



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response FSA's consultation on product intervention

April 2011

About Consumer Focus

Consumer Focus is the statutory consumer champion for England, Wales, Scotland and (for postal consumers) Northern Ireland.

We operate across the whole of the economy, persuading businesses, public services and policy-makers to put consumers at the heart of what they do.

Consumer Focus tackles the issues that matter to consumers, and aims to give people a stronger voice. We don't just draw attention to problems – we work with consumers and with a range of organisations to champion creative solutions that make a difference to consumers' lives.

Introduction

Consumer Focus welcomes this timely paper on product intervention. It is an important analysis looking at how the Financial Services Authority (FSA), and future Financial Conduct Authority (FCA), will confront the largest failure in the regulation of financial services to date – product design. Consumer Focus organised a workshop to discuss the issues presented in this consultation paper at which the FSA Director of Conduct, Sheila Nicoll, kindly agreed to speak.

Attended by consumer representatives, charities, industry and regulators the workshop, along with seminars organised by the FSA and our own consumer research, has shaped our response to the questions set out in the discussion paper.

Consumer Focus tries to understand consumers' experience of products and services and to ensure what is offered meets their needs, ensures an effective market is operational and products are good value. The FSA now acknowledges this is far from being realised in the financial services sector¹. Empirical work we and others have undertaken shows consumer trust in the sector is low² and the market dysfunctional. That is in a large part to do with the fundamental design of products.

It is vital that the regulatory regime, moving forward, not only aims to create good value products but also products that empower consumers. When consumers choose a product they should be sure that the information available to them is sufficient and comprehensible to be assured they will receive good value.

The HM Treasury paper on simple products makes a clear case for why something needs to be done. Consumers are unable to negotiate between the plethora of similar products on the market. Consequently, we believe proactive intervention is necessary to deliver the goals of clear, transparent products that are good value, respond to need and operate to make the overall marketplace functional. Good product intervention can empower consumers and is a stated Government aim which we share.³

Moving forward, we believe the FSA should have the powers to intervene early in any product, sales practice or strategy that undermines consumer confidence or which creates a 'negative equilibrium'.⁴ Furthermore, the regulator needs to ensure it creates a marketplace where those companies that offer clear, good-value and transparent products prosper. This is the criteria upon which our assessment of the discussion paper is based.

This week the FSA and FOS have won the Judicial Review against the BBA on Payment Protection Insurance. The issue was first raised in a super complaint by Citizens Advice in 2005. The BBA may yet appeal and consumer redress may be delayed yet further despite the FSA setting out in detail banks duties to continue to provide redress for many customers whose case is unaffected by the action⁵. That means the regulatory framework has yet to provide redress for consumers 6 years after the issue was first identified. This case must reinforce the message that toxic product need identifying and removed as soon as possible for all involved.

¹ Hector Sands speech <http://bit.ly/gsChP7>

² HMT, *Simple financial products consultation*, p7

³ <http://bit.ly/fwdi9N>

⁴ This term comes from the OFT's investigation into the Personal Current Account market <http://bit.ly/ex5hul>

⁵ FSA letter to CML, BBA et al., *Handling of Complaints during the Judicial Review*, <http://bit.ly/fehG4Y>

Overview

The paper offers a range of potential interventions into the marketplace. Consumer Focus would like to see the new regulator have the full set of powers mentioned and to use them in a much more proactive and interventionist way than has previously been the case to achieve a marketplace that works for consumers.

There are few examples of effective financial markets in the UK where products behave as consumers could reasonably expect or where there is thriving, productive competition. In the last two years Consumer Focus has examined the current account market, the cash ISA market, the short-term small loans market (including pay day loans), the insurance market and the credit card market. In each mainstream financial services market there is unnecessary complexity, poor complaint handling and a lack of focus on consumers' needs as Treating Consumer Fairly (TCF) principle 6 requires firms to demonstrate.

This suggests that the current regulatory architecture underpinned by TCF principles and its enforcement regime have failed to produce appropriate products according to the criteria set out in the introduction. Proactive product intervention alongside closer conduct intervention and an enforcement regime that offers '*credible deterrence*' is key to achieving that goal.⁶

We now wish to turn to some areas of concern in the paper. While there is a convincing narrative of why the FSA would intervene and how it would do so, less is said about when it would do so. Our understanding is that product intervention would be *ex-post* detriment arising, rather than *ex-ante*.

We are aware other mechanisms are in place to tackle detriment before it occurs. The FSA has set out in great detail how it will intervene earlier looking at governance processes and business strategies as part of its '*outcome-focused approach*'.⁷ This shift right across its regulatory activity attempts to ensure there is credible deterrence for firms to prevent detriment. Most notably the FSA aims to do so with intervention in firms' processes, business strategy, risk management and product design approaches, so-called '*horizon scanning*'.

Yet, there are strong grounds for thinking this may not by itself tackle detriment effectively in the design of products. Firms continue to offer products that are inappropriate for consumers and we do not believe a focus on governance, TCF and conduct will ensure products are revamped with consumers in mind. We are therefore concerned that the FSA approach to *ex-ante* regulation will struggle to ensure products are designed appropriately.

With this in mind we believe product intervention needs to be used proactively to be an effective tool in consumer protection. However, for the following reasons we fear detriment may still accrue. This is because:

- detriment may take a long time to manifest itself
- we are unaware if the burden of proof remains too high (criminal test) and whether that will lead to extensive bureaucracy and slow regulatory action in product intervention

⁶ We are strongly supportive of the FSA's recent approach to complaint handling for example, that is proactive and attempts to tackle the chronic unfair treatment of consumers with complaints

⁷ <http://bit.ly/gsc4Mm>

- the FSA has an extensive list of regulatory interventions, product intervention may be rarely used and as a '*worst case scenario*' regulatory intervention tool and thus too slow and unwieldy for consumers' needs
- the FSA's wider consumer protection strategy and internal reforms will all take resources away from product intervention action, therefore decreasing further the possibility of its use

Consequently, there remains a need to think about ex-ante product intervention to limit firms' ability to '*exploit*' consumer behaviour.⁸ We would suggest principles and TCF could continue to play a role in regulation to complement the powers in the discussion paper. Yet this is dependent on principles being backed up with product design standards relevant to each product and strong enforcement action to ensure compliance with these standards, or principles. Such standards work well in other industries⁹ and have been called for widely including from Age Concern¹⁰ (now Age UK) and the Financial Services Consumer Panel.¹¹ We are aware the ABI has started to develop these for differing insurance products. These offer the industry, consumers and the regulator a cost-effective, flexible and effective means to prevent toxicity in product design before it occurs. We would welcome the FSA's thoughts on supporting these measures and how it can encourage industry to create processes and rules to design out toxicity before the need of regulatory intervention. The ABI efforts, alongside examples from the design of standards from manufacturing that the BSI leads on, should be considered as the basis for further investigation.

⁸ This references recent comments by the Governor of the Bank of England

⁹ As suggested in <http://consumerfocus.org.uk/g/4ox>

¹⁰ Age Concern, *Beyond financial inclusion*; Adam Phillips at *Principles or products: treating customers fairly in financial markets*, Consumer Focus roundtable, 31 March 2011

¹¹ As expressed by their chair Adam Phillips at our event on product intervention, 31 March 2011

Detailed response

Q1: What issues should we consider in relation to how our product intervention approach affects equality and diversity?

It is important to understand what it is about the design of products that means a market is inclusive and ensures a diverse range of people feel comfortable accessing, buying and obtaining good value from financial services. The HM Treasury paper on *Simple products* makes clear that the vast range of products in financial services does not aid consumer choice but undermines consumer engagement and trust in the industry as a whole. The differences between products are confusing, often based on ancillary aspects, the value of which are difficult for consumers to evaluate.

It is unsurprising that those who are most vulnerable or who struggle to engage with complex products suffer the most. The Financial Inclusion Taskforce has undertaken significant work on access to the most fundamental utility aspects of banking. Their findings show that the design of current accounts, and basic bank accounts does not work for low-income consumers.

While being without a bank account can be costly, individuals with a new bank account may also face difficulties. Research conducted in 2010 for the Financial Inclusion Taskforce found that consumers on low incomes who had recently opened a bank account experienced a higher degree of penalty charges than would be expected for their income, or the amount of money going through their account¹². Around half of them have been exposed to penalty fees and six in 10 of these having paid charges within the past 12 months. Individuals who do incur charges tend to be charged multiple times, averaging 5.6 times a year, with one in three incurring more than five charges in the previous year¹³.

The same research also found significant increases in debt among people with a newly opened bank account. These experiences may be part of the explanation for the high failure rate of having a bank account – it is notable that more than six out of ten of those currently without a bank account have had one in the past.¹⁴ Poor product design leads to a rejection of mainstream banking either through closing their account or through increased levels of dormancy. Thus the wariness of some consumers towards having a bank account may not be unjustified.

Equally, the OFT found in their 2008 report that it is '*disproportionately...the young and financially constrained consumers*' who pay unauthorised overdraft charges.¹⁵ We would suggest that the design of current accounts and even basic bank accounts actively discriminates against many low-income consumers, those who have recently opened an account and those who lack mental capacity thus contradicting the objectives of equality and diversity. It is not surprising therefore that that lack of trust described in the HM Treasury paper on simple products is especially strong amongst low income consumers.¹⁶

The favoured policy solution to many market errors is to increase switching. It is hoped consumer pressure will ensure firms to produce more appropriate and better-value

¹² <http://bit.ly/fsRsNe>

¹³ <http://bit.ly/fsRsNe>

¹⁴ <http://bit.ly/f9Zobx>

¹⁵ OFT, *Personal current accounts, A market study*, 2008, p69

¹⁶ Consumer Focus, *On the Margins*, 2010

products. This strategy has not borne fruit yet, as the discussion paper shows, consumers are poor at disciplining market participants, so-called '*demand-side weaknesses*'.¹⁷ Consumer Focus research shows that low-income consumers are poorer at using their consumer choice to seek better value products. Our report *Stick or twist* found the young and social grades D or E have switched less and thought about switching current accounts less than other consumers.¹⁸

Therefore, relying on switching as a tool to deliver benefits to consumers has problems in terms of equality and diversity objectives. Many financial products, as currently designed, (such as current accounts or cash ISAs) offer better value for switching regularly. This churn is not based on any longer-term better price or service but simply the offer of an introductory rate to get consumers through the door. Firms hope consumer inertia will mean they will not switch when that deal ends. Our evidence on current accounts and cash ISAs show it is the minority, those in higher social categories, who switch more and are more likely to switch when these deals come to an end than those in lower social categories.¹⁹

Work by other stakeholders also agrees with our analysis that complex product design hurts those most vulnerable. Help the Aged and the Joseph Rowntree Foundation have found detailed significant social and financial exclusion prevails among older pensioners.²⁰ In addition, in 2007 Age Concern and Help the Aged noted the discrimination in the insurance market that older consumers' experience.²¹ The Runnymede Trust has also undertaken research on why the product design may have drawbacks for certain disadvantaged groups. In their view '*this explains why targeted policies are necessary for increasing financial inclusion and may vary by ethnic group*'.

Q2: How could we use our focus on products to promote equality and diversity?

The evidence above supports the notion that the general complexity of financial products works against equality and diversity objectives. We believe an active interventionist approach would aid equality and choice for all consumers, notably those who are most vulnerable. The FSA should have the powers to adapt the design of products according to sociological or ethnographical research into how the design of products impacts on risk, trust and value for differing groups. If it identifies chronic problems then its full range of powers should be used to ensure consumers get good value, with a particular concern that those consumers most disadvantaged do not pay a poverty premium.

Q3: Do you have any comments on our market failure analysis?

It appears clear to us that the evidence for earlier intervention within the discussion paper is overwhelming. As the consultation makes abundantly clear, waves of consumer detriment have occurred in the last 20 years and consumers are unable to discipline market participants to act fairly as predicted by neo-classical economic theory. We fully support the FSA's analysis, consumer protection strategy and logic for greater product intervention.

Q4: What do you think are the criteria by which we should judge when to intervene further?

We agree with the criteria or risk-matrix upon which the FSA plans to judge whether to intervene further. However, there is as of yet a lack of detail to indicate when the FSA will

¹⁷ DP 11/1, p24

¹⁸ Consumer Focus, *Stick or twist*, p16

¹⁹ Consumer Focus, cash ISA research, March 2011

²⁰ Age Concern England, *Being socially excluded and living alone in old age: findings from the English Longitudinal Study of Ageing (ELSA)*, 2008

²¹ Age Concern, Help the Aged, *Insurance and age* 2007

intervene in respect of the evidence burden required to act, and the nature of the escalation process. We believe these are critical issues to ensuring that product intervention powers are used to their full effect. We would hope any future consultation on the use of product intervention powers would specify in more detail how the FSA and future FCA intends to use these powers. In our answer to question 6 we flesh out the problems we identify that means we fear consumer detriment may continue to accrue even with these powers.

Q5: Are there any other relevant indicators that would help us identify potential problems?

Wider engagement with consumers and consumer groups would allow the FSA to respond more quickly to detriment as it occurs. We note that since the Consumer Protection Strategy the level of engagement has grown which we welcome.

We believe lower notions of evidence and proof should be required to justify action to intervene in product design than has been the case with firm specific enforcement action. In particular, we have noted with concern the FSA's inability to use evidence from consumer groups such as mystery shopping when assessing firms' compliance with Conduct of Business or TCF. We fear a similar proof burden, if used in determining product intervention, would be overly onerous and would prevent product intervention powers from being used to their full effect. We flesh out our concerns in question 6 and offer solutions to overcome the problems we identify.

Elsewhere we believe complaints data should be added to the general indicator of problem products in figure 3. We are aware the FSA has undertaken significant work around how complaints information should feed into the regulatory framework such as with DP10/1 *Consumer Complaints and mass claims*. We believe this intelligence should be a central criteria upon which to judge products' appropriateness.

Q6: Do you have any comments on the supervisory approach we have adopted, or suggestions to help develop it?

The discussion paper asks about which tools the FSA should use, be it general product governance obligations or specific product interventions. We believe all options up to and including bans should be made available to the regulator, and it should be free to use which ever tool appears to fit best the problem at hand.

Our comments will now focus less on whether to intervene in product design and more on how it is to be undertaken. The discussion paper details the factors that could cause intervention and which tools should be available. It provides less analysis on which tool to use and when. It appears implicit in the paper that the FSA knows when to intervene using its risk matrix. In recent speeches by senior staff, the FSA has made clear it wishes to intervene earlier in product development and make judgements about firms' business strategies.²² This discussion paper adds to that, defining some characteristics in its risk matrix of unfair product or pricing design that potentially justifies intervention. The discussion paper makes clear, these characteristics (in the risk matrix) alone do not prove a product is unfair; consequently a judgement has to be made. Clearly, choosing which tool is appropriate and proportionate is a matter of judgement. What is clear is that any judgement will have certain thresholds that have to be met in order to justify action. It is the nature of how that judgement is formed that we wish to query.

We are unclear if such judgements will be on the balance of probabilities or whether action will have to meet a criminal test of proof. We believe the FSA must make it clear which is the case as it has important ramifications. If the burden of proof is criminal, such

²² For example, <http://bit.ly/gsc4Mm>

as with enforcement action, then the internal hurdles within the FSA are likely to be higher with more opportunity for industry to push back, challenge or avoid, all the while detriment continues.

We would be concerned if the evidence burden to justify action remains a criminal level of proof as in firm-specific enforcement cases. Enforcement proceedings against firms are at the criminal standard because they are quasi-criminal in terms of the sanctions they can impose. Product intervention is entirely different in nature and therefore should only require a balance of probabilities.

It is likely any such judgements on products under a criminal burden of proof will take a long time, since the FSA will have to be assured it has undertaken due diligence and due process.²³ Equally, the FSA is likely to have to be assured that each of the product governance obligations, systems and controls have been checked and amended before it makes any recommendation to intervene in product design. Finally, any use of extreme measures such as bans are likely to come in place once all other measures have been tried and once changes to governance processes explored. All the while, consumer detriment may well be accruing.

Secondly, a criminal level of proof has historically prevented the FSA from gathering or using important sources of information in its regulatory activities. As an example we are aware that the FSA does not undertake extensive mystery shopping which has led to evidence of consumers' experience not being collected by the FSA. This is in contrast to the now defunct Banking Code, a self-regulatory body that utilised mystery shopping extensively to prove compliance. Our understanding about the lack of mystery shopping is that it is not undertaken because the FSA believes the scale of the exercise necessary for such work to inform enforcement or monitoring activity (under criminal levels of proof) would be so large as to be prohibitively expensive²⁴. Without this type of monitoring a vital piece of intelligence on firm level or industry wide practices is all but excluded from the FSA's armoury. We would be concerned if the spectrum of evidence deemed legitimate when exercising any new product intervention powers is as narrow and exclusionary as it has historically been.

We are also aware that the FSA cannot invoke consumer groups' use of mystery shopping or extensive anecdotal information as evidence when considering enforcement action. This provides further proof that the evidence threshold overall has been set too high. Clearly anecdotal information or consumer group information must require further analysis and substantiating evidence but the experience of consumer groups and consumers is that such information has been roundly ignored in the past rather than providing the basis for further investigation.

As it stands, it appears the proof burden necessary for evidence to be taken into account is far too rigid, exclusive and narrow. The FSA may wish to reflect how far its rigid definitions of evidence go to explain its self-confessed²⁵ reputation for appearing remote from the consumer before the crisis and also why the FSA was incapable of foreseeing and preventing the crisis developing.

If the FSA is granted product intervention powers we believe there is a significant risk the FSA may get caught up in process rather than acting quickly to prevent problems occurring as rapidly as it should. Consequently, we would call for a differing approach to evidence in product intervention than has been the case for firm-specific enforcement action for breaches to their duties under FSA licensing.

²³ The recent Judicial Review brought by the banks against the FSA's judgement on payment protection insurance is a possible example of how industry will attempt to subvert any judgements through questioning the rigour of the FSA's processes.

²⁴ From conversations with FSA staff at a consumer engagement event.

²⁵ <http://bit.ly/gsChP7>

In any follow-up consultation paper we would like to see a greater level of detail about the nature of how such judgements will be reached. In any new approach to product design, the regulator's ability to act depends on the burden of proof used in its risk matrix and what steps it must fulfil before using 'strong' tools. This timeline needs to be spelled out. Processes to inform judgements must be quick, decisive and open to a wide pool of intelligence. We believe this to be critical in terms of the efficacy of 'early intervention'.

It is also important to spell out the wider context in which the FSA will operate these new powers since this will also affect how these new intervention tools are used. As the FSA and its successor's remit expands to cover payment systems and credit, the resources will be stretched. Concurrently, the HM Treasury are going to re-constitute financial regulation under the future FCA and personal current account. This will also lead to significant resource commitments limiting the regulator's ability to utilise its new powers. Consequently, it is vital to ensure product intervention is an efficient and effective regulatory mechanism, as resources are likely to be in short supply.

It is worth reflecting on the level of resource commitment the FSA has committed in its recent regulatory activity, to improving firms' complaint handling. The FSA Financial Risk Outlook in 2010 identified complaint handling as an area of significant detriment and likely resource reduction as firms looked to shore up their capital base. In order to prove the scale of the detriment the FSA looked at a significant number of files of the major banks and insurers to make an assessment of their complaint handling.

The FSA review found '*evidence of poor complaint-handling standards within most of the banks we assessed. This resulted mainly from weaknesses in banks' culture, particularly their governance arrangements, policies and procedures and was reflected in our file review results.*²⁶ Following that the FSA has undertaken a thorough work plan around improving complaint handling, redress, mass claims, enforcement for breaches to DISP, and how complaint handling can feed into regulation.

The resource commitment required to obtain the burden of proof to justify enforcement action was unsustainably high and resource intensive. We worry that product intervention powers, if used with the same evidence threshold, will be even more difficult than for the example cited above.

Furthermore, it is likely product intervention will have less substantive evidence upon which to base intervention than was the case for complaint handling. The analysis proved poor complaint handling was based on historic evidence – on complaint files, recorded timelines and advice. Judgements made on the basis of predicting and preventing detriment are clearly less empirical. In financial services, detriment may only be revealed well into the product life cycle and, in addition, a product that is useful for some customers may be toxic for others. If the evidence burden were to remain as high then it is likely the process would be too long, and acceptable evidence too narrow, to deliberate on important factors that the FSA should use to inform its judgement. This will be particularly difficult considering the FSA's expanded work plan and new approach.

We believe there is the dual danger of the FSA's resources being tied up in proving governance processes cannot be first amended to remedy the problem and also in firms' gaming these measures, thus we could see large resources committed for little return.

In the absence of direct measures by the FSA to prevent bad product design without extensive evidence it is reliant upon improved regulation of firms' processes to ensure bad products do not hit the marketplace. The FSA has made much of its commitment to provide a credible deterrence through a closer inspection of firms processes, business model, distribution channels and FSA '*horizon scanning*' to spot problems.

²⁶ <http://bit.ly/e0ftDz>

It remains to be seen how it can devote its resources in an effective way and take on extra responsibility for payments and credit. We understand FSA regulation of firms' processes will now be tougher and informed by a better understanding of consumer needs in financial markets. We hope this will do as the FSA predicts and prevent detriment occurring. However, we have real concerns about relying on this process to prevent detriment.

It is incredibly resource intensive and we wonder, with such broad regulatory objectives, how the FSA can adequately scrutinise all firms' practices and products. Furthermore, Lord Turner has recently stated that '*any financial system will mutate to create new risks in the face of any finite and permanent set of rules*'.²⁷ This point must make the regulator sceptical about the effectiveness of ex-ante regulatory interventions through governance and business strategy analysis.

Thus, under the proposed regime the FSA would have new tools to analyse to intervene and new tools to do so, yet intervention would still essentially be reactive and not proactive. Intervention would be responsive to detriment in products as identified by the risk matrix or in FSA monitoring of firms' processes. Yet, as noted above with detriment often difficult to spot in financial services this raises once again the issue of how quickly intervention occurs. We believe it is difficult for the FSA to meet the its espoused goal of '*protecting consumers by preventing problems before they occur*'²⁸

Strong, fast and effective product intervention is necessary for consumer protection. Furthermore, a clear framework for product intervention, alongside a clear threat of intervening is likely to lead to benefits for industry as well. A clear policy/framework for product intervention would provide regulatory certainty for firms – something industry claims to want – allowing them to invest in products, systems and marketing with confidence that their product is deemed safe, will not be subject to redress years later and are assured that their competitors are not able to gain a competitive advantage by using unfair means.

Consequently, we would hope judgements on '*early intervention*' would require a lower threshold than the example above on complaint handling or for firm-specific enforcement action. We would like clarification on consumer and consumer groups' involvement in the provision of evidence, and how the matrix will be used. Consequently, we believe further work is required on exactly how the FSA intervenes and whether the tools outlined in the paper are sufficient to deal with the detriment so aptly described in the paper.

If the FSA is unable to deliver such certainty within its legal powers and resources then we must think again about how else such certainty can be achieved in product design. More forceful and preventative measures may be necessary.

Standards

The product intervention paper is quite explicit – the FSA does not plan to give product pre-approval. It identifies significant dangers in that approach. For the regulator it would be too resource intensive, there are dangers in giving products an FSA seal of approval and it may not be best placed to design products.

All the above makes the case for a separate mechanism to ensure consumers products have been pre-tested to remove any toxicity. We suggest that there is merit in exploring the idea of a standards committee for differing products. On such committees consumers and consumer groups could play some role in defining what is an acceptable and fair

²⁷ Lord Turner, FSA, speech, *leverage, maturity transformation and financial stability: Challenges Beyond basel III* <http://bit.ly/gkvdBR>

²⁸ Sheila Nicoll at the Consumer Focus, *Roundtable on product intervention*, 31 March 2011

product in each marketplace prior to the FSA intervening. Hector Sants stated in a recent speech that:²⁹

'A successful consumer protection strategy must restore consumer confidence in the financial marketplace. A key element of restoring that confidence is that the consumer can trust the regulator.'

Standards offer a route map to restoring consumer trust and restore confidence in the regulator by enforcement directly being linked to consumers' expressed concerns.

The *Fair enough?* paper written for Consumer Focus by the National Consumer Federation suggests a standards approach has three benefits³⁰:

1. For consumers it gives them a greater say over the design of products and allows them to feed into policy, through consumer groups with knowledge of their concerns
2. For firms it sets a level playing field knowing that no firm will get away with offering inferior products at the same price. It also allows competition to be based on higher standards of service and not in a race to the bottom with misleading terms or unnecessary complexity
3. For the regulator it frees up their resources. There are fewer products to monitor, greater clarity on acceptable standards and less need to monitor culture, product design processes, governance etc, simply the products at the end. It would further allow the regulator to support product design initiatives without it needing to use its legal powers that may take time and resources to use as the evidence burden may be high to justify regulatory intervention

At the recent Consumer Focus roundtable on *'products, intervention or standards?'* the concept of standards was discussed. While there was no consensus, but some participants around the table felt that standards could play a role in shaping the design of products to prevent detriment. It is suggested that the FSA or future FCA role would be in enforcement action based on those prescribed characteristics for each product. A product where we believe intervention is required is cash ISAs. We have recently written to the FSA calling on it to take action to simplify the product based on the criteria evident in this discussion paper. In our letter we state:

In February 2011 we conducted market research into bonus rates and customer behaviour. For those savers who had a teaser rate that had ended, two-thirds failed to switch even though they were aware the higher introductory interest rate had run out. The research also showed almost a quarter of cash ISA savers did not know whether their account even had a bonus rate. Finally, a third of account holders who were aware their account had an introductory rate were not sure if their rate had expired or not.

This means that far too many consumers have their life savings in accounts paying derisory amounts of interest leaving their savings completely unprotected from the worst impacts of inflation.

We believe our research into consumer behaviour provides evidence that providers are designing this product to interact with consumer behavioural traits in ways that are likely to cause detriment to a majority of consumers. The current FSA discussion paper DP 11/1 references exactly this practice; firms deliberately building in complexity to manipulate consumer behaviour.

Principle 6 of the FSA's 'Principles for Businesses' states: 'a firm must pay due regard to the interests of its customers and treat them fairly'. Consumers are using cash-ISAs as a

²⁹ <http://bit.ly/gsc4Mm>

³⁰ Consumer Focus, *Fair enough?*, <http://consumerfocus.org.uk/g/4ox>

long term nest-egg. We do not believe the introductory rate model complies with firms' duties to the interests of consumers based on our evidence of consumer behaviour.

Our findings are similar to findings by the OFT about bait pricing and time limited prices. We also note that Ofgem is advocating a radical simplification of energy pricing and the introduction of 'evergreen products' to reduce confusion in the market.

Cash ISAs are an interesting test of the regulatory protections consumers have. Our evidence suggests the current design is not appropriate for the majority who want a fair price for long-term savings, not active management every March. While some in industry may claim that consumers are free to switch every time the bonus period ends, their own pricing of these products is based on the majority of customers failing to do so. We call for product intervention to prevent the complex and exploitative design continuing. With that in mind we would be interested to see how far the regulation of governance processes around design and distribution have picked up these problems. If they have not, then it would make the case for product intervention powers and standards.

Q9: What would the impact be on the market?

In the discussion paper, the FSA is clearly concerned about the consequences of product intervention. Most notably, it recognises the danger of firms' reacting to the market by offering consumers less choice, and that the regulatory costs may outweigh the benefits.

Lord Turner has stated that there have been few substantive innovations in financial service products in 20 years that have been beneficial to the consumer.³¹ Recent thinking on innovative product design suggests the opposite in financial services, that most innovations have been positively destructive.³² Consequently, there should be a critical analysis to all products, including any new products and services that are brought to the market.

We further believe intervention can shape competition to offer more meaningful choice, innovation and service rather than less. Several commentators at our event on Product Intervention made the same point. One commentator hoped the new regulator would look at the quality of choice rather than the quantity, a point echoed in HM Treasury's paper on simple products in its analysis of the savings market.

Stronger, earlier intervention may also release regulatory resources. Currently there is a proliferation of near similar products on the market that the FSA is obliged to monitor. The recent HM Treasury consultation paper on simple products makes this point clear, for example on the savings market. Additionally, it is important to factor in the resultant loss of consumer trust, since the quantity of choice comes at the expense of quality, meaningful choice and since consumers struggle to fathom which product is appropriate and best value. This is explored further in our answer to question 1. A regulatory regime that actively intervenes to ensure products are not designed with unnecessary complexity is likely to leave to a drastic reduction of products on the market and save the regulator significant resources. Industry itself would benefit as with greater trust would come greater consumer engagement resulting in more sales of products such as pensions and insurance products.

Finally, many industry participants referred to the regulatory cost of product intervention. Granting these powers does not require the FSA to use them, and as such there is no definitive regulatory cost as they suggest. Yet, it may strengthen the FSA's hands when dealing with firms to ensure their behaviour is changed quickly. Thus, it may reduce the amount of market monitoring, and the need to engage in protracted regulatory battles

³¹ <http://bit.ly/hSeDv2>

³² Andrei Shleifer, Financial innovation and financial fragility, <http://bit.ly/enY5ZN> December 2010; Robert Shiller, *Challenging the crowd in whispers, not shouts*, November 2008 <http://nyti.ms/gAbkDU>

with firms when it has the ultimate power to ban in its armoury. Consequently, these powers may increase the efficiency of regulatory resources, lower regulatory cost and lead to a better marketplace for consumers.



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