



**Consumer
Focus**
Campaigning for a fair deal

Consumer Focus response to HM Treasury's consultation on simple financial products

March 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.

Our response

Consumer Focus welcomes the paper on simple financial products. The paper identifies product complexity as causing consumer mistrust in products and a lack of engagement with the market as a whole. Our research showed consumers switch providers less in financial services products, especially personal current accounts, than in other utility industries such as energy or insurance.¹

As the research for the consultation identifies, consumers lack trust in financial products.² With so much variety and complexity in products – such as bundled current accounts, multiple charges and interest rates for credit cards and even complex savings accounts – it is unsurprising consumers do not trust the huge variety of products on the market. They are unable to make informed choices about what best suits them and they believe the complexity is there to catch them out. All this means consumers are turned off from engaging in the marketplace.³

Complexity also prevents those consumers who do switch from gaining the maximum returns possible. As Mervyn King recently stated banks, “exploit the gullible or unsuspecting customers’ for short term profits”⁴. This, in turn, does not allow the effective discipline of market forces to apply, leading to detrimental outcomes for consumers, market inefficiencies and productive losses.

Restoring consumer trust in financial services is a laudable goal for Her Majesty’s Treasury (HMT). Yet, this requires far more than the production of a selection of simplified products, however well rolled-out. It is vital that the regulatory regime, moving forward, aims to create a marketplace where those companies that offer clear, good-value and transparent products prosper. More broadly, steps need to be taken to enable market entry to those firms who wish to provide products on this basis.

It is also important to consider simplification across financial services. The Financial Services Authority (FSA) also has a discussion paper out on the future of product intervention, while the larger questions around the approach to regulation are addressed in the HMT paper *A new approach to financial regulation: Building a stronger system*.⁵ The FSA paper addresses the question of complex product design as a strategy by firms to exploit behavioural biases. It is vital the FSA’s evolving attitude towards product complexity prevail in any new regulatory structure.

Our response seeks to identify how best HMT should go about designing simple products. We would like the proposals to chime with empirical evidence about the likely behaviour of consumers when presented with a marketplace that includes simplified products and also our experience working with industry to design and disseminate non-market orientated programmes.

The problem

The incentives placed upon firms to design complicated products must be understood prior to any attempts to remediate the detriment they cause. Products are designed under

¹ Consumer Focus, *Stick or twist* <http://consumerfocus.org.uk/g/4oa>

² HMT, *Simple financial products consultation*, p7

³ FSA, *Financial capability in the UK: Establishing a baseline*, March 2006

⁴ Mervyn King, interview in the Telegraph, 4 March 2011 <http://bit.ly/eJjMaH>

⁵ HMT, *A new approach to financial regulation: Building a stronger system* <http://bit.ly/fiocAR>

heavy influence from marketing departments who offer attractive headline figures – for example high savings rates on ISAs, or low borrowing rates on credit cards – that are only given over certain time periods and on certain behavioural conditions.

The evidence suggests most consumers switch or choose a product based on the headline figure offered.⁶ Firms are therefore incentivised to offer the most attractive headline rate, particularly in the era of online price comparison sites or best buy tables. Yet, if products performed as consumers expected, these headline rates would not render a sufficient profit for firms.

Firms therefore have an incentive to ‘*design-in*’ complexity. Products are designed to be behaviour dependent. Firms are aware that consumers have behavioural biases including being ‘over-confident’ and failing to predict future behaviour that may make a product less good value.⁷ The most detrimental is with ‘*ancillary charges*’ on personal current accounts that consumers do not assess in the upfront price (‘*essential bargain*’) prior to purchasing.⁸ Another method is to offer temporary deals (so-called ‘*teaser rates*’), as we addressed in our super-complaint to the Office of Fair Trading (OFT) on cash ISAs.⁹ There is an expectation that many consumers will fail to notice when such offers expire and worse terms take effect.

In this way firms can initially offer attractive rates without it impinging too strongly on their bottom line. It is this model that blights the financial services sector causing the complexity, exploitation and lack of trust described above.

There are challenges to this system from certain market players. First Direct offers a phone and online banking system that prides itself on customer service. Equally some new firms have entered the marketplace – such as Metro Bank, Virgin Money and Tesco Bank – that also want to make a less detrimental business model. Yet, without reform of the industry it is difficult for them to obtain market share.

Few consumers switch providers in financial services – our research found only 7 per cent switched personal current accounts (PCAs) over two years¹⁰, and most buy other financial products from the same provider as their PCA.¹¹ As the FSA has recently pointed out “*we believe that ineffective competition in retail financial services markets more usually results from a number of ‘demand-side weaknesses’. By this we mean that customers are not exerting pressure on firms to produce the desired quality of products or to influence prices*”.¹² Consequently, it is difficult for market forces alone to provide the type of market dynamic needed.

How can we restore trust and confidence in financial products and services?

Dealing with these incentives will require reform of the wider regulatory structure in which products are designed. The FSA now operates under its new regime of outcomes-focused regulation. This consists of making judgements on firms’ business models

⁶ Consumer Focus, *Stick or twist*, 2010; OFT, *Personal current accounts – A market study*

⁷ The consultation refers to behavioural biases in Chapter 2, p7

⁸ As we identified in the PCA market with unauthorised overdraft charges. *Stick or twist* <http://consumerfocus.org.uk/g/4oa>

⁹ Consumer Focus, Super-complaint: Cash ISAs <http://consumerfocus.org.uk/g/4ob>

¹⁰ Consumer Focus, *Stick or twist* <http://consumerfocus.org.uk/g/4oa>

¹¹ Mintel, *Retail banking overview*, 2011

¹² FSA, DP11/1, Product Intervention, 3.4, p24

looking at product design, complaints decision from the Ombudsman, marketing and profitability.¹³

The FSA currently has a discussion paper out on future product intervention. This paper assesses whether principles or prescriptive product regulation is best for producing positive results for consumers. In particular, how the trade-off between dynamic innovation, consumer choice and market freedom have to be reconciled with toxic design, exploiting behavioural prejudices and protecting consumers from manipulative marketing. There is no clear answer in this and the FSA rightly identifies trade-offs and also weights them sensibly.

Any form of standardisation, it is argued by the banking sector, negates consumer choice since it stops firms designing products as they wish in order to respond to consumer demand. Yet, the consultation document on *simple products* sets out why consumer demand is not nearly so well informed, or so diverse. As the research for this consultation proves, consumer demand is for a simpler, more trustworthy marketplace. It is right that a greater level of standardisation takes place across the industry led by the new consumer regulator and not just with the range of products through the initiative laid out in this paper.

With that in mind, Consumer Focus recently produced a discussion paper in association with the National Consumer Federation (NCF) to look at how best products and services could be designed, regulated and monitored to ensure customers are treated fairly and market competition leads to productive competition.¹⁴ This paper identifies how a framework of principle-based regulation can work alongside specific product steering groups to produce standards.

The paper borrows concepts that are used in product design from manufacturing and service delivery industries, and allows consumers and consumer groups across the country to input into both the design and enforcement of standards. Flexible working groups could also adapt how the principles of fairness apply over time as market dynamics and technology evolve.

Consumer Focus is organising a roundtable on this paper on 31 March. We believe HMT are going to attend. One aspect of the debate around product intervention we hope to explore is how standardisation should work across the industry in the creation of simpler and safer consumer products, and what impact that should have on the future of a range of 'vanilla-simple' financial products set out in this consultation.

How to make simple products work

1. Wider simplification of financial services products

As the consultation paper indicates, history teaches us that a distinct set of simple products may not take off. Despite latent demand for simplification, when it comes to purchasing a specific product, product marketing and headline rates matter more. Those few consumers who do switch tend to look for headline rates. They struggle to understand how their future behaviour will affect the value of the product.

Consequently, simple products may not attract custom when ostensibly similar (but more complex) products offer more attractive rates. Firms will equally prefer to market complex products since, as the literature review for the consultation shows, where complexity is found higher profits can be made. For this reason we agree with Government that there

¹³ FSA, *Consumer Protection Strategy*, March 2010, Speech by Sheila Nicole, February 2011, <http://bit.ly/ifiEkl>

¹⁴ Consumer Focus, *Fair enough?* <http://bit.ly/g0wjFF>

should not be price caps to ensure firms are willing to supply and market these products. Yet if headline prices are less attractive than for mainstream products consumers may seek better value elsewhere.

Thus, as discussed above simple products must be accompanied with simplification industry wide to prevent behavioural biases undermining the initiative from achieving real effect.

2. Government involvement

For the reasons set out above it is very difficult for simple products to work without clear Government commitment. We believe it is critical for Government to steer any product design since our experience suggests it is necessary. This view also comes from Consumer Focus's experience of working on industry-led voluntary efforts to design product standards. We have been disappointed with the speed and quality of outcomes. Recent examples include the OFT-led work on PCAs, the *Faster Payments* initiative and Basic Bank Accounts.

Case studies of reforms designing financial products:

1. The OFT has tried to lead on various reforms to the PCA market coming out of its market study in 2008. These include offering consumers opt-outs of UOCs, ensuring those in financial difficulty are offered help and also offering consumers greater control over their account to prevent unauthorised overdraft charges (UOCs). The OFT provides regular updates on its reforms.¹⁵ In general the reforms have taken a very long time to proceed with industry fighting every step of the way. In its last update in September 2010, the OFT noted revenue from UOCs remained stable at £2.5 billion; there was to date no ability to yet opt-out of unauthorised overdrafts. We set out our continued frustration at the lack of progress in our consultation response to question 8 of the BIS Consultation on credit and insolvency¹⁶. So far we have yet to see any viable offering to consumers to prevent UOCs.

2. On faster payments, far too few firms offer the maximum threshold for faster payments of £100,000.¹⁷ Santander only offer £300 for one-off payments and HSBC just £50 for standing orders. It is a considerable disappointment that firms are not providing an adequate payments system for UK consumers. These issues remain the same as those identified by Cruickshank over a decade ago. Industry has failed to 'grasp the nettle' on payments under the voluntary approach. It is only the introduction of the Payments Services Directive that will force banks to produce a fairer payment system. While some firms do offer a full service, others are very slow and seem disinclined to act prior to the 2012 deadline. We recently wrote to the British Bankers' Association asking for a reason why progress was so slow among some of its members. Their response took two months and gave no real answer.

¹⁵ OFT, *Personal current accounts in the UK* <http://bit.ly/ex5hul>

¹⁶ *Consumer Focus response to BIS on managing borrowing and dealing with debt: consumer credit and personal insolvency review* <http://bit.ly/ewlBmw> (PDF 960KB)

¹⁷ See UK Payments Administration <http://bit.ly/eBOTzk>

3. Basic bank accounts (BBAs): The programme to design and expand the supply of BBAs was HMT-led under the auspices of the Financial Inclusion Taskforce. Its results are more mixed than the others discussed in these examples and we believe HMT's influence was vital in ensuring what positive success is evident. The programme has recently been evaluated by the Financial Exclusion Taskforce (FET).¹⁸

In their view, the main success has been in expanding the numbers who have opened a BBA. The data show that, since 2002/03, the number of adults living in households without a transactional bank account has decreased from 3.57 million (in 2.57 million households) to 1.54 million (in 1.14 million households) in 2008/09. The number of adults living in households without a bank account has therefore decreased by 57 per cent and now represents only 3 per cent of the population, compared to 8 per cent in 2002/03. The influence of HMT was felt with total Government support (as with, for example, the Department for Work and Pensions and benefit payments).

Yet, there were also weaknesses that it is worth learning from. No formal standards were set for BBAs and each bank was able to set the specific features of its account. The findings have shown that because the design of BBAs still allows consumers to face charges for entering unauthorised overdrafts, particularly low-income consumers are losing out heavily from opening bank accounts.¹⁹

As a result very few BBAs offer everything that most consumers identify as being important to them in a bank account.²⁰ One account may offer a debit card, but not ATM access for example. Consumers are therefore required to choose from a range of suboptimal products and to make trade-offs on the basis of which features – which should arguably be core for any transactional account – they value and prioritise most.

So while there is a drop in the number of households without a transactional account, the net effect of a poorly designed product has produced dormancy rates for BBAs that are huge. The reasons why are clear. Due to a lack of sympathetic and appropriate design the FET research shows that any savings are offset by an average loss of £140 per annum in penalty charges – a burden mainly borne by the poorest households. This in turn has driven a high rate of account failures where consumers have stopped using their new accounts altogether (15 per cent, including 19 per cent of those on the lowest incomes).

Furthermore, those banks that offer well-designed products with a lack of risk, more control and greater functionality are not matched by others in the industry. BBAs do not offer banks any profit and thus, those which offer the best design and functionality and have to carry a greater burden than the rest of industry.²¹ Greater prescription in the design of BBAs would prevent the risk of charges being incurred and of some market providers carrying an undue burden.

¹⁸ Financial Inclusion Taskforce, *Banking services and poorer households* <http://bit.ly/hNYtOt> (PDF 231KB)

¹⁹ A full list of charges can be found in Moneymadeclear, *No selling. No jargon. Just the facts about basic bank accounts* <http://bit.ly/gvdla5> (PDF 796KB)

²⁰ Consumer Focus, *Opportunity knocks*, 2009

²¹ The Co-Operative Bank for example, have a much higher percentage of the BBA market than the PCA market, and thus are at a competitive disadvantage for providing a more appropriate product.

These examples provide salutary lessons for the introduction of simple products. Without Government, and particularly HMT support and leadership, banks do not commit to the programme of work sufficiently to deliver a consumer-focused product. Yet, even in the example where they do commit – BBAs – without a requirement for consistency across all providers there is no incentive for banks to offer good products because it would result in them carrying an undue burden. All this evidence points towards a clear need for Government involvement in the programme and prescription over the design of the product, if not the price.

Therefore, we believe it is critical that if this process is to be implemented quickly, effectively and according to consumer needs it must be Government driven. Industry's track record is to push difficult issues into the long grass or come up with suboptimal solutions that fall short of meeting consumer needs. Effective action requires Government leadership, even if in some cases the Government only uses its powers as a steer or as a last resort if more collaborative efforts fail.

Government involvement is critical to driving forward delivery. We simply do not accept it will be effective if industry lead the process to deliver a range of simple products. Complexity leads to a direct utility transfer from consumers to firms, and generally to those firms who are larger and make most use of marketing. There is therefore no clear incentive for them to reform.

3. Standardisation

Consumer Focus shares the position with Government that price caps are not the way to standardise products. We must bear in mind the need for firms to arrive at a profit and to maintain the two elements of consumer choice that are good for markets – price and quality differentiation.

It is our view that firms should continue to compete over price. Yet that price should include the vast majority of the overall expense for the product. There is a wide-ranging debate about how far the upfront price or '*essential bargain*' should contain all the necessary information consumers need to assess value. This issue came up in: the OFT's efforts to judge UOCs for fairness at the Supreme Court; in the Government's negotiating position on the Consumer Right's Directive; in the Consumer Credit Directive; in the FSA's mortgage market review; and in Which?'s recent announcement of a super-complaint into card charges.

In essence we believe the FSA's position, as set out in the mortgage market review, is correct.²² It states that the entire profit in a product should be expressed in the '*essential bargain*'. Any ancillary charges that depend on future behaviour should only be 'cost reflective'. The FSA has reserved the right to judge whether those costs are indeed charged at cost reflectivity. This allows consumers to judge the value of a product easily and ensures firms that offer the best value are rewarded rather than those with the most sophisticated marketing.

It is right that any standardised or simple product complies with this rule. A suggestion offered by the NCF paper in their paper for Consumer Focus was for a working group for each product. It should consider what the essential bargain is in terms of the overall price which firms must include in the headline figure. It would be up to any such group to adapt future assessments of the essential bargain as technology and market innovations develop.

We do not believe temporary or introductory deals should be included in any simplified product regime. This issue formed the basis of our super-complaint to the OFT on cash

²² FSA, *Mortgage market review – Responsible lending* <http://bit.ly/eF3ZkX>

ISAs. We stated: ‘Many providers, including many high street banks and building societies, appear to use “bait” prices to attract savings into cash ISA accounts. Headline rates of three per cent and above are not uncommon; after a year the rates drop substantially and there are a large number of accounts paying next to no interest’.²³ Recent research by Consumer Focus indicates that nearly two-thirds of customers who take out a Cash ISA with a bonus rate and are aware it has run out do not switch when the bonus period runs out (polling March 2011).

There is no reason why any firm should have more than one interest rate in a simplified product if the service attached to the product (qualitative factors) are the same. Therefore, while we do not want to standardise price we would call for headline figures to contain all the price on which the firm aims to make profit (ancillary charges being cost-reflective) and temporary deals to be prohibited from any simplified product. Consumers also differentiate on quality. We believe there are two elements to that issue:

- Product-specific quality
- Firm quality (brand)

Product-specific quality

Product specific quality relates to certain factors that make a product higher value than other similar products. In supermarkets consumers are well used to the differentiation of goods from basic, to standard, to luxury range. In finance, many goods are in essence homogenous. An ISA is a tax-free savings account. A loan allows you access to money you repay. Yet, there remain other qualitative factors. Qualitative aspects include:

- **Savings accounts:** Liquidity – Speed and ease with which your savings can be accessed
- **Loans:** Early repayment options
- **Current accounts:** could include ability access account details online, access to a free overdraft, or bundled products sold with the current account

Consumer Focus would be happy to see a limited number of qualitative variables attached to each simple product which could affect the price of the product. The number of variables would vary from product to product: current accounts would have more variables than saving accounts for example. Without an agreed limit on these variables we return to the excessive complexity the research for this consultation identified and it would be too difficult to manage and design within the framework of a simplified product. The exact number and type of variables should be based on stakeholder engagement and consumer research to discover what consumers value as meaningful choice.

The consultation suggests deposit savings accounts would be one of the first products to offer a simple product alternative. To work through this example, the price would be the APR interest rate (without teaser rates). The two qualitative aspects could be around liquidity: how long the customer needs to keep the money in the bank before accessing it (instant access, 6 months, 1 year); and notice to access deposit savings (instant access, 4 weeks, 3 months). These two variables could be priced accordingly by the product providers.

The consultation paper notes there are over 2000 savings products on the market. Beyond these two variables we are not convinced there are other variables that add value for consumers (though, of course, that could be determined in future working groups). If the qualitative angle was reduced to these two variables consumers would be able to

²³ Consumer Focus, *Consumer Focus issues super-complaint to Office of Fair Trading about UK cash ISA market*, press release <http://consumerfocus.org.uk/g/4oc>

weigh up how much they valued access (liquidity) as compared to returns. Consumers could then be assured price (APR interest rate) equalled value.

Firm quality (brand)

The second aspect of quality is brand. Firms spend huge sums on advertising, or sponsorship such as the *Barclays Premiership*, or the *RBS 6 Nations*. It is clear brand recognition and value are seen as vital in the marketplace. Customer service, quality of advice and branch availability could all be assessed in a range of ways and may impact on consumer choice of provider. One aspect of qualitative assessment is on complaints data. The FSA and Financial Ombudsman Service (FOS) are rightly trying to improve consumers' understanding of which firms are committed to giving good customer service by publishing complaints data.

We hope complaints data can become a productive way for consumers to differentiate brands. Complaints data can give consumers an informed opinion about which firms are customer-service orientated, trustworthy to prevent problems and able to deal with complaints effectively. We publish graphs based on the FSA aggregated data and the FOS data. The next publication will be released in early April on the most recent set of figures. We hope to distribute these graphs widely to help consumers choose.

It is early days in the publication of complaints data as part of the FSA's approach to transparency as a regulatory tool. Currently we have certain difficulties with the publication of the data, most notably the data fails to:

- differentiate between banking products (within the banking and credit category)
- give an indication of market share so it is difficult to assess how good or bad the bank is proportionately to their customer base
- capture complaints resolved at four weeks
- show how many complaints are resolved within the end of the business day

This aspect of qualitative assessment, based on brands actual performance in generating and/or avoiding complaints on specific products can be enhanced greatly. Alongside clear pricing and a few key critical variables on the product quality, consumers could benefit from clear, rigorous evidence of a firms' commitment to complaint handling and customer service.

We believe the simple products brand could be a way to promote complaints data as a means for consumers to judge banks quality. As part of the development of simple products, work could help ensure complaints data informs consumers about firms' performance to further the power of complaints data to discipline market participants.

Under our proposed system of standardisation, consumer choice could at last have the potential to discipline market operators to deliver value. If accompanied by clear pricing²⁴ and a quick, efficient, hassle-free switching system, dynamic consumer-focused competition could ensue.

Other methods to improve consumer comprehension

The traffic light system developed by the Food Standards Authority to express health externalities could have merit in this arena, where the price mechanism could not be used to inform consumers. Further research should be undertaken on the potential of 'health warnings' to ascertain their effectiveness in what is a different market.

²⁴ A lack of clear pricing was identified in our Super-complaint on Cash ISAs. Banks were not obliged to put the interest rate on statements. Reforms have subsequently been put in place

We reiterate, however, that to reach the laudable goal of clear signals to consumers the first step should be simpler charging frameworks, and fewer types of charges or fees. Traffic lights may not be needed to inform consumers if the market was not structured to confuse. It is the systematic exploitation of the dichotomy between headline price and actual value that means markets do not work well for consumers.

Linking simple products to financial advice

We support linking simple products to simple financial advice and comparison tables – available on the Moneymadeclear website or on private comparison websites or newspapers' money sections. Clear, comparable products are very compatible with this format of selection.

Linking to regulated financial advice

Industry likes to make much of the need for complexity in investment products. In reality, much of the complexity of investment products is about marketing rather than any actual investment returns. We would welcome efforts to simplify and clarify what investment products actually do, what the terminology actually means and how best to simplify product design to leave consumers more aware of the nature of an investment product, expected returns and risk.

Simple investment products could therefore be useful, though with the various caveats about making simple products work as expressed in the HMT consultation document and in our response. The impact of inflation on savings means that in a low interest rate environment investment products offer best hope of returns for consumers. Generally speaking consumers should diversify the investment of their assets if they have sufficient sums to make this possible and regulated advice should support this goal.



Consumer Focus response to HM Treasury's consultation on simple financial products

For more information please contact Oliver Morgans on 020 7799 7965 or email oliver.morgans@consumerfocus.org.uk

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Consumer Focus

Fleetbank House
Salisbury Square
London EC4Y 8JX

Tel: 020 7799 7900

Fax: 020 7799 7901

Media Team: 020 7799 8004 / 8005 / 8006

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