheila Nicoll concluded her speech on product intervention and European engagement by saying:

> “The discussion paper we are publishing today is aimed at fostering a public debate on a more interventionist approach towards products. In the paper, we start by focusing on a particular set of drivers which we think contribute significantly to failures in these markets. We explain what we’re already doing to address these failures and discuss a wider set of options for the future, some of which are quite radical.

> “As we lead the re-examination of our approach at national level and participate at the EU level, we recognise that one of the crucial issues is how far along the spectrum of earlier and more intense interventions we should progress. There is clearly a balance to be struck and trade-offs for greater intensity. The issue deserves wide debate, involving consumer groups, firms and their representative bodies, the press and the politicians.”

**Next Steps**

- The consultation period will end 21 April 2011
- The FSA intend to publish papers in the **first half of 2011** explaining their expected approach to the transition to regulation by the CPMA. The FSA will use responses to this discussion paper to inform those papers.

Link to the discussion paper and Sheila Nicoll speech:
Reaction

Consumer groups broadly welcomed the discussion paper as it signals a change of approach to one that centres more on consumer protection. The industry reaction was mixed – with some in favour of increased product regulation – particularly around structured products – and others weary of the potential for increased costs associated with new forms of intervention.

Consumer Groups

Peter Vickery Smith - Which?: “If left to its own devices, the industry will spend its energy inventing products and sales practices that fill the balance sheets but don’t deliver for their customers”.

Link: http://www.bbc.co.uk/news/business-12274837

Sarah Brooks - Consumer Focus: “The sad fact is that for many consumers mainstream banking does not provide them with the sort of products and service they should be able to expect. We welcome this signal the FSA is setting its sights not only on regulation, but on effective protection for consumers”

Link: http://www.dailymail.co.uk/money/article-1350574/Financial-Services-Authority-pledges-crackdown-toxic-products.html?ito=feeds-newsxml

Michael Littlechild - GoodCorporation: “Intervening earlier in the product chain is long overdue and should be welcomed, but will it lead to a lack of focus at the sharp end where these products are sold? Most of the fines and scandals of recent times have been about bad-selling, not bad products”.

Link: http://www.guardian.co.uk/business/2011/jan/25/name-for-new-consumer-watchdog-undecided

Industry (including trade associations):

Robert Sinclair - Director of AIFA: “We must be sure that any potential long-term benefits of product intervention are not undermined by excessive short term pain. In particular, it is essential that the associated costs do not rest on the shoulders of the IFA profession.”

Link: http://www.mortgagestrategy.co.uk/regulation/costs-of-fsas-product-intervention-must-not-fall-on-advisers-says-aifa/1025159.article

Maggie Craig, acting Director General at the ABI: “There are some potentially useful ideas here and we can understand why consumers want simpler products, if they can be made to work. However, there are also dangers to be avoided. Heavy regulation of both the sales process and product design could make it uneconomic for firms to offer products to consumers.”

Link: http://www.insurancetimes.co.uk/story.asp?sectioncode=13&storycode=388913&c=1

Tom Brown, partner, and head of investment management, Europe at KPMG: “There is a concern that the structured product sector is not as well regulated as traditional mutual fund world. Some more regulatory oversight of structured products would be a good thing.”

Link: http://www.mortgagestrategy.co.uk/dont-allow-directives-to-stifle-ideas-fsa-warned/1025438.article

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