Financial Services Authority

Retail Conduct Risk Outlook 2011

Retail Conduct Risk Outlook
2011

25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

MIX
Paper from responsible sources
FSC® C022704
FSC
www.fsc.org

Contents

Chairman's foreword

Financial services have to cater for a wide, and sometimes contradictory, set of consumer needs.

For many consumers, financial services firms are a utility. They use them to pay bills, facilitate home ownership, provide some measure of protection, and save safely – either for retirement or for shorter-term goals. Much of the concern expressed about these services reflects a view that consumers are in an unequal relationship with financial firms; that it is difficult for customers, through shopping around, to drive day-to-day service improvements.

Other consumers, for a variety of reasons, have more sophisticated needs. Some have higher levels of wealth or financial capability, and some may be reliant on their financial assets as a source of income. These consumers may seek professional advice to help achieve their investment goals and demand a degree of choice and complexity that would – and often does – bewilder those with more straightforward needs.

The macroeconomic environment and new regulation has added to this long-standing heterogeneity. Low interest rates, for example, have benefited some borrowers, but created risk for others. They have stressed some firms' business models, but also created new selling opportunities – as consumers focus more on returns on their saving, and the need for financial security.

The Retail Conduct Risk Outlook builds on our previous Financial Risk Outlooks in analysing how these trends may translate into conduct risk – that is, the risk that firm behaviour will result in poor outcomes for customers. The environment could create new risks in different ways. Increasingly, cost-focused banks may neglect post-sales services; investment firms marketing complex new products may not properly consider whether they would be suitable for their intended audience; or adviser firms may adapt business models to comply with the Retail Distribution Review, but in ways that may disadvantage their clients.

This outlook contains all of the highest priority retail conduct issues, which we will be addressing in our Business Plan in March.

But our Consumer Protection Strategy, which we launched in March last year, requires us to be more pre-emptive, and more interventionist. Therefore, not all of the issues highlighted in this report are risks for today. Indeed, many of the potential issues in Chapter B of this report are risks that, through early dialogue with firms and consumer representatives, we would like to prevent from occurring.

As we look ahead to the Financial Conduct Authority, the Retail Conduct Risk Outlook illustrates the consumer protection challenges facing the FSA, its successor bodies, and financial firms over the coming years.

Adair, Lord Turner, FSA Chairman

Executive summary

Introduction

Over the last year, we have launched our enhanced Consumer Protection Strategy. The strategy includes a commitment to earlier identification of retail conduct risks. The Retail Conduct Risk Outlook (RCRO) presents our view of current, emerging and potential risks to consumers arising from poor conduct by firms. The outlook aims to inform a dialogue with consumers and firms, increase awareness of risks, and inform our own supervisory focus.

The RCRO covers risks arising from firms' conduct in their direct relationship with consumers. It does not cover wholesale risks or financial crime risks. It also does not cover risks to consumers posed directly by developments in the macro-economy, or risks within the scope of other regulators (for example, the Office of Fair Trading (OFT)).

The RCRO, together with the forthcoming Prudential Risk Outlook, replaces the previous FSA publication, the Financial Risk Outlook.

Chapter A: The environment

This chapter discusses how firms and consumers have responded to the uncertain macroeconomic environment, the growth of new regulation, and other market developments. It sets the scene for the risk discussion in Chapter B.

1. The macroeconomic background and outlook for households

In real terms, household income was relatively resilient during the recession, although it did not grow much over the period as a whole. This, coupled with falling interest payments on secured debt, allowed some consumers to channel extra income into financial assets and, to a lesser extent, debt repayment. Despite this modest deleveraging, many households continue to carry high levels of debt, which may leave them vulnerable to future income shocks – either as a result of unemployment, or rising interest payments.

Consumers saved more in the initial phase of the financial crisis, but the saving rate fell as their confidence in the economy increased during 2009 and early 2010. There are signs that savings are now increasing again as consumers respond to employment uncertainties. The pattern of saving has been affected by the very low interest rate environment and equity volatility, with consumers attempting to reconcile the desire for yield against the need for security.

There appears to have been little conscious attempt by consumers to pay down secured debt. This may be because those customers most able to pay down debt are also most likely to be benefiting from very low interest payments.

Below these aggregate trends, however, is a diversity of experiences among households. Significant falls in interest income have cut the disposable income of those households with significant net positive cash positions (deposits minus loans), particularly older age groups. Meanwhile, significant falls in interest expense have benefited most mortgage borrowers, but with very significant diversity of experience between different consumers, depending on the particular form of their mortgage contract.

2. Regulatory background and outlook

New financial services regulation has been initiated, both as a response to the financial crisis and to address longer-standing issues.

Some sectors will be particularly affected by regulatory change, especially those affected by a combination of measures. The Life Insurance sector, for example, is required to implement the Retail Distribution Review (RDR) and Solvency II, and respond to the government's pension reform initiatives (auto-enrolment and NEST) in 2012.

The RDR, in particular, is expected to have an impact on business models in affected sectors.

3. Firms: supply of financial products

Firms have been affected by macroeconomic developments, market conditions and new regulation in a number of ways:

Banking has been affected by the low interest rate environment. This has affected all banks, but mostly those banks with a large back-book of tracker mortgages pegged close to the Bank Rate. As a result of fierce competition for retail deposits and the withdrawal of traditional sources of income, banks are seeking to develop alternative ways to generate profit, either by 'up valuing' customers into premium products or services, or by aggressively cutting costs.

Asset managers are offering increasingly complex investment products and strategies to consumers searching for yield in the current low interest rate environment. Some of these products aim to address potentially incompatible consumer demands for both high yield and investment security.

Life insurers are considering how to change their business models and product mix to alleviate pressures on their long-term prospects – for example, by targeting the changing needs of the pre-retirement market. They are also responding to a number of large-scale regulatory initiatives, which will have a significant effect on the way they do business (for example, the RDR and Solvency II).

In relation to **retail intermediaries**, current economic conditions and pressures in the mortgage market have meant that many mortgage intermediaries have struggled to maintain income levels with many deciding to close their business – the number of firms whose primary business is home finance broking has almost halved in the three years to December 2010. The number of financial advisers has also fallen by 6%, following a smaller decrease in 2009. However, the number of general insurance intermediaries has continued to rise, although at a slower rate than in recent years. In addition to the RDR, other regulatory changes that may affect the structure of this sector include increased capital requirements for Personal Investment firms, the MMR and pension reforms. The combination of all these changes may have a significant impact on the business models of firms, which could lead to conduct risk arising for consumers of the impacted businesses.

All firms are affected by a large number of regulatory and public policy initiatives. In some cases (for example the RDR) regulatory change will require firms to radically change business models and strategy. This should bring benefits to most consumers, but may also introduce new risks, which we will keep under review within our supervisory activities.

4. Consumers: important segment-specific effects

Consumer experience is diverse. Key factors affecting the diversity of experience between consumers include:

- the very unequal distribution of financial assets ownership – this is a longstanding but important determinant of how demand for products and services differs by customer segment;
- the very different impact of the low interest rate environment, and of its potential reversal, on different customer segments;
- the potentially diverse risk/return preferences of different customer segments, in the face of extremely low returns on low-risk assets;
- important variations in consumer priorities by age, with customers approaching retirement particularly vulnerable to some trends and firm behaviours.

Chapter B: The risks

We have categorised the risks in the RCRO into current issues, emerging risks and potential concerns.

1. Current issues

This section is an update on things we have focused on through 2010. They are issues that have already given rise to significant levels of consumer detriment. Some of these issues have crystallised because of, or been exacerbated by, the financial crisis – for example:

- unfair terms in mortgage contracts (Chapter B 2.2);
- treatment of mortgage customers in arrears (Chapter B 2.3); and
- sale and marketing of structured investments and deposits (Chapters B 2.5 and 2.6).

Other issues are longstanding, such as:

- complaints handling in major banks (Chapter B 2.1); and
- payment protection insurance (Chapter B 2.4).

2. Emerging risks

These issues tended to arise from either business model/behavioural change by firms, or product innovation, which has in many cases increased product complexity. On business models and behaviours, key risks are:

- the implementation of the Banking Conduct of Business Sourcebook/Payment Services Directive (Chapter B 3.1) – where we remain concerned at widespread disengagement with the regime;
- strategies in the run up to the introduction of the RDR (Chapter B 3.2) – where we are monitoring firms' behaviour, ensuring that revenue maximisation does not lead to consumer detriment;
- weaknesses identified in the network model for advisers (Chapter B 3.3) – where we have concerns over the level of control and oversight that networks exert over their advisers;
- using platforms (Chapter B 3.4) – where we are monitoring the development of a growing market; and
- firms' reward policies and practices (Chapter B 3.6) – where we are examining how firms control the risks that staff incentives may pose.

Emerging product risks include:

- Traded Life Policy Investments (Chapter B 3.9.1);
- Exchange Traded Funds and other exchange traded products (Chapter B 3.9.2) – where we discuss the growing complexity of these products;
- Self Invested Personal Pensions (SIPP) – where we highlight concerns over SIPP operator governance and issues for consumers (Chapter B 3.9.3); and
- Unregulated Collective Investment Schemes – where we discuss the findings of our thematic review and the key risks these products pose to consumers (Chapter B 3.10).

3. Potential concerns

Potential concerns are either risks that our supervisory work suggests are already present at an early stage of development, or risks that we might expect to develop given our assessment of how firms and consumers may respond to the environment. Key risks here include:

- Generating income through fees in banking (Chapter B 4.1), especially as it relates to:
  - developments in private banking and wealth management – which recent evidence suggests may be expanding;
  - protection products and possible PPI replacements – where we are monitoring the market to ensure new or substitutable products do not pose risks similar to PPI; and
  - packaged accounts – where we are keen to ensure consumers understand the benefits and costs of these products.
- Risks associated with bundling products (Chapter B 4.2) – where we discuss risks that may come to the attention of consumers (for example, in increased complexity).
- Risks associated with cross-selling (Chapter B 4.4) – where we discuss possible risks in mis-selling and product design.
- New business models that may emerge as a result of the RDR (Chapter B 4.5) – where we discuss how these may give rise to new risks.

Introduction

The Retail Conduct Risk Outlook (RCRO) plays a key role in informing our enhanced Consumer Protection Strategy. As we explained at its launch, that strategy seeks to achieve three goals:

- make the retail market work better for consumers;
- avoid the crystallisation of conduct risks that exceed our tolerance; and
- deliver credible deterrence and prompt and effective redress for consumers.

This section outlines how the strategy works and how the RCRO forms part of it.

The Consumer Protection Strategy

In March 2010, we launched our enhanced Consumer Protection Strategy.[1] This articulated a more proactive approach to regulating firms' conduct towards their retail customers.

The strategy requires us to make judgements on firms' decisions and actively intervene earlier in the product life cycle. It includes a greater willingness to test outcomes using methods such as mystery shopping and on-site visits. Over the last year, we have begun to implement this strategy, including through:

- a more intensive supervision of the conduct of large retail firms;
- an increased focus on product intervention, which we discussed in more detail in our Product Intervention Discussion Paper (published in January 2011[2]); and
- a greater use of the range of enforcement and other regulatory tools for dealing with poor conduct.

Another key part of the strategy is earlier identification of retail conduct risks. This requires an analysis of key market trends and of current and future possible responses from firms and consumers.

The RCRO presents our view of drivers of risk and where we are likely to see future issues arising. It is designed to inform a dialogue with regulated firms and consumers, to increase awareness of those risks in order to prevent them causing widespread detriment, and to inform our own supervisory focus.

1 Hector Sants, Chief Executive of the FSA outlined the FSA's new Consumer Protection Strategy in his speech at the annual Lubbock Lecture at Oxford University's Saïd Business School. See http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/044.shtml

2 DP11/1, *Product Intervention*, January 2011, FSA. www.fsa.gov.uk/pages/Library/Policy/DP/2011/11_01.shtml

Approach to retail conduct risk identification

Environmental factors are important in influencing the behaviour of both firms and consumers. Therefore, in Chapter A we set the scene for the rest of the RCRO by identifying key developments in the macroeconomic and regulatory environment faced by firms and consumers. We also outline how firms operating in different sectors (insurers, banks, asset managers, intermediaries) and consumers are likely to respond to these environmental changes.

Chapter B sets out our view of the key risks, drawing on the analysis of the environment and behaviours discussed in Chapter A. First we provide an update on current issues of poor conduct in firms that have resulted in consumer detriment. We then discuss where we see evidence of emerging misconduct from firms. Finally, we identify potential areas of risk that we believe may arise in future.

Scope of this document

This document is a discussion of risks arising from firms' conduct in their direct relationship with retail customers. Examples of such risks include firms selling financial products to consumers that are not suitable to their needs, or consumers not being treated fairly by firms. This document does not contain a discussion on wholesale conduct risks, i.e. risks that may arise because of firms' conduct in their relationship with other firms, or risks arising from financial crime.

Our analysis is also restricted to issues that are directly linked to our current statutory responsibilities. For example, we have not discussed risks for consumers arising directly from the macroenvironment (e.g. consumers' inability to afford their mortgages if the Bank Rate increases) or from the impact of competition on the market structure (e.g. the current structure not providing sufficient access to all the products and services consumers need). It also excludes risks of firms' unfair treatment of customers in the unsecured credit market, which is currently regulated by the Office of Fair Trading (OFT).

Links with other FSA publications

The RCRO is part of a suite of publications from the FSA, including the forthcoming Prudential Risk Outlook (PRO) and the Business Plan. The RCRO and PRO together replace the Financial Risk Outlook (FRO).

The analysis behind the RCRO and PRO helps to inform how we set our priorities and deploy our resources. Our Business Plan, which will be published in March, describes those priorities and the resulting resource requirements.

Equality and diversity

The public sector equality duty requires us to have regard to the need to promote equality of opportunity, to eliminate discrimination, harassment and victimisation and to foster good relations between people with characteristics protected by equalities legislation and other people. This document does not explicitly discuss the implications of the environment or the identified risks for minority groups with protected characteristics covered by the Equality Act 2010 (such as age, gender and disability). However, the public sector equality duty will be taken into account in considering what further policy, supervisory or enforcement action might be appropriate in this area, given the risks which we identify in this document and in our supervisory work.

Where next?

Through the RCRO we seek to identify possible risks to consumers earlier, and update firms and consumer groups on what we are doing about the issues already causing consumer detriment. We expect this document to inform our regular dialogue with consumer groups and firms and through this and our ongoing programme of work, we aim to see fewer risks resulting in detriment for consumers.

Chapter A – The environment

1. Introduction

In this section we cover the following:

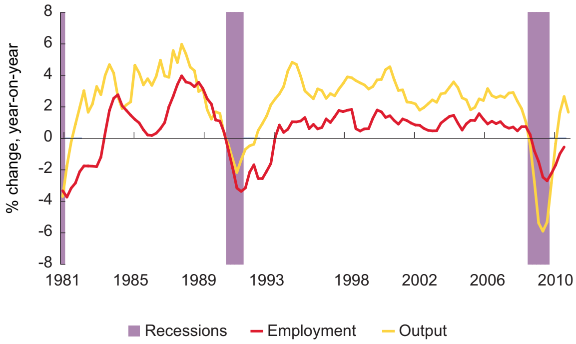
- The macroeconomic background and outlook for households – this section provides a brief summary on the UK economy, focusing on household income, expenditure, savings, investments and debt.
- Regulatory background and outlook – this section presents key UK and international regulatory interventions that are likely to have an impact on firms and their interaction with customers.
- Firms and the supply of financial products – this section discusses trends emerging in the supply of financial products by firms in different financial sectors (insurers, banks, asset managers, intermediaries) considering the current macroeconomic and regulatory context.
- Consumers and the demand for financial products – this section discusses the distribution of financial assets and wealth among different groups of consumers and how different segments may be affected by macroeconomic trends and firm behaviours. It considers the implications for the financial products and services consumers demand.

Environmental conditions and responses from firms and consumers are an important driver in determining where and how future retail conduct risks may arise. The analysis in this section therefore sets the scene for many of the retail conduct risks highlighted in Chapter B.

2. Macroeconomic background and outlook for households

Consumers and financial services firms face an uncertain macroeconomic environment. Many households remain vulnerable to further macroeconomic shocks, such as higher unemployment or interest rates. This section discusses the key macroeconomic trends that are most relevant to consumers. The forthcoming PRO will consider the wider macroeconomic environment and other trends relevant to prudential risk and financial stability.

Figure 1: Employment and output in latest and past recessions



Source: ONS
Note: Recession is defined as two or more successive quarters of contraction in GDP, ending when growth resumes.

2.1 The UK economy

In 2010, the UK economy returned to growth after experiencing its largest contraction in GDP since the Second World War. However, the economy shrank by 6.4% of GDP in 2008/9, and less than half of that fall has been recovered (Figure 1).

Employment did not fall as far as might have been expected, given the scale of the contraction and the pattern of previous recessions (Figure 1). The impact of lost national income was partly absorbed by labour market flexibility (such as cuts in hours and wage moderation).

However, the outlook for the UK economy remains uncertain. While GDP was higher in the third quarter of 2010 than market expectations, recent Office for National Statistics (ONS) estimates suggest that GDP decreased in the fourth quarter of 2010 and was flat, even after allowing for weather-related effects. Ongoing vulnerability remains in the corporate, household and public sector balance sheets. If demand does not recover as quickly as firms expect or hope, postponed job cuts may yet materialise.

2.2 The household sector

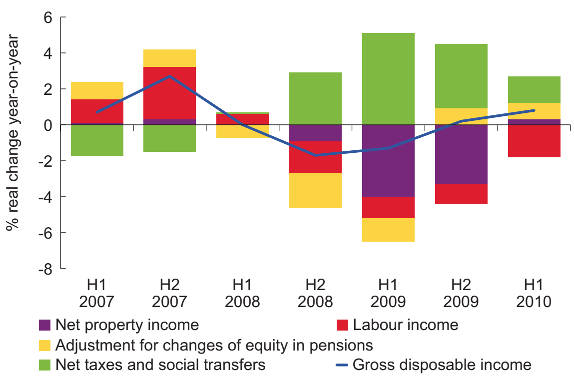
Understanding the key trends in the household sector at an aggregate level is an important first step in identifying the financial pressures faced by consumers at a more 'micro' level. This section discusses some of these key household trends and the outlook for the sector. The section on consumers later in this chapter identifies the implications of these overall trends for different customer segments.

2.2.1 Income, expenditure and savings

In real terms (i.e. adjusted for inflation), household income[3] fell slightly during the recession, as a result of offsetting factors that affected different customer segments in different ways (Figure 2).

3 Household income in this section refers to total available household resources. This is defined by the Office of National Statistics as disposable income after the effect of net fiscal transfers and taxes and net property income (i.e. interest, dividends and rents). Looking forward, pressures on variable household revenues are likely to intensify as rising VAT and commodity prices increase consumer price inflation.

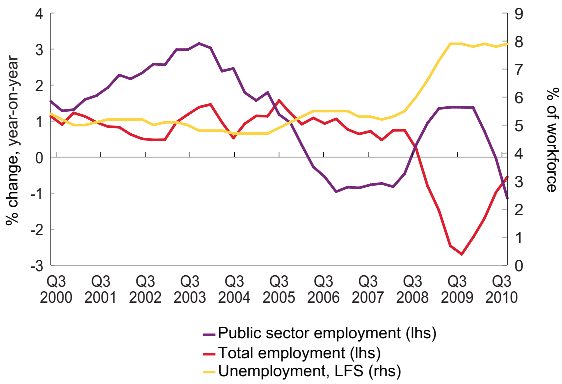
Figure 2: Real household income growth



% real change	H1 2007	H2 2007	H1 2008	H2 2008	H1 2009	H2 2009	H1 2010
Gross disposable income	0.7%	2.7%	0.0%	-1.7%	-1.3%	0.2%	0.8%
Net property income	0.1%	0.3%	0.0%	-0.9%	-4.0%	-3.3%	0.3%
Labour income	1.3%	2.9%	0.6%	-1.8%	-1.2%	-1.1%	-1.8%
Net taxes and social transfers	-1.7%	-1.5%	0.1%	2.9%	5.1%	3.6%	1.5%
Adjustment for changes of equity in pensions	1.0%	1.0%	-0.7%	-1.9%	-1.3%	0.9%	0.9%

Source: ONS

Figure 3: Public sector job creation



Source: ONS
Note: Employment measured by number of jobs; unemployment is people actively seeking work as a share of total workforce

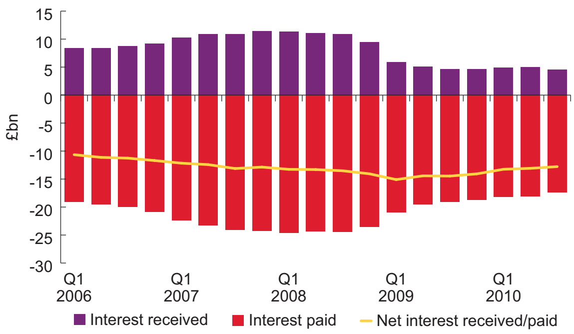
Real labour income (the largest part of household income) fell through the recession, but less so than might have been expected, as a result of a relatively small rise in unemployment compared to the experience of previous recessions. The labour market instead partly adapted to the fall in output by adjusting worker-hours, moderating wages and through increased labour force inactivity. Private sector job losses that ocurred immediately after the start of the financial crisis were also to some extent replaced by new jobs in the public sector (Figure 3). This support largely disappeared in 2010.

The impact of this fall in labour income on net household income was offset until 2010 by a positive contribution from net taxes and social transfers (Figure 2).

Overall, net property income (including net interest, dividend and rent income received by households) declined (Figure 2) because of a number of factors, including falls, more recently reversed, in equity values. Within this overall negative trend, however, there is an important diversity of experiences among households. For example:

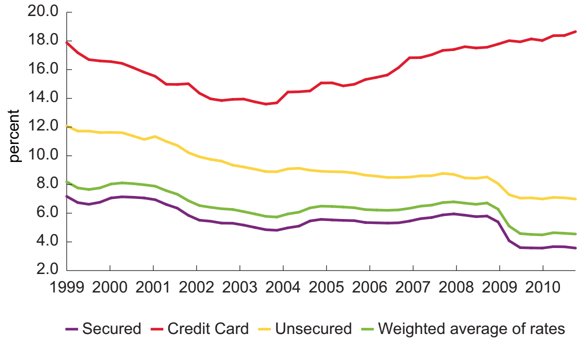
- The very significant fall in interest income (Figure 4) has cut the disposable income of households with significant net positive cash positions (deposits minus loans), in particular in older age groups.

Figure 4: Net interest received



Source: Bank of England
Note: Figures are unadjusted for FISIM (Financial Intermediation Services Indirectly Measured), an indirect measure of the value of financial intermediation services provided but for which financial institutions do not charge explicitly.

Figure 5: Household interest rates by debt type



Source: Bank of England

- The very significant fall in interest expense (Figure 4) has in general benefited mortgage borrowers, but with very significant diversity of experience between different borrower groups. For example:
  - credit card borrowers in general have suffered from increasing interest rates, while mortgage borrowers have gained from a fall in secured rates (Figure 5); and
  - within mortgage borrowers, major differences exist according to the type of mortgage contract held (see section 4.1 for the impact of these on specific firms, and 5.2 for the impact on specific customers).

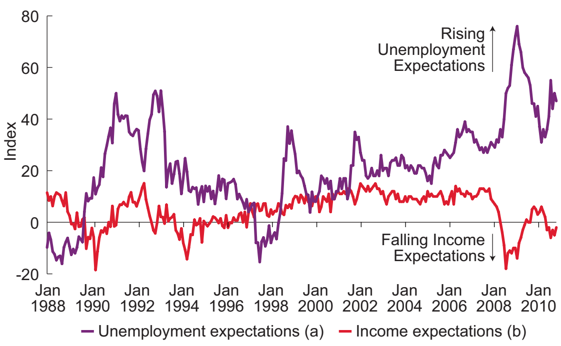
Looking ahead, the impact of fiscal consolidation means that the overall trend in real household income may become less favourable, while the diversity between different groups will continue to exist. As a result, pressures on particular segments may become severe.

The government announced its Emergency Budget in June 2010, with a primary focus on reducing the budget deficit through both expenditure reductions and tax rises. In October, the Comprehensive Spending Review (CSR) set out the public expenditure plan. The CSR presented £81bn of total spending cuts to 2014. The Office of Budget Responsibility expects a fall in general government employment of just over 400,000 between 2010/11 and 2015/16, more than offset by a rise in market sector employment of around 1.5 million. A crucial question going forward will be how these offsetting forces play out in the economy.

A crucial determinant of the pattern of financial services demand is how consumers choose to allocate their income between consumption and saving. The saving rate has increased significantly since before the crisis. Three phases of development, driven by changes in consumer expectations and confidence, can be seen:

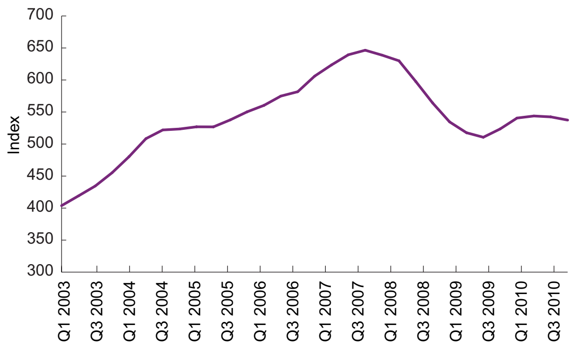
1. Households' expectations of earnings plunged between 2008 and early 2009 (Figure 6) with increasing unemployment expectations (Figure 6), falling house prices (Figure 7) and falling consumer confidence (Figure 8). As a result, households' consumption fell and the savings ratio rose dramatically from the very low levels experienced before the crisis (Figure 9). Increased savings were used to accumulate financial assets and, to a lesser degree, to pay down debt.

Figure 6: Survey measures of income and unemployment expectations



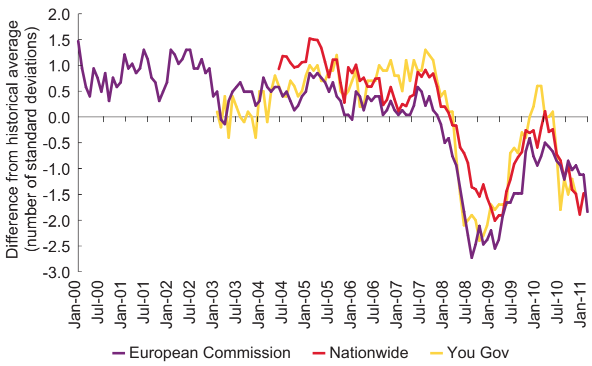
Source: Research carried out by GfK NOP on behalf of the European Commission
Note: (a) The question asks how households expect unemployment to change over the next twelve months. (b) The question asks how households expect their personal financial situation to change over the next twelve months.

Figure 7: Halifax house price index



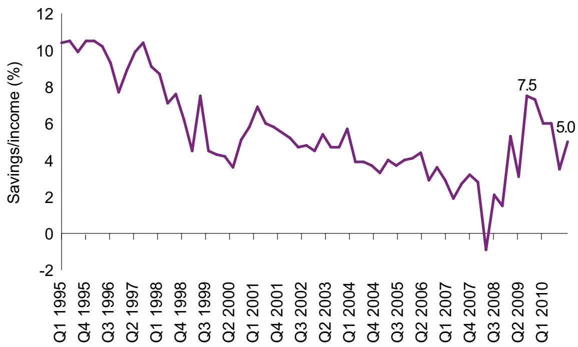
Source: Halifax
Note: Index 1983=100. Seasonally adjusted.

Figure 8: Indicators of consumer confidence



Source: Research carried out by GfK NOP on behalf of the European Commission, Nationwide, You Gov

Figure 9: UK household savings ratio



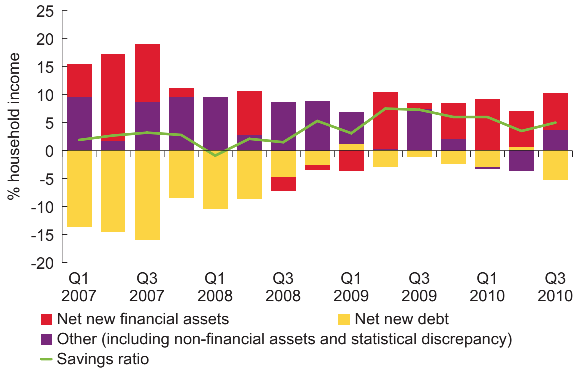
Source: ONS

2. In 2009 and early 2010 there was a partial reversal of these trends. The recession proved less severe than originally feared, as unemployment had increased less than expected. Property prices stabilised (Figure 7) and in some regions rose. As consumer confidence recovered (Figure 8), and unemployment expectations fell (Figure 6), the household savings ratio fell back again after peaking in mid-2009 (Figure 9).

3. However, as we progressed into 2010, these trends reversed again. Households have again become more pessimistic about their finances and the general economic outlook (Figures 6 and 8). Consumers seem to expect little improvement in their financial situation over the coming 12 months and unemployment expectations have risen sharply in recent months (Figure 6). Possibly as a result of this, more recent data suggests the savings ratio starting to pick up again in the second half of 2010 (Figure 9). The latest figures on consumer confidence (from GfK NOP for the European Commission) may presage an intensification of these developments.

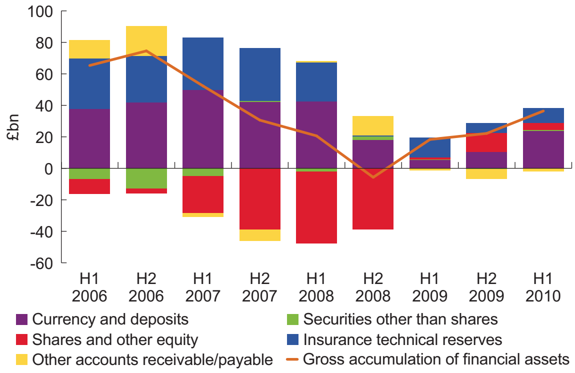
Several factors may affect the future evolution of household savings. If the recovery regains momentum, uncertainty recedes, and equity and property prices perform well, the household saving rate could fall further. However, as long as the current uncertainty continues, the

Figure 10: Net lending/borrowing as % of income



Source: ONS

Figure 11: Accumulation of financial assets



Source: ONS

savings ratio is likely to remain at current levels or rise further. Some households may increase their saving to reduce their indebtedness and make adequate provision for their retirement.

2.2.2 Household accumulation of financial assets

Over 2008/9, the rise in the savings ratio resulted in both a much reduced pace of new borrowing, with total household debt roughly static, and a significant flow of money into increased financial assets (Figure 10).

However, despite the uncertainty in the economy over the period, these savings were not entirely channelled into deposits (Figure 11). Following a period of financial assets disinvestment in 2007 and 2008, households started to increase their money flows into equity and pension funds in 2009, suggesting that the low interest rate environment may have encouraged search for yield by some households.

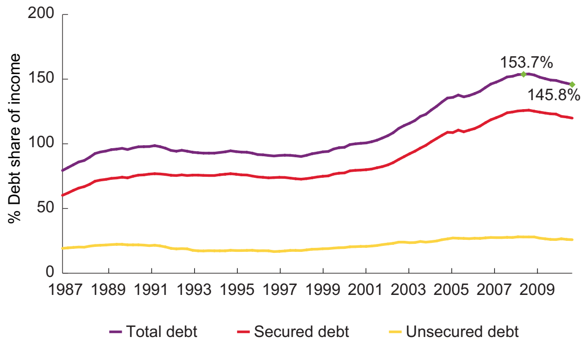
Latest data suggests a much more substantial deposit growth in the first half of 2010 (Figure 11). This may reflect a deterioration in stock market performance in the mid part of 2010 and competition for new deposit business by banks to meet new liquidity standards and to repay the Treasury and Bank of England's liquidity support schemes.

Search for yield on one hand, and for capital protection on the other, have been two crucial drivers of households' decisions on investment. This desire for potentially incompatible objectives may continue for some time. The later sections on Firms and Consumers explore how this search has translated in terms of supply and demand of investment products.

2.2.3 Household debt

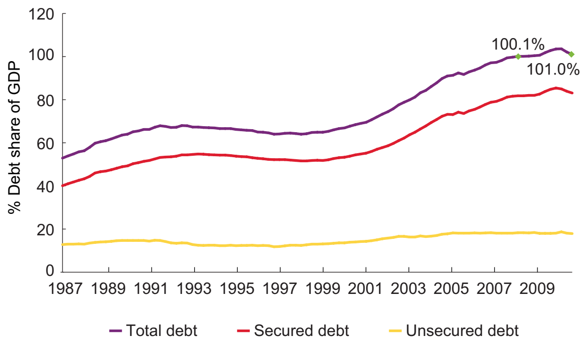
Household income leverage, whether measured by total debt to GDP or by debt to post-tax household income ratio (Figure 12) increased dramatically in the eight years running up to the financial crisis. Some deleveraging from these high levels is desirable since it would result in reduced risk, both for the macro economy and for individual consumers. But the pace at which deleveraging occurs and the precise way in which it is achieved, has a significant influence on the risks that will arise during the transition. Here we consider the pace of household sector deleverage and the consumer borrowing trends that are driving it.

Figure 12: Household debt as a share of post-tax income and GDP



	Changes	
	Q4 1990 to Q1 1993	Q2 2008 to Q3 2010
Nominal stock of debt	12.1%	1.3%
>> Secured debt	16.8%	1.9%
>> Unsecured debt	-4.5%	-1.5%
Nominal household disposable income (4-quarter average)	17.2%	6.8%
Debt as a share of household disposable income	-4.3% (from 97.8% to 93.5%)	-8.0% (from 153.7% to 145.8%)
>> Secured debt as a share of household disposable income	-0.2% (from 76.0% to 75.8%)	-5.8% (from 125.7% to 119.9%)
>> Unsecured debt as a share of household disposable income	-4.0% (from 21.7% to 17.7%)	-2.2% (from 28.0% to 25.9%)

Source: ONS



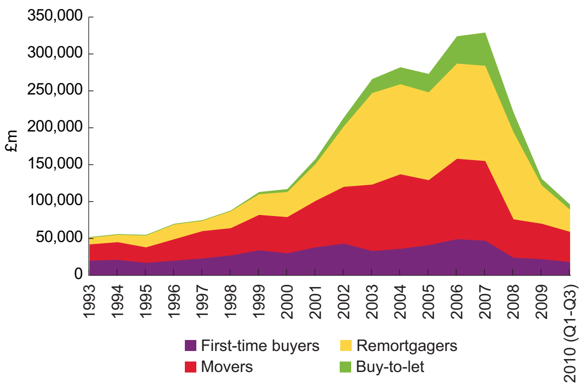
	Changes	
	Q4 1990 to Q1 1993	Q2 2008 to Q3 2010
Nominal stock of debt	12.1%	1.3%
Nominal GDP (4-quarter average)	10.2%	0.3%
Debt as a share of GDP	1.1% (from 66.2% to 67.3%)	0.9% (from 100.1% to 101.0%)

Source: ONS

New mortgage lending collapsed between 2007 and 2008 (Figure 13). This partly reflected the dramatic reduction in remortgaging activity, which had grown to account for a large share of the pre-crisis market (Figure 13). But loans for house purchase (whether by first-time buyers or by home movers) also collapsed (Figure 13), and net lending (the increase in the net stock of debt), which had been running at £5,000m to £10,000m per month pre-crisis, fell to and has remained at a minimal level (Figure 14). An important but difficult to answer question is, what is the balance between supply and demand factors in explaining these trends?

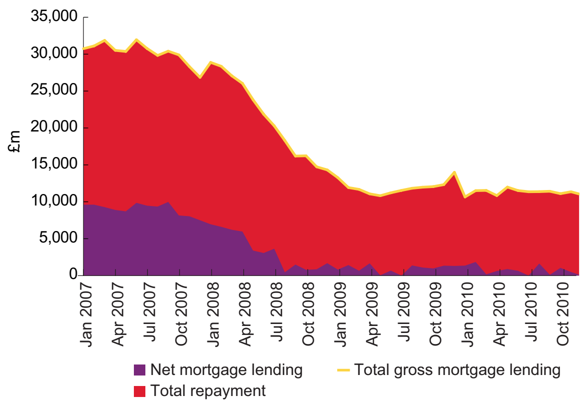
- In the initial collapse (2007 to 2009) supply factors were clearly significant, with credit-lending criteria tightening rapidly. The availability of high loan-to-value (LTV) mortgages was dramatically restricted (Figure 15) and the percentage of loans made at LTVs above 80% fell from approximately 35% to 20% (Figure 16). Even in this initial period, however, demand factors were likely also important, as the falls in consumer confidence (Figures 6 and 8) drove an increase in the savings rate.
- After 2009, indications of supply availability suggest significant easing, with strongly competitive mortgage supply in particular available up to 85% LTV (Figure 15). High loan-to-income (LTI) ratio loans now account for as high a share of the market as in the pre-crisis peak (Figure 17).
- After some signs of market recovery in 2009 to the first half of 2010, demand slowed down in late 2010, perhaps reflecting the expectations and consumer caution highlighted in Section 2.2.1 above.

Figure 13: Value of gross mortgage lending by type of loan



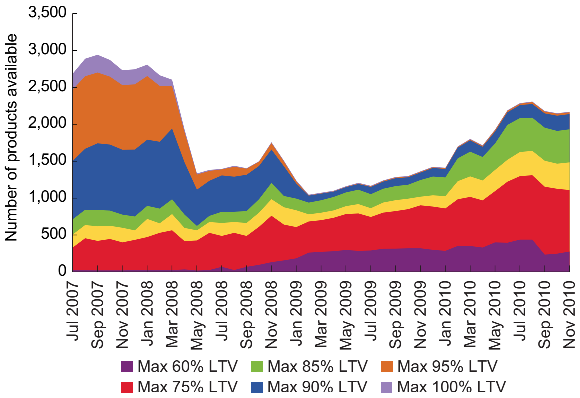
Source: CML

Figure 14: Net and gross mortgage lending



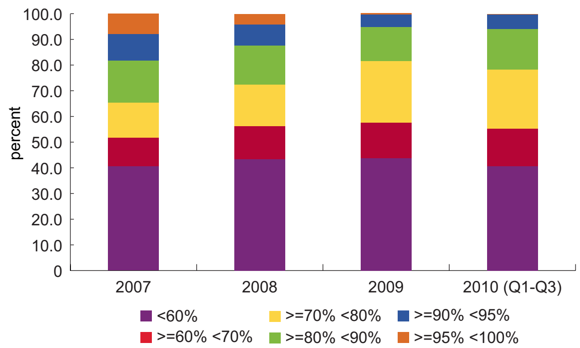
Source: Bank of England

Figure 15: Number of PRIME residential mortgage products available, by LTV



Source: Moneyfacts

Figure 16: LTV bands – all regulated mortgages



Source: FSA Mortgages PSD
Note: Data excludes lifetime mortgages and business loans

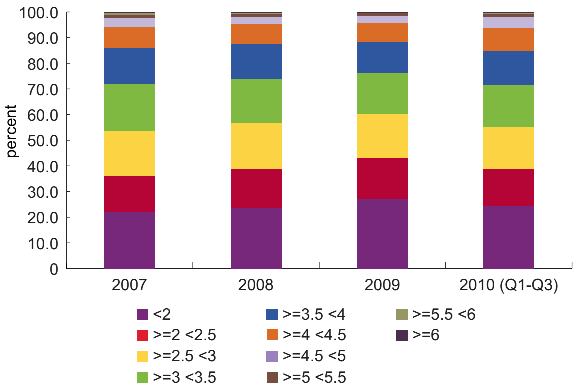
The net effect of the resulting trend in mortgage debt, combined with the development of nominal GDP and household income, has been a process of gradual deleveraging. However, this deleveraging has not been primarily driven by conscious decisions to pay down mortgage debt, as regular and lump sum repayments have not risen significantly (Figure 18).

This limited role for debt repayment may reflect the fact that the households best able to repay debt are also likely to be those with the lowest mortgage interest rates and, therefore, with the least incentive to devote available financial saving to reducing debt. Instead, deleveraging has resulted primarily from a combination of a slightly increasing debt stock, with more rapid increases in nominal household income.

As important as these overall trends in mortgage debt, however, is the fact that developments in interest rates have resulted in highly diverse effects on different firms and customers. This diversity is discussed in Sections 4.1 and 5.2.

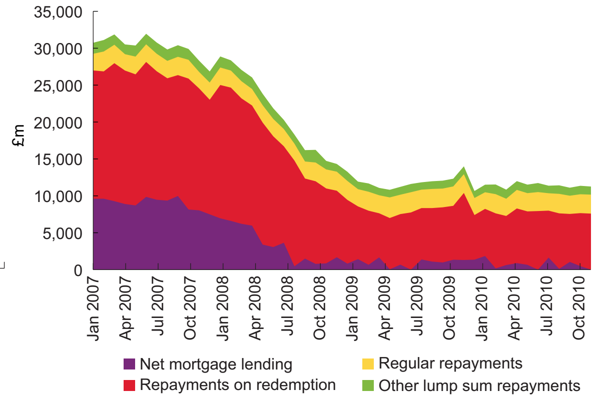
Developments in arrears and repossessions are also key determinants of consumer welfare, with important implications for conduct risk. The overall experience in this recession has been far more favourable than in the early 90s, but with important regional and customer segment variations.

Figure 17: LTI bands – all regulated mortgages



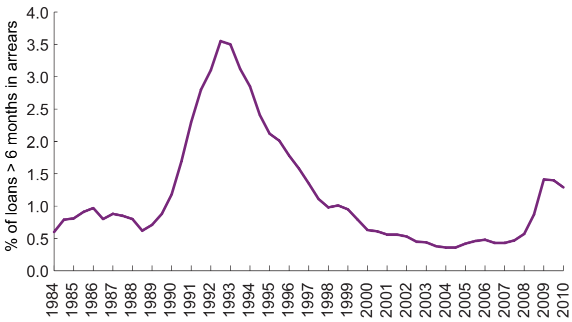
Source: FSA Mortgages PSD
Note: Data excludes lifetime mortgages and business loans.

Figure 18: Repayments of gross mortgage lending



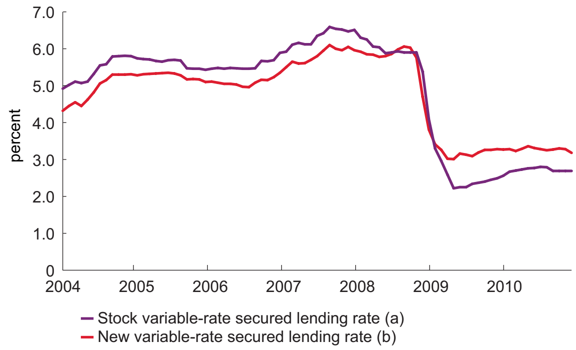
Source: Bank of England
Note: The fall in repayments on redemption reflects the fall in remortgaging activity: falling redemptions linked to reducing remortgaging have no impact on the stock of debt outstanding.

Figure 19: Arrears on mortgages



Source: CML

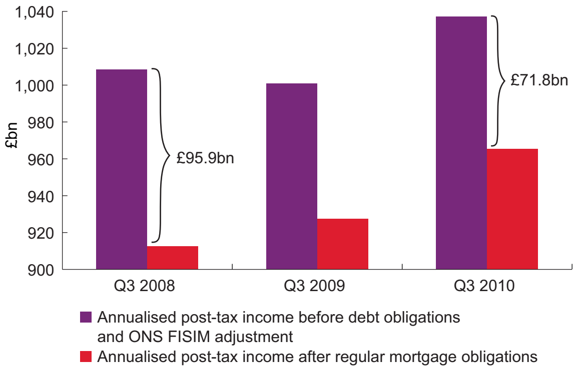
Figure 20: Lending rates to households



Source: Bank of England
Note: (a) The stock lending rate is the effective secured lending rate prevailing on all loans on lenders' balance sheets. (b) The new lending rate is the effective secured lending rate prevailing on new lending each month.

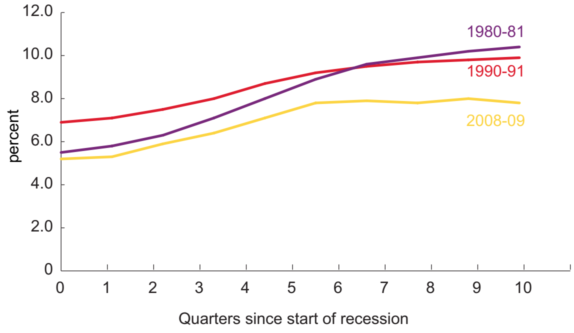
- Mortgage arrears increased sharply between 2007 and 2009 but peaked in mid-2009 at rates less then half those faced in the early 1990s (Figure 19). This reflects two factors:
  - First, the low level of interest rates, as average mortgage rates, for both existing and new borrowers, have fallen significantly (Figure 20). As a result, consumers have enjoyed the benefit of a £20bn reduction in mortgage payments (Figure 21).
  - Second, unemployment so far has increased far less in this recession than in the early 1990s (Figure 22).
- Within this overall favourable picture, however, there are important customer segment variations. Mortgage arrears are significantly higher in particular regions (Figure 23). There is also a tail of poor quality pre-crisis lending, with self-certification of income sometimes used to stretch apparent mortgage affordability, and arrears higher among credit-hungry customer segments able to gain credit through specialist lenders, even with impaired credit history (Figure 24). High arrears and default rates have also been experienced in Buy-to-Let portfolios (Figure 25).

Figure 21: Annualised cash benefit to mortgage-paying household to lower interest rates



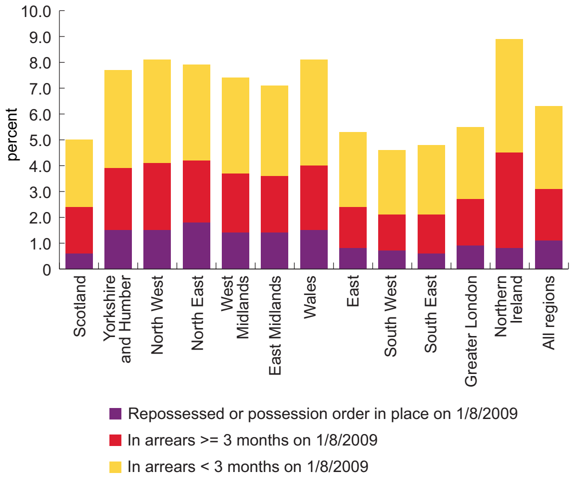
Source: ONS

Figure 22: Unemployment rate: previous and current recessions



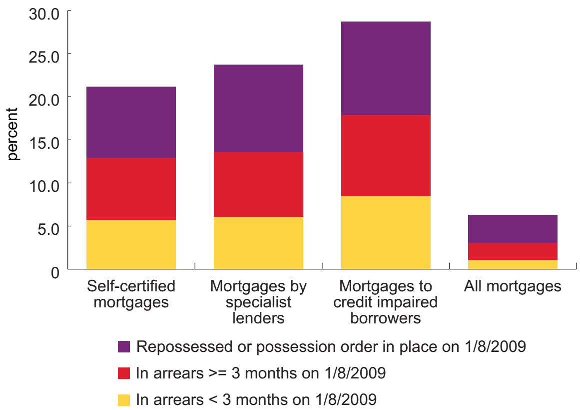
Source: ONS
Note: (1) Quarter 0 refers to: Q4 1979 for the 1980s; Q2 1990 for the 1990s; Q1 2008 for the 2000s. (2) Unemployment is all unemployment aged 16 and over.

Figure 23: Performance of mortgages sold between April 2005 and March 2009, by region (measured on 1 August 2009)



Source: FSA Mortgages PSD and Arrears dataset

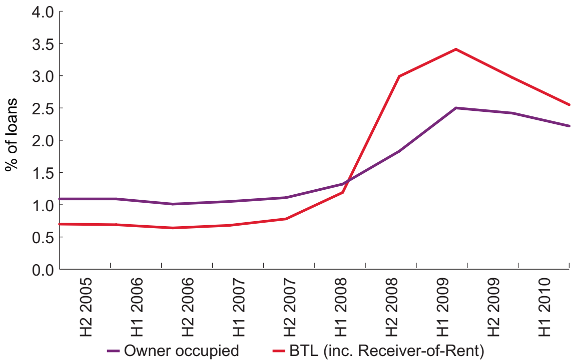
Figure 24: Performance of mortgages sold between April 2005 and March 2009, by type (measured on 1 August 2009)



Source: FSA Mortgages PSD and Arrears dataset

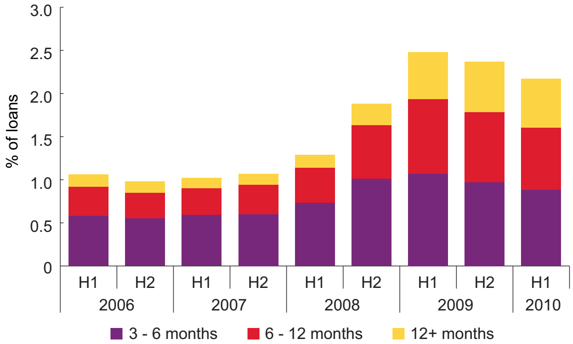
- There is also a danger that the scale of the potential arrears problem among this tail of distressed borrowers is being somewhat masked by the extensive use of forbearance strategies, which can appear attractive to both borrowers and lenders when interest rates are very low. Longer lasting arrears cases (e.g. greater than six months) are continuing to grow as a percentage of total arrears (Figure 26), and lenders have been capitalising interest arrears at an increasingly rapid rate (Figure 27). The use of such forbearance strategies is not so widespread as to contradict the conclusion that the recent experience is far more favourable than in the early 1990s, but it does highlight the vulnerability of specific customer segments.
- This vulnerability could become somewhat widespread if either unemployment or interest rates rise in the near future.

Figure 25: Residential Buy-to-Let (including receiver of rent cases) 3 month + arrears



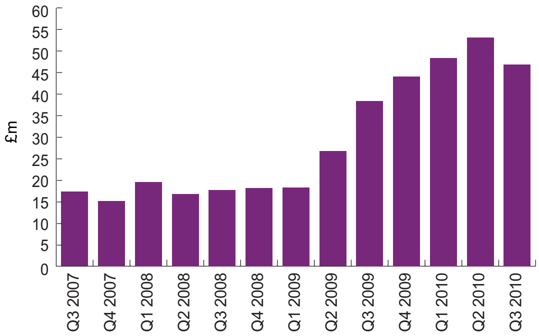
Source: CML

Figure 26: Mortgage arrears by length of delinquency



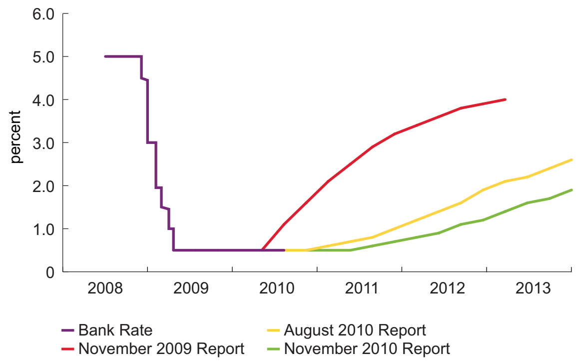
Source: CML

Figure 27: Arrears amount capitalised



Source: FSA MLAR

Figure 28: Market expectations on the Bank Rate



Source: Bank of England, Bloomberg
Note: Data from the November 2010 Inflation Report. The November 2009, August 2010 and November 2010 curves are estimated using overnight index swap (OIS) rates in the fifteen working days to 4 November 2009, 4 August 2010 and 3 November 2010 respectively. The recently published February 2011 Inflation Report suggests market participants' interest rate expectations for the next three years, implied by OIS rates, were higher in the fifteen working days to 9 February than at the time of the November Report.

2.3 Potential impact of very low interest rate environment

Interest rates have fallen in the last two years to extremely low levels. Market expectations on the Bank Rate have fallen steadily over the last year (Figure 28), although more recent data suggests this trend may have now reversed.

While continued low interest rates will keep household debt burdens manageable, and limit growth in arrears, this could generate two new risks:

- On the liabilities side, households may be more inclined to take on more interest rate risk (e.g. through variable rate borrowing) and to take on mortgages at high initial LTIs (Figure 17). In addition, the necessary process of household balance sheet adjustment may be postponed. So households will therefore remain vulnerable to income shocks from unemployment and to interest rate rises from today's extremely low levels.
- On the assets side, however, consumers may be attracted to higher returns but also higher risk assets.

Section 5 discusses how these overall issues will affect different customer segments in different ways.

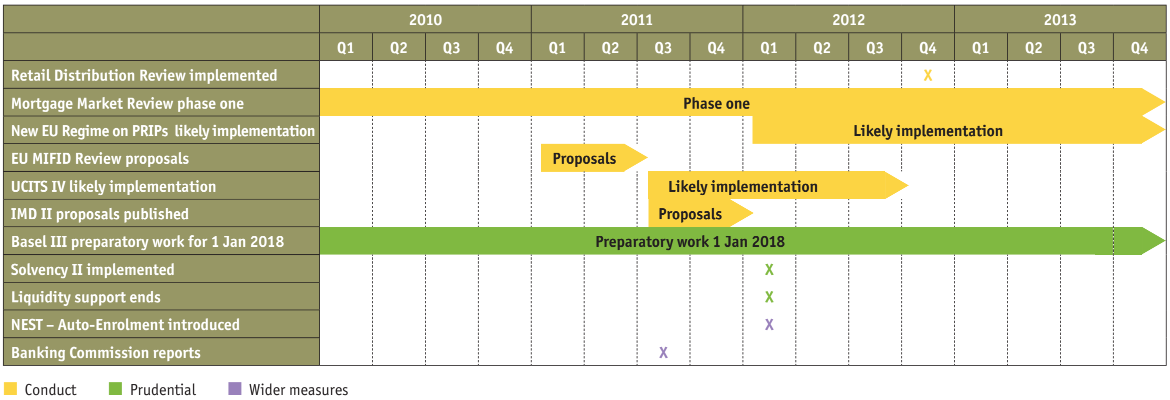
3. Regulatory background and outlook

New financial services regulation has been initiated, both as a result of the financial crisis and to address longer-standing issues.

Some regulatory changes affect a broad part of the financial services industry, while others target specific segments. Many of these initiatives may have a profound impact on how regulated firms structure their business and the way they interact with consumers. In some sectors (for example, life insurance) a number of different regulatory initiatives will intersect, causing complex interactions and impacts.

Below we summarise some of the main developments. The set of issues considered is not exhaustive. For example, some initiatives that are at an early stage of development or that only affect a relatively smaller segment of the market are not discussed.

Figure 29: Timescale of various regulatory initiatives



In Sections 4 and 5 we analyse the impact these initiatives are likely to have on consumers and firms' behaviour. We categorise these initiatives under three headings:

- those explicitly developed to address consumer protection issues;
- developments in prudential regulations that may have consumer protection side effects; and
- wider policy initiatives, with implications for the financial services industry.

3.1 Measures aimed at consumer protection

In retail investments, our rules for implementing our **Retail Distribution Review** (**RDR**) will come into effect at the end of 2012. Our proposals aim to ensure that:

- consumers are offered a transparent and fair charging system for the advice they receive;
- consumers are clear about the service they receive;
- consumers receive advice from highly respected professionals; and
- advisory firms are more stable than now, and better able to meet their liabilities.

The new rules will apply to all advice given for such products and services, regardless of the type of firm for whom any individual adviser works – so advisers within banks, asset managers, life insurers, sole traders, partnerships, stockbrokers, networks, IFAs or financial advice firms will be subject to the same regulatory environment.

The RDR is a key part of our Consumer Protection Strategy. It is an example of intervention, which aims to address problems across an entire market where previous, more piecemeal approaches had not been effective. Rule-making in this area will be supported by our intensive supervision of firms and by the work of the Consumer Financial Education Body (CFEB) to improve consumers' financial capability.

The **Mortgage Market Review (MMR)** responds to the causes of poor consumer outcomes in mortgage borrowing. It aims to foster a mortgage market that is sustainable for all participants, across the economic cycle. In October 2009, we published our MMR Discussion Paper, where we identified several failings in market practice and regulation and set out the case for regulatory reform of the mortgage market.

Since then we have taken specific steps to address pressing issues and consulted on longer term and more fundamental reforms.

- **Pressing issues –** We have already strengthened our rules relating to arrears handling, and have extended, from 2012/13, our approved persons regime to anyone who advises on or sells mortgages.
- **Longer-term reforms –** We have published Consultation Papers[4] setting out possible policy initiatives to address problems created before the crisis by the extension of unaffordable mortgage credit. The aim of the proposals is to protect customers by cutting off the tail of clearly poor lending, without unnecessarily restricting borrowers' ability to make significant but affordable contracts. Key elements in the proposals are requirements that lenders verify income in all cases, and take responsibility for robustly assessing affordability for each borrower.

The crucial issue now is to decide how to strike the right balance between consumer protection, customer choice and innovation in this area. Over the coming months we will be conducting analysis to inform proposals on where the cut-off point in assessments of 'affordability' should ideally lie. We will publish detailed analysis of the consequences of different calculations along with our final proposals later this year, taking into account the feedback we have received.

In addition, the European Commission (the Commission) continues to examine possible policy options for European **interventions in mortgage credit markets**, following its 2007 white paper on the integration of EU Mortgage Credit Markets, the 2009 public consultation on responsible lending, extensive consultative work and various studies on a range of mortgage topics. We are supporting the Commission's work in this area and, along with the Treasury, we are aiming to ensure an appropriate outcome is achieved.

A new EU regime for **packaged retail investment products (PRIPs)**, which is expected to have complementary elements to the RDR, is likely to be implemented in 2012 or 2013. We are participating actively in the development of the PRIPs proposals. The aim is to harmonise the consumer protection standards that apply to substitutable retail investment products that are sold by different parts of the financial services industry, e.g. life assurers and fund managers.

4 CP10/16, *Mortgage Market Review – Responsible Lending*, July 2010, FSA. www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_16.shtml

A number of other regulations are also planned in retail investment business. For example, at European level, **UCITS IV** – the latest version of the UCITS regulations, which led to the creation of a particular class of collective investment scheme targeted at retail investors – will come into force between July 2011 and July 2012. The new rules will make a number of technical changes, including making it easier for UCITS funds to merge and to be sold across EU borders. They will also replace simplified prospectuses with a key information document (KID).

The Commission is also considering the possible introduction of legislation on **tying and other potentially unfair commercial practices** in the retail financial services sector. This follows previous work undertaken by the Commission as part of a sector inquiry into retail banking, which identified tying as a major barrier to the integration of EU retail financial services markets.

The Commission is currently reviewing the **Markets in Financial Instruments Directive (MiFID)** and is expected to propose changes to the Directive in the first half of 2011.

Finally, the Commission is reviewing the **Insurance Mediation Directive (IMD)** with the aim of issuing a legislative proposal (IMD2) in late 2011 consisting of a revision of the existing provisions of the IMD (with a possible extension to direct sales) and the inclusion of rules for PRIPs selling practices.

We have also recently published a **Discussion Paper on product intervention.**[5] This describes some of the options open to us to develop a key component of our Consumer Protection Strategy (described in the introduction), i.e. 'greater scrutiny of products and their governance'. Where in the past our consumer protection work focused on the point of sale and the payment of redress after detriment has occurred, the Discussion Paper describes how we will now seek to intervene earlier in the product value chain, proactively, to anticipate consumer detriment where possible and stop it before it occurs. We are considering a range of product interventions that might be adopted in the future if significant risks to consumers emerge from particular products. The Discussion Paper is a preliminary document setting out possible options to be considered in more detail in later documents.

3.2 Prudential measures with possible side effects on conduct

The RCRO is focused on how firms treat their retail customers. Prudential measures can affect the behaviour of firms in a way that may indirectly have an impact on outcomes for customers.

Here we discuss prudential initiatives that may have such indirect effects.

The **Basel III Framework**, published on December 16th, covers both significant microprudential and macroprudential reforms for internationally active banks. The Framework sets out:

- higher and better-quality capital;
- better risk coverage;
- the introduction of a leverage ratio as a backstop to the risk-based requirement;
- measures to promote the build up of capital that can be drawn down in periods of stress; and
- the introduction of two global liquidity standards.

5 DP11/1, *Product Intervention*, FSA, January 2011. www.fsa.gov.uk/pages/Library/Policy/DP/2011/11_01.shtml

The standards will be phased in gradually so that the banking sector can move to the higher capital and liquidity standards while supporting lending to the economy.[6] It is expected that the European Commission will propose legislation through further amendments to the Capital Requirements Directive (CRD IV package) during 2011, which will implement Basel III in the EU for a wide range of institutions (i.e. banks, building societies and certain investment firms).

Following the market crisis, we began a major **review of liquidity policy**. The far-reaching overhaul culminated in a Policy Statement[7] that set out our rules on the liquidity requirements expected of firms. The new rules represent a fundamental change to our approach and will significantly tighten our required standards for liquidity risk management and resilience to stresses. It also reinforces our intensive supervisory agenda and will subsequently have an impact on the deployment of our supervisory resources. The development of an enhanced prudential framework for firms and their improved ability to monitor their liquidity risk will reduce the risk of failure. This will enhance consumer protection and build confidence in the financial system.

The Bank of England's **Special Liquidity Scheme** was introduced in April 2008 to improve banks' liquidity positions by allowing them to exchange high-quality but illiquid asset-backed securities and other assets for very liquid UK government debt. This scheme is currently scheduled to end in early 2012. By then, banks will have to raise liquidity without official support.

In insurance, **Solvency II** will fundamentally reform the risk management and capital adequacy rules for the European insurance industry. It aims to establish an enhanced, more risk sensitive set of EU-wide capital requirements, require robust risk management standards, and provide a consistent measurement of assets and liabilities. The new regime is expected to be operational from 1 January 2013. The Level 1 Directive states that the new regime will begin on 1 November 2012, but we expect the Commission's forthcoming proposals for the Omnibus II Directive to include a revised implementation date of 1 January 2013.

These changes in prudential regulation could have consequences for firms' behaviour that have consumer protection implications. These are considered in Section 4 of this chapter.

3.3 Other wider measures

Two wider policy initiatives may also have an indirect impact on how firms will engage with their customers.

The workplace pension reforms that will be introduced from 2012 will require all employers to automatically enrol their eligible employees into a pension and contribute to it. The government is also creating the **National Employment Savings Trust** (**NEST**), a multi-employer occupational pension scheme that employers can use to meet the automatic enrolment obligation. NEST is designed to be a low-cost pension scheme and is targeted at people on low to moderate incomes.

In addition, the **Independent Commission on Banking**, led by Sir John Vickers, may propose structural measures as part of its report into how risk can be reduced and competition increased in banking. The Commission will produce a final report by the end of September 2011.

---

6 http://www.bis.org/press/p101216.htm

7 PS09/16, *Strengthening liquidity standards including feedback on CP08/22, CP09/13, CP09/14*, October 2009, FSA. www.fsa.gov.uk/pages/Library/Policy/Policy/2009/09_16.shtml

4. Firms and the supply of financial products

Here we consider key trends emerging in the supply of financial products by firms for each sector. Some of them derive from the macroeconomic environment, while others reflect longer-term drivers, e.g. longevity trends. We then discuss how different consumers segments will be affected in different ways by the overall macro trends and by changes in firm behaviour.

In particular, the following section looks at key trends in the banking and mortgages, asset management, insurance and retail intermediaries sectors. It also assesses firms' responses to the macroeconomic and regulatory changes described in the previous sections. It is not a broad-based description of the market, but focuses on market developments that may give rise to new risks or change existing ones. The risks are then further described in Chapter B.

4.1 Retail banking and building societies

UK banks have significantly improved their capital ratios in response to the crisis. Stress testing and recapitalisation exercises carried out by the Tripartite Authorities have contributed to these improvements and to greater confidence in the UK banking sector. Nevertheless, some of the fundamentals of retail banking (deposits, savings, secured and unsecured lending) remain challenging.

Wholesale funding conditions started to improve during the course of 2010 compared to the previous year, but funding challenges are still a major influence on firm behaviour. Current challenges include:

- the need for banks and building societies that have accessed the Bank of England's Special Liquidity Scheme or the government's Credit Guarantee Scheme to repay by 2012 to early 2013;
- the relatively high cost (compared to pre-crisis levels) of wholesale funding; and
- the current high level of competition for retail funding.

Firms responded to these challenges in various ways, including: re-pricing products such as unsecured loans and mortgages, where possible; aggressively competing for retail deposits; cutting costs; improving efficiencies; and increasing their focus on alternative sources of income, particularly fee-generating products.

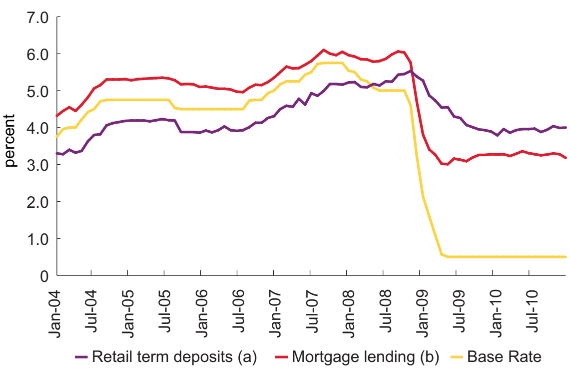
4.1.1 Mortgage lending

There have been key developments in the volume of mortgage market lending, with the rapid growth of the pre-crisis period replaced by much lower sales volumes, and with new gross mortgage lending only marginally exceeding repayments (see Section 2.2.3).

As important as this change in market size, have been very significant changes in the structure of bank and building society margins, on both the lending and deposit-taking side. These changes, however, have very different effects on different firms, depending on the mix of precise terms in their existing mortgage books (the equally significant heterogeneity arising among customers as well as firms is described in Section 5.2).

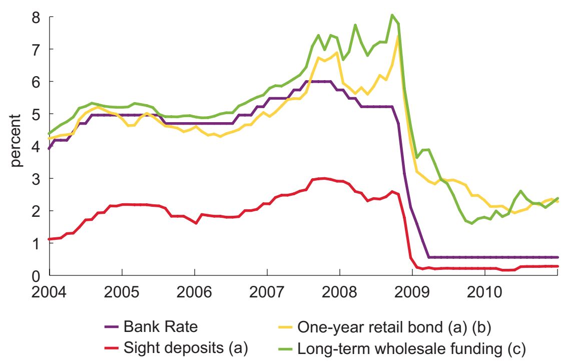
The dramatic fall in the base rate has produced a major dislocation in the traditional relativity of funding and lending rates. The essence of what has happened is clear from Figure 30.

Figure 30: Changes in interest rate relativities



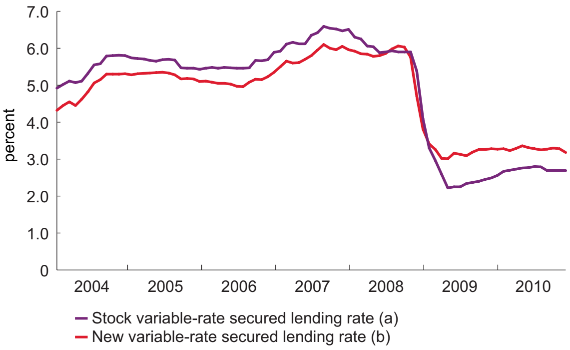
Source: Bank of England
Note: (a) The retail term deposit rate is the rate of return on interest bearing bank (excluding mutuals) time deposits by the household sector. The same rate is also shown in Figure 35. (b) The mortgage lending rate is the new variable-rate secured lending rate. The same rate is also shown in Figure 20.

Figure 31: Cost of different funding instruments



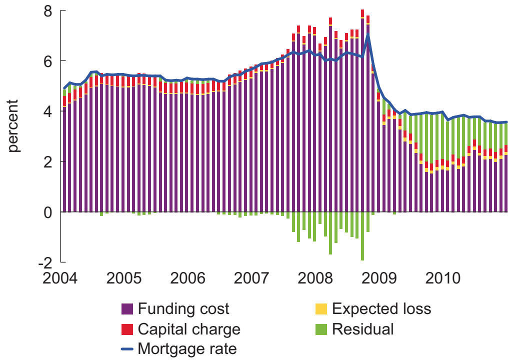
Source: Bank of England, Bloomberg, BBA, Markit and Bank of England calculations.
(a) The sight deposit and one-year retail bond rates are weighted averages of rates from banks and building societies. (b) The one-year retail bond rate is the cost of a floating-rate one-year retail deposit, i.e. the cost of a one-year fixed-rate bond net of a one-year interest rate swap. (c) The long-term wholesale funding cost is proxied by the sum of 3-month LIBOR plus an average of the 5-year CDS premia for the major lenders.

Figure 32: Divergence in lending rates to households
(repeated from Figure 20)



Source: Bank of England
Note: (a) The stock lending rate is the effective secured lending rate prevailing on all loans on lenders' balance sheets. (b) The new lending rate is the effective secured lending rate prevailing on new lending each month.

Figure 33: Decomposition of new secured lending rate



Source: Bank of England, Bloomberg, British Bankers' Association, CML, Markit and Bank of England calculations.
Note: Mortgage rate is average quoted rate for 75% LTV Bank Rate tracker mortgage. Information on the methodology underlying this analysis can be found in the Bank of England Quarterly Bulletin 2010 Q3.

Before the crisis the 'normal' pattern (in the absence of loss leading competition) was that most interest rates on deposit products were at or below the base rate. However, while most lending was at least marginally above the base rate, some but not all important sources of funding now cost far more and significantly more than typical mortgage rates. The traditional analysis that assumes that the Bank Rate (or some other mid rate such as Libor) can be used to distinguish between margins on the lending and deposit taking side of the balance sheet, has therefore lost its validity. While mortgage lending at an average rate of 3.2% to 3.3% might seem to deliver an average margin of 2.7% to 2.8% above the current base rate, the reality depends crucially on the specific mix of funding available to each individual firm.

The variety of different interest rates applicable on different categories of lending and funding are shown on Figures 31 and 32.

Bank of England calculations published in their 2010 Q3 Quarterly Bulletin, suggest that the overall aggregate effect of these changes has been to make new mortgage lending now more than adequately profitable, compared with a pre-crisis period in which intensive competition held lending rates below those required to compensate for the costs of funding, potential losses and capital (Figure 33).

However, this overall finding masks a great diversity of individual firm experience, with each specific firm's profitability determined by:

- the balance between new lending since the crisis and the pre-crisis existing book. In a reversal of the pre-crisis pattern, new lending is now on average more profitable than the back book (Figure 32); and
- the mix of pricing contracts that apply to the back book, and in particular the percentage of the back book priced at a margin over base rate (i.e. tracker loans), the size of the margins on such lending and the period of time for which those margins must legally apply.

4.1.2 Deposits and savings

Following the sharp slowdown in interest-bearing deposit growth (particularly interest-bearing sight deposits) during the financial crisis, growth in this category of deposits recovered toward the end of 2009, but appeared to slow down again in the second half of 2010 (Figure 34).

Despite the slow down in the pace of growth, competition for interest-bearing retail deposits, in particular for time deposits, remains intense. This is reflected in the rates offered on time deposits – far above the base rate but also, in many cases, above mortgage rates (Figure 35). This intense competition reflects the pressures being placed on banks and building societies both to repay the Bank of England SLS funding, and to meet FSA (and subsequently Basel III) liquidity standards.

This fierce competition for, and high cost of, retail deposits means that firms may be increasingly determined to maximise the value of these accounts – for example through the cross-selling of other products. This creates the potential for particular conduct risks, which are considered in Chapter B.

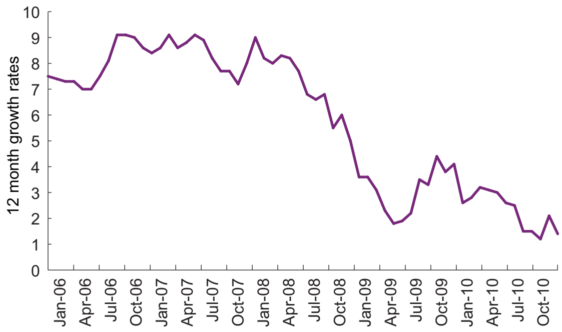
4.1.3 Fee income generating products

Some traditional sources of fee income for banks have been reduced as a result of regulatory action. An example of this is income from the selling of payment protection insurance in conjunction with loans (Figure 36).

Current environmental pressures on banks may lead to an increased focus on developing new products or services that generate fee income, including through cross-selling other types of protection products, bundled products and providing wealth management services, some of which may be unsuitable for their target market.

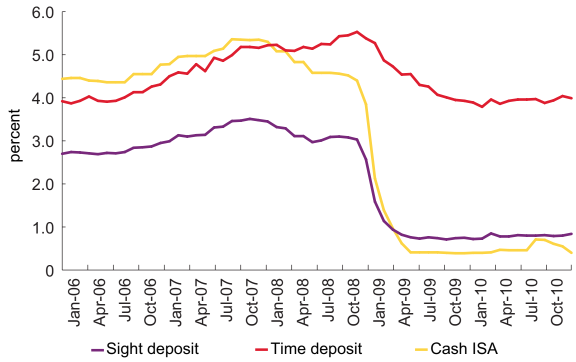
The risks associated with current strategies are discussed in more detail in Chapter B.

Figure 34: Household interest-bearing deposits with UK banks



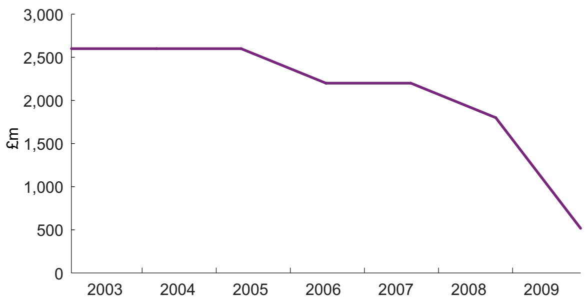
Source: Bank of England
Note: Deposits include sight deposits, interest-bearing time deposits and cash ISAs from the household sector. Interest-bearing bank time deposits are deposits where part of the balance is not accessible without penalty, either on demand or by close of business on the day following that on which the deposit was made, and where interest is payable. In January 2010 deposits held at mutuals were excluded from the series.

Figure 35: Interest rates on time deposits, sight deposits and cash ISAs



Source: Bank of England
Note: Data are rates of return on interest-bearing bank (excluding mutuals) deposits from the household sector from the Bank of England. Interest-bearing bank time deposits are deposits where part of the balance is not accessible without penalty, either on demand or by close of business on the day following that on which the deposit was made, and where interest is payable. Rates of return on deposits held with banks by the household sector are effective interest rates. Effective rates are calculated as a function of average deposit balances and interest receivable on those balances. Note that in January 2010 deposits held at mutuals were excluded from the series.

Figure 36: Distribution income from PPI



Source: Competition Commission

4.1.4 Competition

The competitive environment for banks and building societies has not changed significantly since our last update in March. Two new banks entered the market in 2010, but it is too early to tell the effect they may have on the competitive environment.

Another possible influence on future competition is the divestments of businesses and assets required of RBS and Lloyds Banking Group by the European Commission as a condition for receiving state aid approval. These sales may result in existing competitors increasing their market shares or new competitors entering the market.

Figure 37: Best selling IMA sectors, 2009 and 2010

Best selling sectors – 2009

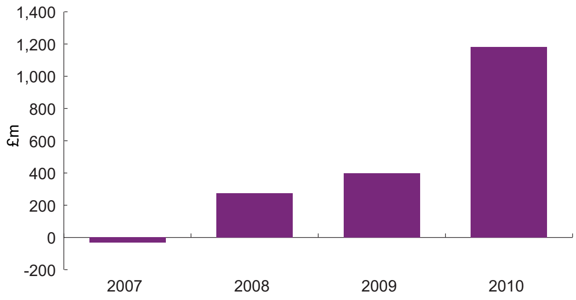
Best selling sectors	Net retail sales £m	% Total gross retail sales	Total funds under management £m	% Total funds under management
£ Corporate Bond	5,971	9%	43,540	9%
Absolute Return – UK Domiciled	2,550	3%	8,419	4%
£ Strategic Bond	1,963	4%	17,029	4%

Best selling sectors – 2010

	Net Retail Sales £m
£ Strategic Bond	2,742
Global Bonds	2,423
Absolute Return – UK	2,297

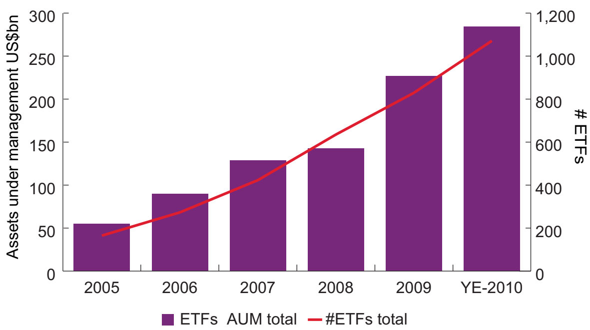
Source: IMA

Figure 38: Net retail sales of tracker funds



Source: IMA

Figure 39: Growth of European ETFs



Source: ETF Landscape, Industry Review, Year End 2010, BlackRock

4.2 Asset management

4.2.1 Trends in product supply and innovation

The low interest rate environment and higher savings ratio in the UK have been among the key drivers of demand for asset management services. Against the backdrop of low interest rates, the UK asset management sector experienced a record year for retail investment in 2009, with net retail sales of £25.8bn. This trend continued in 2010, when net retail sales showed an inflow of approximately £24bn.[8]

This reflects customer desire to achieve yield uplift relative to returns available on deposit accounts. But among some customers, this desire is combined with a search for capital security. Products that appear to deliver this potentially incompatible combination may seem particularly attractive to customers in this environment.

Among the product categories growing most robustly this year are Bond Funds, and Absolute Return Funds (Figure 37), Passive Funds (Figure 38) and Exchange Traded Funds (Figure 39).

Some key features of these developments are:

- **Absolute Return Funds** – Asset managers are continuing to develop more complex investment strategies and promote them to retail investors, often through adopting regulated fund formats, such as UCITS. Absolute Return Funds are an example of this. There is a

8 Data from IMA.

wide variety of Absolute Return Funds on sale in the UK. It is important to recognise that these products, although they may use the same sector name, use a wide range of different investment strategies to attempt to achieve a similar goal. Consumers (and sometimes their advisers too) may have difficulty distinguishing between products that are using complex investment strategies across multiple asset classes, or of assessing the level of risk that is being taken to achieve returns.

- **Exchange Traded Funds (ETFs) –** Similarly, rapid growth in the ETF market has led to a high level of innovation in this product area. This creates the risk that consumers do not understand the difference between product types in terms of investment strategy, tax status and risk. For example, there are an increasing number of synthetic (also called swap-based) ETF products that expose investors to collateral and counterparty risk. Similarly, consumers can access ETF products from overseas jurisdictions that may operate under a different regulatory and tax regime. There are also numerous other types of exchanged-traded vehicles such as Exchange Traded Notes (including Exchange Traded Commodities) that may pose additional risks to consumers. Chapter B discusses some of the risks that may be associated with ETF and other exchanged-traded products.
- **Passive funds –** There has been a long-term trend towards a rising proportion of assets being managed passively, which has recently been manifested in the growth of ETFs (discussed above). It is anticipated that the changes to adviser remuneration in the RDR may lead to advisers recommending passive funds more frequently. According to the Investment Management Association (IMA), the proportion of institutional assets managed passively is approximately 24%, whereas only around 6% of retail funds are index trackers. While passive management may not reach the same level for retail investors, there remains considerable scope for growth in this area. Some commentators have suggested that this will lead to pressure on fees for active management, although there is no evidence that this is currently happening.
- **Unregulated Collective Investment Schemes (UCIS) –** Recent developments in the manufacturing and distribution of UCIS also follow this trend of increasing product complexity, where the underlying assets have become increasingly illiquid and risky. Possible risks for consumers associated with these developments are discussed in Chapter B.

4.2.2 Innovation in distribution: platforms

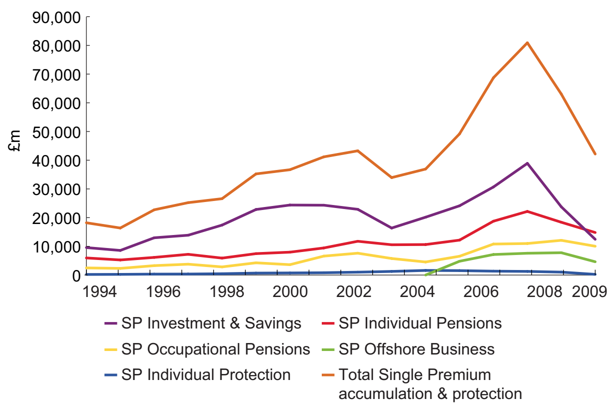
Significant technological developments have taken place in recent years, mainly around the development of platforms and associated software tools for advisers.

Platforms are an online service tool used by investment intermediaries (and sometimes end consumers) to view and administer their clients’ investment portfolios.

In the third quarter of 2010, platforms administered about £135bn in Independent Financial Adviser (IFA) assets[9] and about half of all new retail fund investment business is placed through platforms. Although the number of platforms is growing, market shares remain relatively concentrated among the top four firms. Given the business model of platforms and the market structure, we expect the market to remain highly concentrated as market participants seek to benefit from economies of scale.

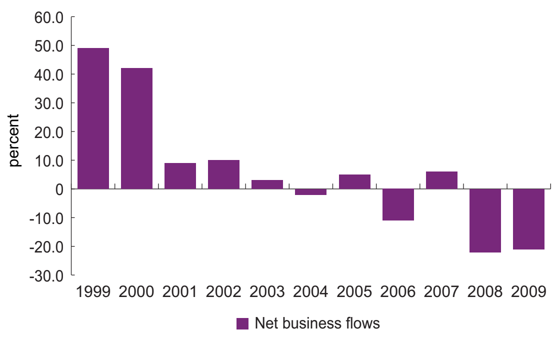
9 *The (plat)form guide* November 2010.

Figure 40: New single premium accumulation and protection sales



Source: ABI

Figure 41: UK life sector net business flows



Source: FSA Returns
Note: New business flows are the excess of premium inflows over claims incurred as a percentage of claims incurred.

4.2.3 Competition

The asset management industry in the UK remains highly fragmented and competitive. Analysis of the industry by the IMA shows no trend towards increasing concentration. There has been some consolidation in the industry during the downturn – for example, BlackRock acquiring Barclays Global Investors, Henderson acquiring New Star Asset Management and BNY Mellon acquiring Insight. This consolidation, however, has not significantly reduced the number of firms in the industry or increased concentration.

At the same time, as mentioned above, retail investors appear to be increasing their investments in products that market themselves as offering more stable absolute returns rather than simply providing exposure to an asset class. Firms that have strong product offerings in this area have seen significant inflows over 2010.

4.2.4 Responses to regulation

As described in the Regulatory Background and Outlook section, several regulatory initiatives affect the asset management industry. The RDR may require asset management firms to alter their business models – for example, some firms may need to alter their charging structures and may choose to launch new share classes to support the rules on charging required under the RDR.

The introduction of the key investor information document (KID) under the UCITS IV Directive (UCITS IV) will require firms to present information about UCITS funds to consumers in a different format. The KID is designed to describe more clearly a fund's aims, its risk and reward profile and its charges, which should lead to consumers making better informed decisions. There is a possibility that consumers may be discouraged from buying products that are classified as higher risk, even where those products might best meet their needs. Firms may need to improve the quality of their marketing and sales advice to explain the risks and benefits of such products. They may also need to invest in systems and controls to ensure that these KIDs meet the requirements of the directive. Separately, the management company passport contained within UCITS IV may lead to new entrants coming in to the UK retail funds market.

4.3 Life insurance

The life insurance sector covers a diverse spectrum of firms, both in terms of their size, ownership and product mix. Firms range from being large diversified groups through to niche players and those closed to new business. As a result, changes in the macroeconomic environment and regulation will have diverse impacts on different firms.

Although the trend towards increased longevity among the UK population, coupled with the transfer of risk around later life to consumers, should help stimulate a growth in demand for long-term savings and insurance, the life sector faces challenges.

In the two decades before the financial crisis, life companies experienced an increase in single premium business – for example, lump sum investments into pensions (Figure 40) – while growth in regular premium business remained relatively static. This has had a significant impact on product persistency, costs (including acquisition costs) and customer/adviser loyalty. In addition, consumers' perception of some life products has been negatively affected by pension and endowment mis-selling, as well as the issues surrounding Equitable Life.

The recent recession saw falling asset values, widening bond spreads and low interest rates. These pose significant challenges, especially to firms offering fixed, defined or partially defined liability products, such as annuities or with-profits policies. Life insurers' revenues have historically been supported by investment returns. Lower returns and asset price falls have therefore put pressures on margins, creating a focus on cost reduction, particularly in firms that have legacy business written on the assumption of a more positive market outlook.

Economic uncertainty has also reduced the capacity and propensity of some consumers to invest in long-term savings products, particularly for single premium products, or put in place adequate protection (Figure 40). While this will have an impact on all providers of long-term savings and insurance, the life sector will feel the impact more acutely given the concentration of their businesses in these markets.

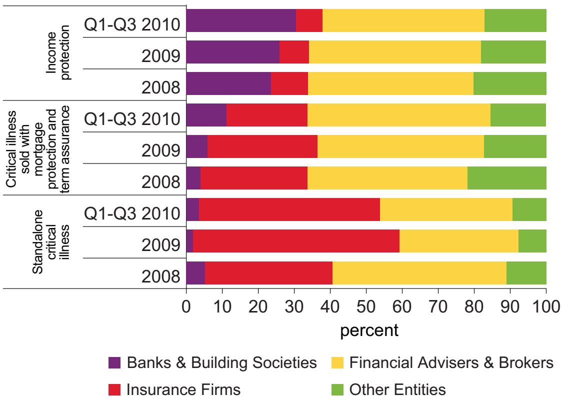
Although some of these pressures have now eased due to improved market conditions, there is still uncertainty around the shape and pace of the current recovery. Furthermore, some of the pressures in this sector are longer term in nature. The overall trend over the last decade has been of net business flows out of the industry, as shown in Figure 41.

4.3.1 Responses to regulation

The life insurance sector will be significantly influenced, in particular by, three regulatory initiatives discussed earlier in this chapter: the RDR, Solvency II and the Pensions Reform.

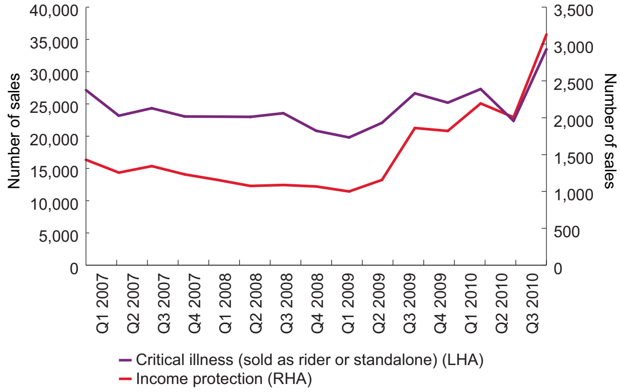
While the RDR should bring better outcomes for consumers, the changes to product distribution will affect life insurers. The prohibition of commission on investment products will not allow insurers to use commission as a tool to incentivise sales. This will put further emphasis on product design to ensure firms can compete effectively with other insurers, asset managers and platform service operators. The change in the distribution landscape will also alter how insurers reach the end consumer, given their current intermediated model. It is likely that new routes to market will be developed, including direct sales to customers. There will also be substantial investment in system changes to take account of the RDR.

Figure 42: Share of total pure protection sales by selling firm category



Source: FSA Pure Protection PSD

Figure 43: Number of sales of pure protection policies (CIC and IP) by banks



Source: FSA Pure Protection PSD

At the same time the sector will need to implement Solvency II. While the detail is not yet finalised, the areas where the impact is likely to be significant include the level and quality of capital and valuation of technical provisions. In addition, Pillar II requirements will require enhanced governance and risk management and Pillar III will require greater transparency. As a result of the above factors, we are already seeing evidence of many firms in this sector recognising the need for significant changes to their business strategies, e.g. firms closing to new business, restricting the range of products they manufacture, limiting the range of distribution channels they use, and altering their distribution mix by, for example, building up a direct sales channel, selling off blocks of existing business portfolios, or merging brands and operational infrastructures.

The government's introduction of pension auto-enrolment should increase the amount of long-term pension savings, an important business line for life insurers. The impact this would have on the life sector depends on a number of factors, including the impact of NEST on current occupational pension provision and competition for this business from alternative providers.

Other legislative changes, such as changes to the tax system, or the proposed abolition of compulsory annuitisation, could also influence the range or features of products that insurers offer.

4.3.2 Competition

The cumulative impact of the above changes may accelerate the trend for declining net business flows. In turn, this may drive sectoral restructuring and consolidation and increase the trend in mergers and acquisitions in those firms most acutely affected by these factors.

Solvency II could also act as a significant influence on the consolidation of the industry. The impact will differ depending on the capital position of a firm, with some insurers benefiting from Solvency II leading to a gain in their market share, while other firms may exit the market or sell their 'back books' of discontinued business.

Core components of the life investment market (for example, pensions) continue to see increased competition from non-life investment providers, such as fund managers and those offering passively-managed funds. In future other potential entrants to the market could continue to compete in this sector's core markets.

4.4 General insurance and protection insurance

The retail general insurance market includes a variety of products widely purchased by consumers including motor, property and travel insurance policies. Motor and home insurance are the two largest retail markets, with respectively £9.3bn and £6.3bn in gross written premium in 2009. Changes in the economic environment have a less significant impact on this segment compared to others. Historically, the level of claims tends to increase during more challenging economic conditions and some consumers may be tempted to reduce cover, but this latter effect is limited by the legally required nature of some insurance (e.g. motor).

A key recent development in the general insurance market is the change in the way policies are distributed to consumers. The role of price comparison websites (also known as 'aggregators') as a distribution channel has grown dramatically over the past two to three years. More than half of new private motor insurance premiums were generated by sales through these websites. Aggregators are increasingly introducing clients to firms providing mortgage and investment advice.

The protection business includes products like critical illness cover, income protection policies, non-investment life insurance and payment protection insurance. While smaller than other lines, this segment is relatively more exposed to the current environment. The slowdown in economic activity has affected volumes across different protection lines. Economic uncertainty, while sometimes increasing consumers' demand for protection and peace of mind, also depresses demand for credit, one of the main drivers of protection product sales.

Against this trend, the share of pure protection business (in particular critical illness and income protection policies) distributed by banks continued to grow at the end of 2009 and 2010 (Figure 42).[10] In addition, pure protection sales by banks in recent quarters increased significantly (Figure 43) and protection business remains an important area of focus in banks' strategies.

Payment Protection Insurance (PPI) is another important protection product. Mis-selling of PPI policies has been a significant issue in recent years, giving rise to consumer detriment. We provide an update in Chapter B on our work in this area.

4.4.1 Competition

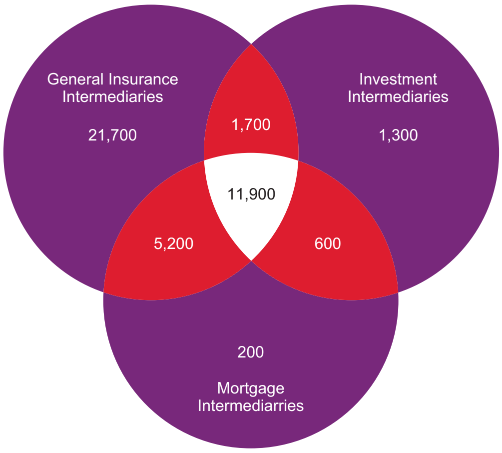
Although the retail non-life sector is fairly concentrated in some areas (e.g. the top five insurers write around 50% of motor insurance and two thirds of household insurance by Gross Written Premium) it remains increasingly competitive on price, particularly in light of the increased role played by price-comparison websites as a distribution channel.

There is less evidence of competition to attract customers in other areas of the general insurance model, such as contractual terms and the claims-handling experience, as consumers tend to focus less on these factors when purchasing an insurance contract. This may become particularly important at a time when competitive pressures on pricing and lower returns on assets are forcing firms to look at alternative ways to maintain profitability.

The disposal by large banking groups of their insurance subsidiaries could result in new entry or increased competition in the UK market. However, any new entrant or existing player looking to take market share would need to adopt an aggressive, price-driven approach while accepting potential vulnerability to large losses in the start-up phase.

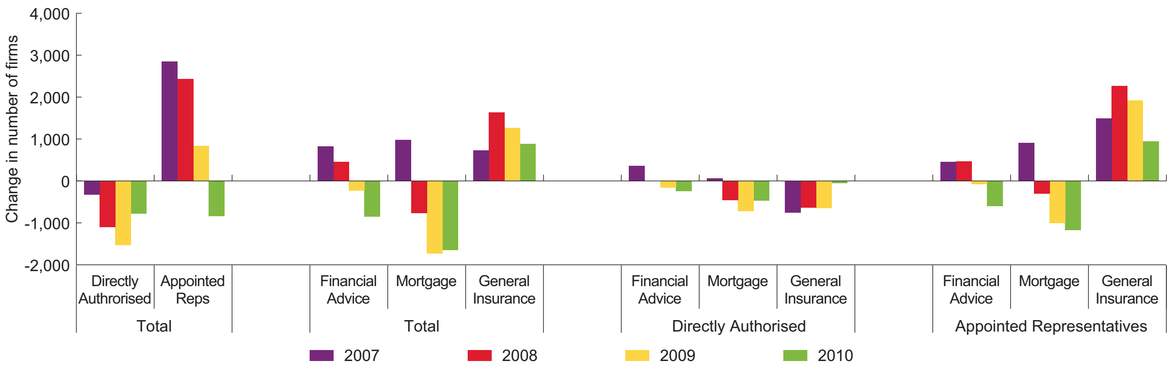
10 Note that very few CIC policies are currently distributed as stand-alone policies.

Figure 44: Permissions held by retail intermediary firms



Source: FSA
Note: Figures include both directly authorised firms and appointed representatives and are rounded to the nearest 100 firms. They only include firms whose primary financial services business is in one of the three retail intermediary sectors.

Figure 45: Changes in the number of retail intermediary firms



Source: FSA

4.4.2 Responses to regulation

The main regulatory development affecting the non-life insurers is Solvency II. As the deadline for Solvency II approaches, the potential demands on capital and the choice of model continue to dominate most firms' agendas.

4.5 Retail intermediaries

We published a Retail Intermediaries Sector Digest alongside the Financial Risk Outlook in March 2010. The trends and issues identified in the digest have continued and are still relevant.

The sector is still highly competitive, with around 42,000 firms operating across the general insurance, investment and mortgage markets. Figure 44 shows that the biggest single group is general insurance intermediaries – including both firms whose primary business is general insurance mediation and those who sell general insurance alongside other non-financial products – for example, retailers and motor dealers. Among the remaining firms, the majority hold permissions to conduct business in all three categories.

Figure 45 shows the changes in the number of firms in the sector in each of the last four years. The number of firms shrank in 2010, mainly due to the number of mortgage intermediaries reducing by a further 27% (1,645 firms). The number of firms whose primary business is home finance broking has nearly halved over the last three years, from over 8,500 firms down to 4,364 firms in December 2010. Current economic conditions and pressures in the mortgage market have meant that many mortgage intermediaries have struggled to maintain income levels, with many deciding to close their business. It is not clear what will be the outlook for this sector once the mortgage market recovers: some of the changes experienced by the sector may have permanent effects. In the meantime, it is important that firms continue to treat their customers fairly and, if necessary, exit the market in an orderly way.

The number of general insurance intermediaries has continued to grow in 2010, again driven by a growth in the number of appointed representatives. However, with an increase of 3% (881 firms), this trend is weaker than seen in recent years. The number of financial advisers has also fallen by 6%, following a smaller decrease in 2009.

Price comparison websites (also known as 'aggregators') continue to have an important and growing role. There are now around 16 main price comparison websites covering a variety of policies, e.g. home and motor insurance, with around 40 'white label' sites (i.e. third-party firms that offer similar services using software provided by an aggregator as their comparison tool). Many of these firms are looking to expand, with some moving into areas outside of general insurance – for example, investments, as well as life and protection policies.

4.5.1 Responses to regulation

In addition to the RDR being implemented at the end of 2012, other changes that may affect the structure of this sector include increased capital requirements for Personal Investment Firms, the MMR and pensions reform. Many of these changes will improve the sustainability of the sector over the longer term, but, if firms do not make adequate progress in preparing for implementation, the combined effect could have an impact on the sustainability of individual firms.

With the RDR deadline now less than two years away, it is important for firms to ensure that their plans for achieving the qualification requirements and for developing a remuneration model based on adviser charging, are progressing at a suitable pace.

We commissioned research in the first half of 2010 that looked at preparation for the professionalism changes.[11] 52% of IFAs had already achieved an appropriate qualification, in line with the average for the whole market. A further 27% of IFAs were making progress towards their qualification, while 16% had not yet started a qualification. Among tied advisers, 43% had already achieved an appropriate qualification, with 43% 'in progress' and 13% yet to start.

Chapter B discusses some of the business changes firms are considering before and after the RDR implementation and what potential risks these may pose to consumers.

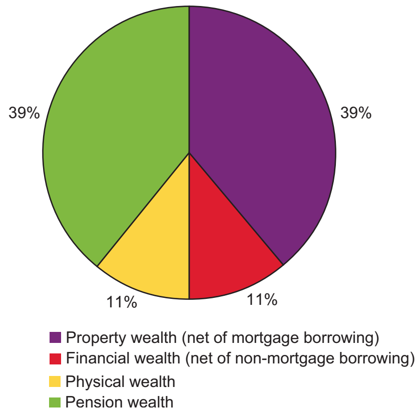
4.5.2 Competition

Despite the reduction in firm numbers shown in Figure 45, the retail intermediary market is still made up of a very large number of firms across the investment, mortgage and general insurance markets. The majority are smaller firms, but there are also larger firms, including both networks and nationals.

---

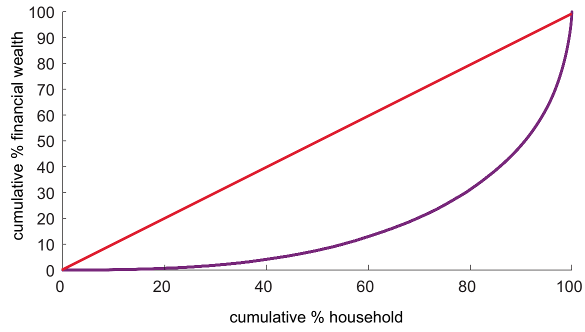
11 *The cost of implementing the RDR professionalism policy changes*, NMG, June 2010.

Figure 46: Breakdown of aggregate wealth by component 2006/08



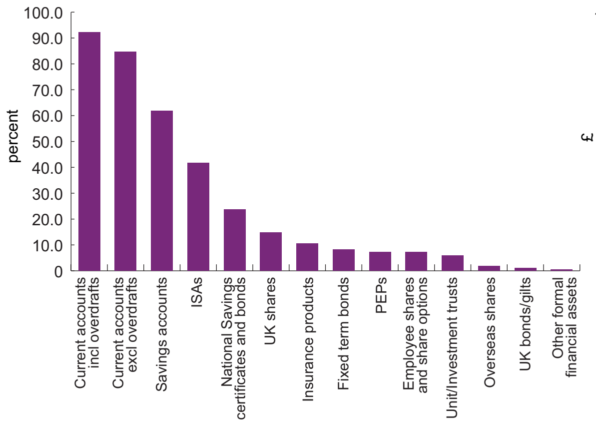
Source: ONS

Figure 47: Distribution of net household financial wealth 2006/08



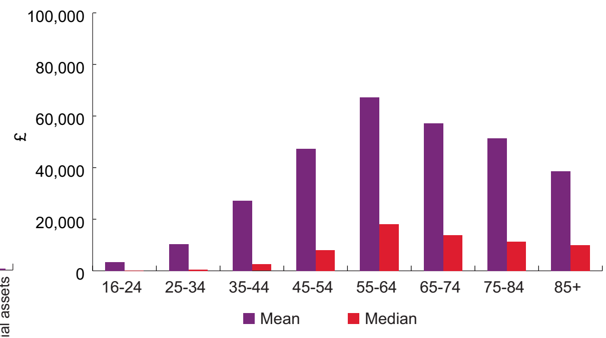
Source: ONS analysis based on Wealth and Assets Survey data

Figure 48: Proportion of households with financial assets



Source: ONS
Note: Insurance products include any life insurance, Friendly Society or endowment policies (excluding mortgage endowments and life insurance policies with no value except in case of death).

Figure 49: Distribution of net household financial wealth by age of household head, 2006/08



Source: ONS
Note: Results exclude households with zero net financial wealth.

Consolidation has been a feature in particular of the general insurance intermediary market in recent years, but there continues to be significant numbers of firms entering the market.

Some financial advice firms and advisers are planning to leave the market because of the RDR. We have carried out research with both firms and individual advisers to estimate the impact. The survey of firms[12] found that 23% of 'advisory firms' would exit the market because of the RDR proposals, with smaller firms most likely to exit the market, and adviser numbers therefore reducing by 11%.

The survey of advisers[13] came to a similar conclusion, estimating that 8% to 13% of investment advisers might leave the industry, retire early or move to another role as a result of the RDR. Looking specifically at advisers in financial advice firms, the survey found that 11% of both IFAs and tied advisers said that they will exit the advice market as a result of the RDR, with a further 7% and 5%, respectively, not yet clear how they will respond.

These exits would still leave a market characterised by many thousands of individual firms.

12 *RDR proposals: Impact on market structure and competition*, Oxera, March 2010.
13 *The cost of implementing the RDR professionalism policy changes*, NMG, June 2010.

5. Consumers and demand for financial products: important segment-specific effects

In Section 2 of this chapter we discussed some key aggregate trends in the macro-economy and their implications on the household sector. However, consumers of financial services are not all the same, and one of the features of this crisis, and of the factors and trends identified above, is that they have had very different impacts on different customer segments.

Here we highlight four specific dimensions of consumer heterogeneity, which are important to bear in mind when assessing how the macro trends and firm behaviours mentioned above will affect specific segments. These four dimensions are:

- the very unequal distribution of ownership of financial assets (this is a longstanding but important factor of how demand for products and services differs by customer segment);
- the very different impact of the low interest rate environment, and of its potential reversal, on different customer segments;
- the potentially diverse risk/return preferences of different customer segments, in the face of extremely low returns on low risk assets; and
- important variations in consumer priorities by age, with customers approaching retirement particularly vulnerable to some trends and firm behaviours.

5.1 Distribution of assets and wealth among consumers

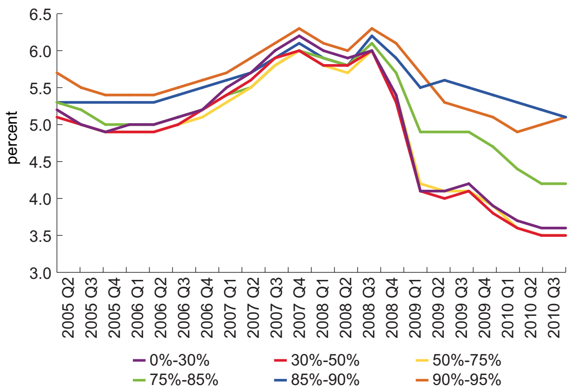
The demand for financial products and services by different consumer segments is materially influenced by the underlying distribution of assets and wealth.

Only a small proportion of households engage with financial service providers to buy investment products. This reflects the fact that the distribution of wealth in the population is highly concentrated. The ONS Assets and Wealth Survey[14] analyses the distribution of financial (and non-financial) assets and wealth among British households. Key findings from the survey are:

- Total wealth (including private pension wealth) in Great Britain in 2006/08 was £9 trillion.
- Net financial wealth (calculated by subtracting from financial asset values the value of any non-mortgage financial liabilities) accounted for 11% (£1 trillion) (Figure 46).
- Half of all households in Britain have net financial wealth of £5,000 or less. In addition, the distribution of ownership of net financial assets is much more concentrated than that of property and physical wealth, with the wealthiest 20% owning 84% of net financial wealth and median values much lower than mean values (Figure 47).
- 25% of households had net financial wealth that was negligible or negative. As a result only a small proportion of households engage with providers of complex investment products. For the vast majority of the population, financial asset holdings are dominated by current accounts, savings accounts, ISAs and National Savings products (Figure 48).

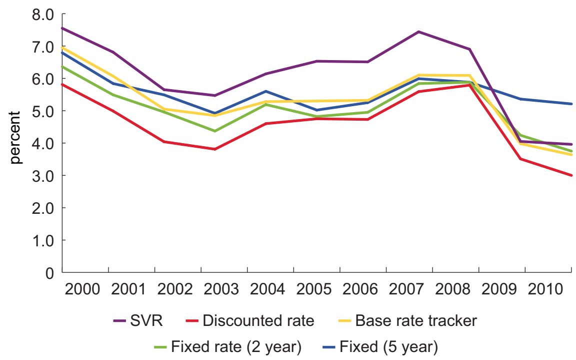
14 The ONS Wealth and Assets Survey (WAS) aims to address gaps identified in data about the economic well-being of households by gathering information on, among others, level of assets, savings and debt; saving for retirement; how wealth is distributed among households or individuals; and factors that affect financial planning. The main results from the 2006/08 WAS for Great Britain, wave 1 of the survey were published in December 2009. The main results from the 2008/10 WAS will be published at the end of 2011.

Figure 50: Initial interest rates on mortgages by LTV bands



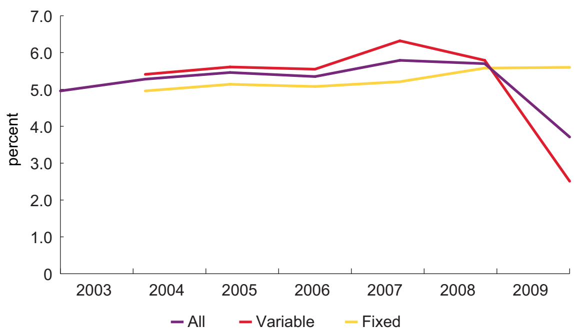
Source: FSA Mortgage PSD
Note: Interest rates for 95%+ LTV band are not shown due to a small number of mortgages in this category in 2009-10.

Figure 51: Average quoted interest rates by mortgage type



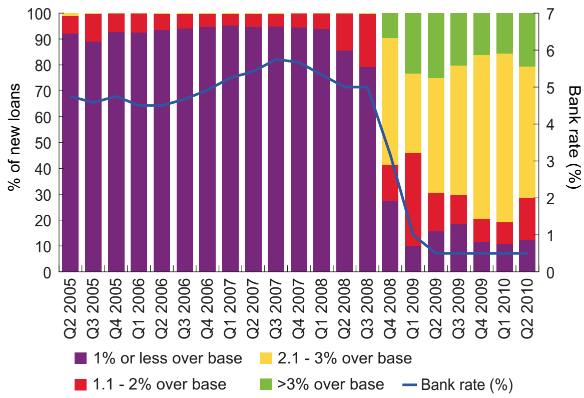
Source: Bank of England
Note: 1. All rates shown are averages within the period. 2. All rates shown are weighted averages of publicly quoted rates. 3. Mortgage rates are based on a 75% loan-to-value.

Figure 52: Average rates on outstanding loans by mortgage type



Source: Bank of England
Note: All rates shown are averages within the period.

Figure 53: Margin over base rate on tracker mortgages sold



Source: FSA Mortgages PSD, Bank of England
Notes: (1) Initial gross interest rate is an optional reporting field. Tracker mortgages where intial gross interest rate was reported range from 36-78% of tracker mortgages sold in each quarter. (2) PSD mortgages sold are reported per quarter so an average base rate over each quarter was calculated in order to establish margin.

- The distribution of net financial wealth by age shows an increasing average net financial wealth over people's working lives, peaking in the pre-retirement period, and decreasing again in retirement (Figure 49). The distribution is slightly different for poorer households with little net financial wealth (i.e. with higher non-mortgage liabilities and lower financial assets). These households have still relatively low net financial wealth in pre-retirement years, and peaking for those aged 75 to 84.

The findings of the Asset and Wealth Survey confirm that different consumer segments are mostly affected by different risks – e.g. younger consumers for mortgages and deposit issues, individuals in pre-retirement for investment and advice issues. It is therefore important to keep this under consideration when considering the risks discussed in Chapter B.

5.2 Impacts and vulnerabilities arising from low interest rates: diverse customer segments

Section 4.1.1 described how the changing pattern of interest rates for different lending and funding products can have a highly heterogeneous impact on the profitability of different firms, given the different mix of price contracts within the mortgage back book. Similarly on the consumer side, the impact of low interest rates has varied hugely by specific customers: as does vulnerability to any rapid increase in interest rates from these low levels.

The most obvious cause of divergence in customer experience is highlighted by Figure 4: depositors have suffered income loss from the fall in interest rates, while borrowers have on average gained. The negative impact on depositors falls in particular on older age groups, and possible implications for investment product demand are considered in Sections 5.3 and 5.4.

But even among borrowing customers, the impact of low interest rates has been hugely diverse. This is because of the greatly increased dispersion of mortgage pricing terms, compared with the pre-crisis period. Whereas before the crisis, price differentiation was inadequate to reflect the different risks of different mortgages, pricing is now strongly differentiated by LTV ratio (Figure 50).

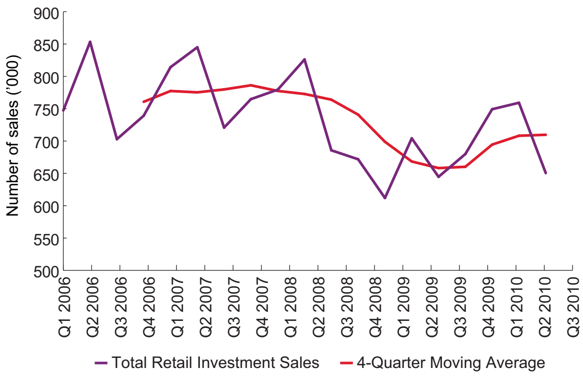
In addition, there are now major variations between the interest rates paid by borrowers on fixed rate contracts, on standard variable rates, and on base rate trackers (Figures 51 and 52).

Within the category of base rate trackers, there are huge variations in the margins above base (and in the effective interest rate being paid). Before the crisis, 90% of base rate tracker mortgages were sold at margins of 1% or less over base. Some borrowers only enjoyed these rates for a limited initial period and are now moving onto Standard Variable Rate. A minority, however, have a long-term contractual right to borrow at a margin which today results in a total interest rate of 1.5% or less. New base rate tracker mortgages granted since the crisis are at much higher average rates: 70% at more than 20% over base and 20% at over 30% (Figure 53).

As a result of this price diversity, the net benefit of over £20bn to household budgets (Figure 21) has been extremely unequally distributed. Part of this distributional effect has been simply random: the consequence of specific mortgage price options that are not strongly correlated to identifiable customer segments. However, one more systematic effect is that the benefit has accrued least to high-LTV customers, who will also tend to be more vulnerable to falls in house prices, and to any future deterioration in income or employment prospects. The fact that over 30% of new mortgages are base rate trackers (and now at much higher margins) creates a significant vulnerability of this customer segment to any future rises in the Bank Rate.

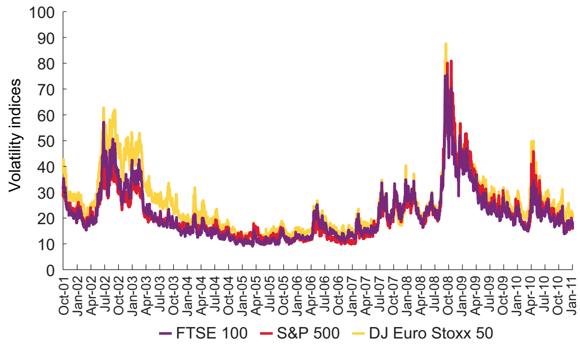
This vulnerability could be particularly important given that, as Figure 17 highlighted, borrowing at high-LTI ratios has recovered to account for as high a proportion of total lending as it did at the pre-crisis peak.

Figure 54: Total retail investment product sales



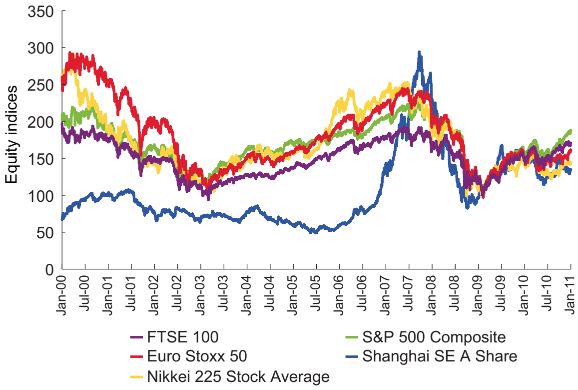
Source: FSA Retail Investments PSD
Note: Total retail investment products include pensions, investments, endowments, Equity ISAs and long-term care insurance.

Figure 55: Stock market volatility indices and major equity indices
Volatility indices



Sources: Datastream, FSA calculations

Figure 55: Stock market volatility indices and major equity indices
Equity indices



Sources: Datastream, FSA calculations

Figure 56: Percentage of FSA Annual Survey respondents not willing to take any risk with their investment

Source: FSA Annual Consumer Awareness Survey, 2010

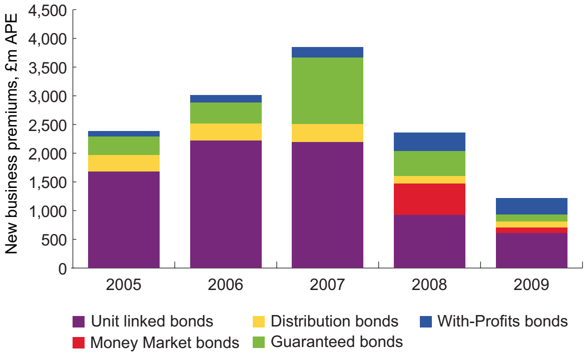
5.3 Consumer attitude to risk and demand of financial products

In contrast to the trend observed in the March 2010 Financial Risk Outlook (FRO), the sales of retail investment products picked up in 2010, rising by almost 14% for the period between January and September 2010 compared to the corresponding period in 2009 (Figure 54).

As discussed in the 2010 FRO, property, equity and asset prices fell during the financial crisis and continue to remain volatile (Figure 55). Many consumers saw the value of their investments materially affected. At the same time, many consumers experienced extremely low interest rates on their safer asset holdings.

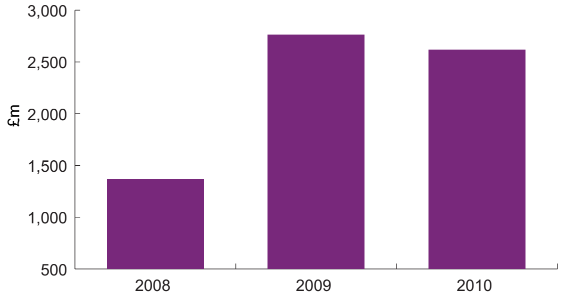
These developments have had a complex impact on consumer risk-return preferences, with a search for both yield and safety, sometimes by different consumer segments, sometimes as potentially incompatible objectives in the same segments. In the current very low interest rate environment, consumers are potentially susceptible to offers of products that appear to offer the combination of higher yield without higher risk.

Figure 57: Sales of life insurance investment bonds by new business premium (Annual Premium Equivalent)



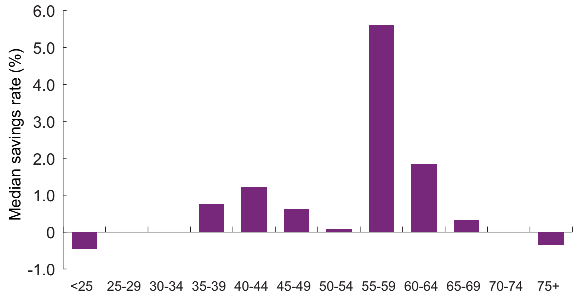
Source: Datamonitor UK Investment Bonds 2010

Figure 58: Net retail sales of absolute return funds



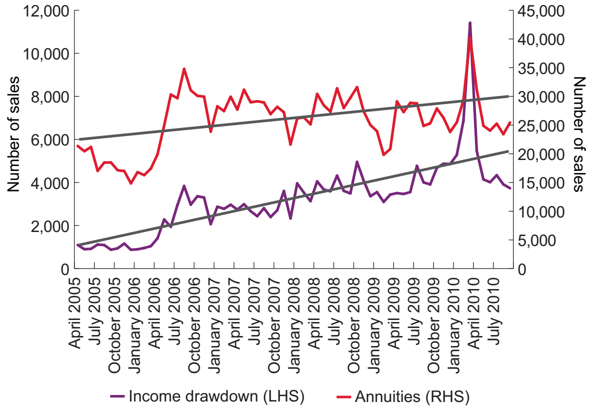
Source: IMA

Figure 59: Median annual saving rate by age group



Source: IFS analysis based on BHPS data.
Note: Saving rate calculated as the real change in wealth between 2000 and 2005 divided by real income in 2000. Wealth is liquid financial wealth, i.e. balances in savings accounts plus equity/bonds less outstanding non-mortgage debt. Both active saving (payments into savings/investment accounts) and passive saving (capital gains) are included. Pension wealth is excluded.

Figure 60: Income drawdown and pension annuity sales



Source: FSA Retail Investment PSD
Note: The March 2010 spike in sales of pension annuities and income drawdown may be explained by the change to the minimum retirement age, from 50 to 55, that took place on the 6th of April 2010. The implication of this change was that customers approaching the age of 50 and looking to retire in the next few years could withdraw their benefits before April 2010 or alternatively would have to wait until the age of 55.

According to our latest Consumer Awareness Survey,[15] overall, consumers' net attitude to risk returned to 2008 levels in January 2010, with 58% of consumers unwilling to take any risk with investment, down from 67% at the start of 2009 (Figure 56). Within this average, however, major variations exist by customer segment, producing divergent trends in product demand.

As seen above, the current environment has led some investors to transfer money to fixed-interest deposit and savings products. This has particularly affected certain asset classes, like insurance investment bonds, i.e. single premium life assurance-based investments typically offering nominal life cover to the investor (Figure 57). This fall may also reflect recent tax changes that could have diminished some of tax benefits of insurance bonds compared with other investment products.

Within this overall decline, the relative shares of different investment bond categories varied significantly. New business premium from unit-linked bonds fell by around 30% in 2009, possibly as a result of consumers reacting to falling stock and property markets.

15 See http://www.fsa.gov.uk/pubs/consumer-research/crpr83.pdf
The omnibus survey is carried out by TNS during January 2010.

While with-profits bonds experienced a smaller decline, probably because of the risk smoothing in the returns they pay to investors. New business premium in guaranteed bonds fell significantly in 2008 and 2009 after a growth in their popularity in 2007.

For asset managers, as discussed in Section 4.2, Bond Funds and Absolute Return Funds were the best selling IMA sector in 2009. In 2010 they continued to be highly attractive to investors searching for yield in light of the stock market volatility and relatively low returns on bank and building society deposits (Figure 58).

5.4 Consumers close to retirement

Unsurprisingly, the years immediately before retirement show the most substantial level of accumulation in financial wealth. The Institute of Fiscal Studies (IFS) analysis of the wealth and savings of UK families before the crisis, based on data from the British Households Panel Surveys, suggests that in the years before retirement net financial savings rates[16] were negligible in about all age groups except 55-64 year old (Figure 59).

With the long-term trend of declining defined benefit pension schemes, consumers are increasingly dependent on annuity income and any other private investment put in place to fund their retirement. As discussed in the 2010 FRO, the crisis has had a material impact on the value of investments held by consumers close to retirement. In addition, annuity rates have fallen due to low nominal interest rates and rising longevity.

This may leave consumers close to retirement vulnerable to offerings of products that give the potential for greater return, but that are not suited to their individual circumstances, or are higher-risk than they appreciate or desire.

In addition, low interest rates have led investors close to retirement to increasingly invest pension pots in the stock market. There has been a surge in interest in 'income drawdown' plans, which allow investors to take out varying levels of income from their pension. A positive trend in the share of sales of income drawdown compared to pension annuities is confirmed by FSA Product Sales Data (PSD) (Figure 60).[17]

The current environment has made it easier for financial firms to sell products that appear to satisfy the risk appetite of the consumer but may be riskier than they appear. It is essential that consumers understand the risk level, capital protection, costs and likely impact on investment return. Chapter B highlights some potential risks for consumers in this area.

6. Conclusions to Chapter A

In Chapter A we have discussed a number of important environmental drivers affecting the behaviour of both firms and consumers.

For firms, environmental conditions vary by sector:

- persistently low interest rates and diminishing availability of traditional sources of fee income are forcing banks to revise their strategies;

16 Saving rate is defined in this context as the real change in non-pension financial wealth between 2000 and 2005 divided by real income in 2000. Wealth is liquid financial wealth, i.e. balances in savings accounts plus equity/bonds less outstanding non-mortgage debt. Both active saving (payments into savings/investment accounts) and passive saving (capital gains) are included. Pension wealth is excluded.

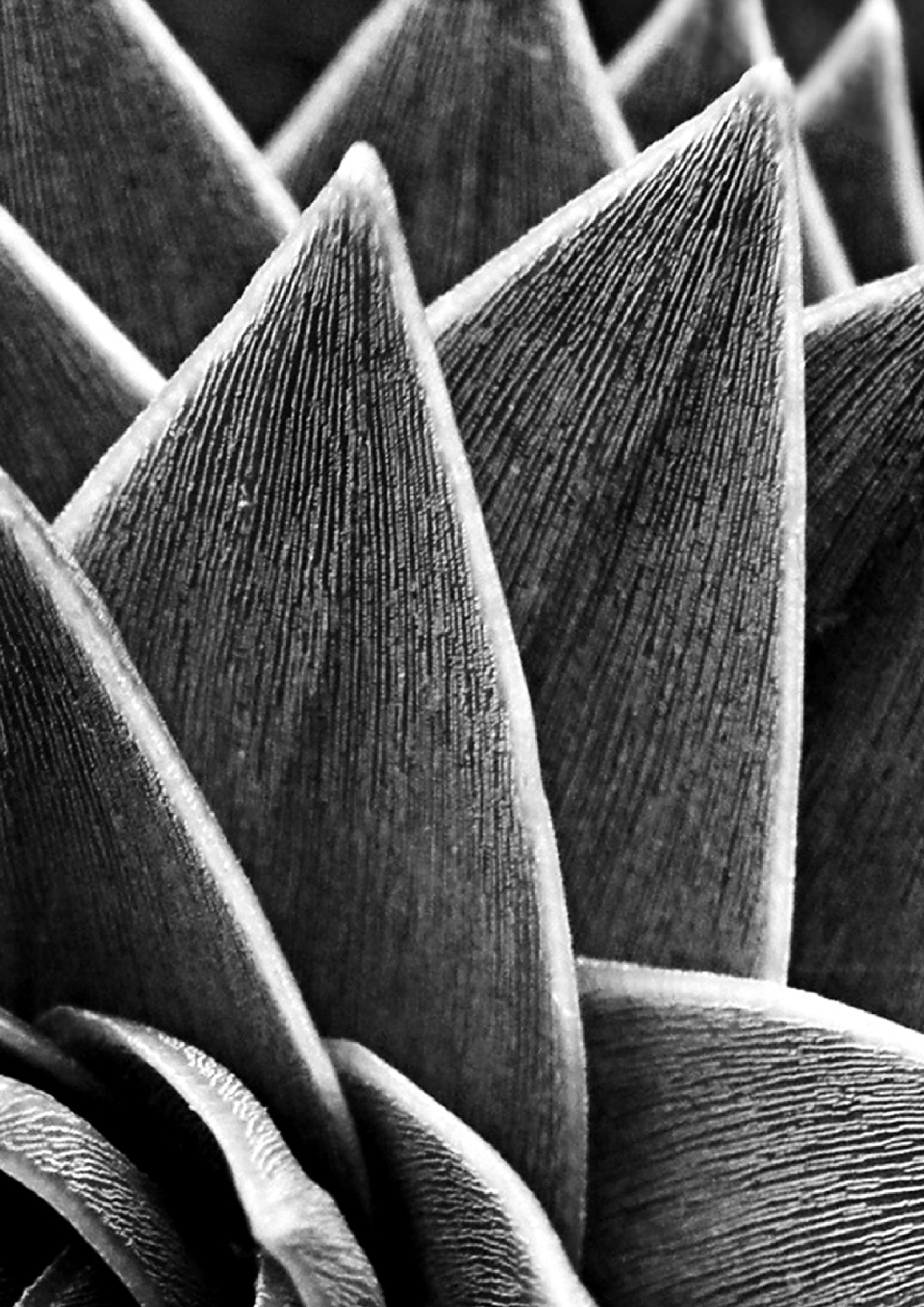
17 The March 2010 spike in sales of pension annuities and income drawdown may be explained by the change to the minimum retirement age, from 50 to 55, that took place on the 6th of April 2010. The implication of this change was that customers approaching the age of 50 and looking to retire in the next few years could withdraw their benefits before April 2010 or alternatively would have to wait until the age of 55.

- innovation is increasing in the asset management and life sector – in terms of products, distribution and their wider business model; and
- regulatory initiatives are affecting all firms, but asset managers, life insurance firms and retail intermediaries are particularly affected by new regulation and policy interventions coming into force at the end of 2012.

For consumers three themes dominate:

- search for both yield and security on savings and investment products in a low interest rate environment, and in an environment of volatile stock markets;
- diversity of experience on debt – with many seeing disposable income rise as a result of lower mortgage rates, while others (particularly those with high levels of credit card debt) seeing disposable income falling; and
- employment and income uncertainty, which may grow over the next year (this may lead to demand for products that offer some protection against possible income shocks).

In Chapter B we discuss how these drivers and behaviours may create risks for consumers in their interaction with financial firms, together with evidence of current issues that have caused consumer detriment.



Chapter B – The risks

1. Introduction

This section describes the retail conduct risks that we believe require particularly careful firm and supervisory focus now and over the next few years. Some of these risks arise or have become more pressing as a result of the changes in the environment described in Chapter A. Some, however, reflect structural features of retail financial services markets which create the potential for customer detriment whatever the macroeconomic circumstances. These continuous features of the market are described in Box 1.

We have found it useful to consider the identified risks under three categories:

- Current issues, i.e. risks that have already crystallised, with poor firm conduct already resulting in customer detriment. This category includes issues relating to:
  - complaints handling in major banks;
  - unfair terms in mortgage contracts;
  - the treatment of mortgage customers in arrears;
  - payment protection insurance;
  - the sales and marketing of structured investment products; and
  - the sales and marketing of structured deposits.
- Emerging risks, i.e. risks where we have evidence of poor conduct in firms but little or no evidence yet of widespread consumer detriment, although we believe the issue could grow. These include concerns relating to:
  - responses to the banking conduct regime;
  - transition to the RDR implementation;
  - systems and controls' weaknesses in the network model;
  - the use of platforms;
  - portfolio advice services, discretionary portfolio management and advice on distributor influenced funds;
  - firms' reward policies and practices;
  - investment risk profiling;
  - with-profits funds operation;

- the increasing popularity of complex investment products: traded life policy investments, exchanged traded funds and other exchange traded products, and self-invested personal pensions; and
- unregulated collective investment schemes.

- Potential concerns, i.e. risks that may emerge in the future, given the possible impact of environmental factors and firm behaviour. These include:
  - fee income generation in banking: private banking and wealth management, protection products and potential PPI replacements, and packaged accounts;
  - the bundling of investment and deposit products;
  - cost-cutting and efficiency improvement initiatives;
  - cross-selling;
  - business model change following the RDR;
  - firms' responses to other regulatory developments; and
  - tax changes and their implication for financial products.

The risk classification is not driven solely by the time at which an issue first became or might become apparent, but also by the extent to which any emerging evidence of firm misconduct is already combined with evidence of actual customer detriment. Figure 61 shows the logic that drives the classification of risk to the three categories.

Figure 61 – Categorising the risks

Categorisation of risks			
	Evidence of consumer detriment	Evidence of firm misconduct	Drivers may increase risk of misconduct
Current	X	X	X
Emerging		X	X
Potential			X

Several of the risks considered were also identified and discussed in the 2010 FRO. Some of the issues then highlighted have been resolved, others continue to be of concern. This is not surprising: it reflects the long-term nature of many financial products and customer relationships and the long periods of time over which customer detriment arises and becomes apparent. Figure 62 illustrates the relationship between the issues discussed in the 2010 FRO and those discussed in this report.

Figure 62 – Changes in risks since the 2010 FRO

Risks (if any) that were crystallised in March 2010, are now resolved, and therefore not mentioned in the document	Mortgage Payment Protection Insurance
Risks (if any) that were crystallised in March 2010, are still important, and therefore an update is included under current issues	Treatments of customer in arrears; Sales of structured products; Payment Protection Insurance; Poor complaints handling; Unfair terms in mortgage contracts.
Risks (if any) that were emerging/a cause of concern in March 2010, are still emerging/a concern and therefore are included under emerging risks or potential concerns	Retail banking business models; Platforms; Insurance (including risks associated with with-profits policies); Regulatory changes (including RDR).
Risks that are a new cause of concern and therefore are included under emerging risks or potential concerns	Responses to the banking conduct regime; Firms' reward policies and practices; Unregulated Collective Investment Schemes (UCIS); Complex investment products – including Traded Life Policy Investments, ETFs and self-investment personal pensions; Investment Risk Profiling; Portfolio Advice Services (including Distributor Influenced Funds); Networks.

Note: The March FRO also included a reference to risks associated with unauthorised share fraud firms. We have not included a discussion of risks related to financial crime in this RCRO but may do so in the future.

Box 1: Risks to consumers, information asymmetries, behavioural biases and financial capability

The risk of consumer detriment in financial firms is increased by the prevalence of three inherent features of this market:

An asymmetry in the information available to consumers and providers – This asymmetry comes from: the complexity of many of the products and services these firms offer; the fact that for many products or services (e.g. mortgages) consumers make few purchases, so that there is little learning from experience; and the length of time before the characteristics and quality of the products or services purchased are fully evident.

Limited financial capability – This can make it hard for some consumers to process the information that is available and make informed decisions. Firms can further increase this informational advantage by increasing product complexity or the number of products offered in a way that may not be justified by the additional benefits such complexity and choice bring to customers.

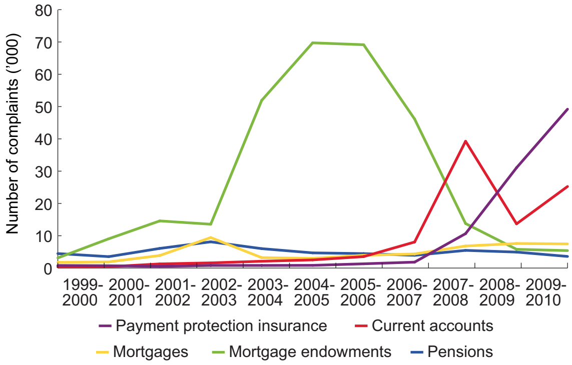
Systematic behavioural biases – This can lead consumers to make financial decisions that are not in their best interests. We explored these behavioural biases in our Consumer Research Paper 69: *Financial Capability: A Behavioural Economics Perspective*. They include the tendency to put off difficult decisions (procrastination), favouring short-term gains much more than long-term ones (hyperbolic discounting), placing more importance on potential losses than potential gains (loss aversion) and the desire to stick to current choices even when they are not beneficial to them (status quo bias).

Firms are often aware of these biases and may have an incentive to take advantage of them. For example, introductory bonus rates (i.e. attractive initial rates that change after a certain period of time) have continued to feature prominently in savings products[18] and are often displayed in the best-buy tables published in the media. These introductory offers often leave the onus on the customer to recognise when the offer ends and to take action to avoid receiving poor returns after the initial period.

All the above factors (information asymmetry, limited financial capability, systematic behavioural biases, and firms' responses to all these consumer characteristics) are behind many of the risks highlighted in this chapter.

18 Evidence quoted in the Defaqto 2010 Retail Banking report suggests that 16.8% of all instant or easy access accounts include an introductory bonus rate.

Figure 63: Financial products leading to new complaints to the ombudsman service



Source: Financial Ombudsman Service

2. Update on current issues

The following issues are examples of poor conduct we have seen in firms that resulted in consumer detriment. They were mentioned in the 2010 FRO and this section provides an update on them.

2.1 Complaints handling in major banks

The figure below shows how the Financial Ombudsman Service (the ombudsman service) has had to cope with waves of complaints over the last ten years (Figure 63). It is important that all firms have appropriate mechanisms in place to handle consumers' complaints fairly and ensure appropriate compensation is paid out to their customers.

Since September 2009 we have been publishing aggregate complaints data covering all firms.[19] Data for the first half of 2010[20] suggested, among other trends, an increase in the number of closed complaints, an increase in complaints relating to 'advising, selling and arranging', and total redress paid in the first half of 2010 increased by 43% to £406m.

In April 2010, we published our Review of Complaints Handling in Banking Groups. This review assessed several banking groups and found poor standards of complaints handling within most of the banks assessed. This was mainly due to weaknesses in banks' culture, particularly their governance arrangements, policies and controls. Five of the banks have agreed to make significant changes as a result of this review and two banks were referred to our Enforcement Division for further investigation of their complaints handling. The disciplinary outcome of one of these investigations have now been published.[21]

The change necessary in some banks requires sustained and rigorous effort from senior management, including formally embedding fair complaints handling within firms' governance structures. Our focus for 2011 is to undertake further intensive and intrusive assessments of the banks that remain a concern and we will not hesitate to take further regulatory action if sustained and timely improvements are not made. We will also use our analysis of complaints data to increase the wider supervisory focus on complaints handling.

19 In addition, in April 2010 new rules came into place requiring firms to publish their own complaints data every six months. We also publish consolidated firm-specific data, based on this material, enabling the performance of firms to be compared across their peer group.

20 A full commentary on H1 2010 data is available at: http://www.fsa.gov.uk/Pages/Library/Other_publications/commentary/aggregate_com/index.shtml

21 http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/003.shtml

In response to our findings, and evidence from other supervisory work, in September 2010 we published proposed changes to complaints handling rules in CP10/21.[22] We expect to publish a Policy Statement in this area in Q2 2011. As set out in the CP, we propose to:

- abolish the two-stage complaints handling process;
- require firms to identify a senior individual responsible for complaints handling; and
- set out how firms can meet existing requirements to undertake root cause analysis and have regard to decisions made by the ombudsman service.

We also propose increasing the ombudsman service's award limit to £150,000 to reflect its fall in real terms since the limit was last raised.

Regulated firms currently report to us that they receive around four million complaints from customers each year. New rules now require firms to publish their own complaints data. We published this firm-specific data for the first time in September 2010, enabling customers to compare and contrast the way firms deal with their complaints.

2.2 Unfair terms in mortgage contracts

A number of mortgage lenders have proposed, or taken, action in their standard mortgage contracts which is to the detriment of consumers. While firms may have prudential reasons for taking these actions, and may wish to balance the interests of savers and borrowers, they need to handle the whole process carefully to not breach FSA rules and principles (including Treating Customers Fairly) or the law.

Some firms are seeking to boost their revenues by including terms that move consumers from their discounted initial rate deal to the firms' Standard Variable Rate (SVR) in particular situations. We have come across firms using terms to change a consumer's mortgage to the firm's SVR if the consumer breaches any of the conditions of the mortgage, regardless of the significance of the breach. This could result in the consumer paying a significantly higher interest rate than they had originally expected.

We have seen some lenders use contractual terms including terms that demand immediate repayment of the mortgage if, in their opinion, the consumer's circumstances have only changed to a minor degree or the consumer has committed a minor breach of the terms and conditions of the mortgage. It would appear that such terms could give firms wide discretion to demand repayment of the mortgage, to the detriment of consumers.

To address these matters, we have published undertakings under the Unfair Terms in Consumer Contracts Regulations 1999 from firms agreeing not to apply such terms unfairly. We have also reminded firms with similar terms in their contracts of the messages contained in these undertakings.

2.3 Treatment of mortgage customers in arrears

As we showed in Chapter A, the combination of very low interest rates, an unemployment increase less than feared, and a fall in house prices less than some commentators had predicted has so far limited the impact of the financial crisis on homeowners. This has meant that after rising arrears and repossessions in 2008/9, numbers fell back slightly in the first half of 2010. Regulatory action to require appropriate forbearance has also had an effect.

22 CP10/21 *Consumer complaints: The ombudsman award limit and changes to complaints-handling rules*, September 2010, The ombudsman service and FSA.

While most mainstream lenders are treating customers in arrears fairly, we have seen a number of problems, primarily with specialist lenders. These problems include:

- **Unfair charges –** Information provided to customers on arrears charges is often unclear, charges are sometimes applied in circumstances that do not appear to be compatible with treating customers fairly, and there is little evidence that firms are ensuring arrears charges overall reflect the additional cost of administering these cases.
- **Inadequate controls in outsourcing arrangements –** Some lenders do not have adequate controls in place to ensure that, where they outsource arrears handling, the third party is treating customers fairly. Frontline staff in third party administrators (TPAs) often lacked the training and competence to deliver the fair customer outcomes required under MCOB 13, and TPAs' own oversight of their business was inadequate to detect and deal with the detriment customers suffered as a result.
- **Impaired credit lenders** are much more inclined than mainstream lenders to impose a 'one size fits all' policy and move swiftly to take possession, without establishing borrowers' individual circumstances. Their internal controls and training and competence arrangements are also noticeably less developed than those of mainstream lenders. There is anecdotal evidence that the terms of securitisation covenants are restricting their ability to treat customers in arrears fairly.

We have taken enforcement action against mortgage firms where we identified breaches in our rules or principles. Some of the lenders we visited more recently are taking steps to rectify earlier failings, in particular by collecting more information on customers' income and expenditure when they fall into arrears, and tailoring their response in each case to the individual's circumstances. But this is an area that will require continuing vigilance, particularly if there is a deterioration in the general economic environment or interest rates start to rise.

2.4 Payment Protection Insurance (PPI)

PPI mis-selling has been a significant issue in recent years, giving rise to consumer detriment, and has been covered in previous FROs.

Since we took over the regulation of PPI we have, amongst other things, carried out three thematic reviews and reports, issued warnings, visited over 200 firms and taken enforcement action against 24 firms. In addition, the PPI market was subject to a Competition Commission enquiry which began in 2007.

In August 2010, we published a Policy Statement, PS10/12, *The assessment and redress of PPI complaints*. This set out a package of measures designed to ensure that firms handle PPI complaints more fairly and consistently, and deliver fairer outcomes to customers who may have been mis-sold PPI but who have not complained.

The latest development is the judicial review of PS10/12, launched by the British Bankers' Association (with Nemo Personal Finance subsequently joining as an interested party) on 8 October 2010. This challenge was considered by the Administrative Court in late January 2011 and a decision will follow.

2.5 Sale and marketing of structured investment products

The interest in structured investment products remains high in the current low interest rate environment. Market volatility may also increase the number of consumers considering investing in structured investment products with features that offer some degree of capital protection.

Customers investing in structured investment products take on a number of risks, such as counterparty risk, inflation risk and market risk. The varying features of structured investment products, such as whether the product offers full or partial capital protection and the circumstances in which that protection does or does not operate, can be hard for consumers to understand. There is also the possibility that the cost of the product could outweigh the benefits, and that a consumer could be better served by a different product. Therefore, the quality of the design, marketing and distribution of structured investments is critically important, so customers are provided with products that:

- are promoted in a way that is clear, fair and not misleading; and
- meet their individual needs, circumstances and objectives.

As highlighted in the 2010 FRO, our review of the marketing literature and advice provided in the sale of Lehman-backed structured investment products found a number of failures. Some marketing material, for example, was deficient in its explanation of counterparty risk and made inappropriate use of terms such as ‘guaranteed’ or ‘protected’. Advice was found to be unsuitable in nearly half of the cases assessed (approximately 160), including recommendations that did not meet the customer’s attitude to risk (predominantly, exposing the customer to excessive levels of risk).

Firms should provide advice which is suitable for a customer’s individual needs, circumstances and objectives. Financial promotions for structured investment products should be fair, clear and not misleading.

2.6 Sale and marketing of structured deposits

Demand for structured deposits also increased significantly throughout 2010. Structured deposits have some similarities with structured investment products which offer 100% capital protection. In both cases, returns might be linked to the performance of one or more indices, securities or commodities. However, the mechanisms for delivering protection of capital are quite different. In the case of a structured deposit, the deposit-taking firm generally has an obligation to repay the depositor, while in the case of a structured investment product, the protection is usually provided by a third-party issuer of debt securities. More information on what is a structured deposit is provided in Box 2.

Box 2: What is a structured deposit?

FSA Handbook Definition:

A Structured Deposit is a deposit paid on terms under which any interest or premium will be paid, or is at risk, according to a formula which involves the performance of:

(a) an index (or combination of indices) (other than money market indices);

(b) a stock (or combination of stocks); or

(c) a commodity (or combination of commodities).

The fact that these are deposits means that:

- they should only be provided by a firm authorised to accept deposits;
- the capital invested is fully refunded by the deposit taker upon maturity;
- they have the potential to be wrapped in a Cash ISA (if available);
- the capital invested is generally protected through the FSCS.

The term of these products is normally between one and six years and penalties are commonly levied in the event of early withdrawal.

Structured Deposits are covered by the Banking Conduct Regime which includes Banking Conduct of Business Sourcebook and the FSA Principles.

Firms must ensure that descriptions of structured deposits in financial promotions are accurate and sufficiently clear for the average member of the promotion's target audience to understand. This may pose particular challenges where the basis for the return on the deposit is more complex. It is important that firms ensure any statements about compensation arrangements in their financial promotions for structured deposits are accurate. We recognise that this can be particularly challenging in the case of some structures involving a number of firms. However, consumers may be covered in different ways at different points in the chain (or not at all). We have identified a number of instances in which individual structured deposit customers would not have been covered by the FSCS in the event of a default by the deposit-taking firm because of the way in which the deposit was set up. Although some structured deposits are very simple, we have seen examples of others that were either inherently complicated or described in a way that made them appear so.

3. Emerging risks

The following issues have been categorised as emerging. As explained in the introduction, these are risks where we have evidence of poor conduct in firms but little or no evidence yet of widespread consumer detriment. However, we believe these issues could grow.

3.1 Responses to the banking conduct regime

We introduced a new regulatory regime for retail banking in November 2009 that took over from the voluntary, self-regulatory Banking Code. This new regime comprised:

- the Banking Conduct of Business sourcebook;
- the Principles for Businesses; and
- the Payment Services Regulations.

Our early reviews of compliance with the new Banking Conduct Regime (BCR) suggest that many banks and building societies have widespread disengagement with the new standards.

For example, poor conduct has been found in the area of refunding unauthorised transactions. Firms are required to immediately refund customers who have had debits charged to their account without their authority. The burden of proof, in the event of dispute, is on firms. If firms have prima facie evidence that the consumer did authorise a transaction, or evidence to suggest either fraud or deliberate or grossly negligent behaviour by the consumer (in relation to keeping their security details safe), then they can take reasonable time to investigate before refunding. Use of, for example, card and PIN is not, of itself, sufficient to prove customer liability. Earlier this year we found that contractual terms and conditions were often non-compliant, that disputed transactions were not being refunded immediately, and that there was not always an adequate justification for refusing to refund claims.

We received an assurance from firms with deficient processes that they had revised their terms and conditions and supporting processes. Further testing will continue to take place to check that they are complying.

It is important that firms fully comply with the BCR – customers have a right to receive the specified levels of service. A culture change is needed in firms. We will consider taking regulatory action where we find non-compliance with the BCR.

3.2 Transition to the RDR implementation

As mentioned in Chapter A, the RDR will require both adviser and provider firms to change their business models, in response to the new adviser charging regime and new qualification requirements. Later in this chapter we discuss the potential risks associated with changes in firms' business models triggered by the RDR. In this section we focus on emerging risks as firms prepare for the RDR implementation.

Firms may seek to maximise their recurring revenue stream before the RDR is implemented to facilitate their transition to the RDR. In some cases firms may do this in ways that produce poor outcomes for consumers.

For example, some providers may seek to use the period before the RDR is implemented to acquire market share by offering large commissions to adviser firms, which could result in unnecessary churn in the retail investment market and excessive costs for consumers. Where owners of firms are planning to leave the market and are looking to sell their businesses, there is a risk that, in an attempt to build up their book to increase the attractiveness of the firm, they increase income through selling significant amounts of commission-based products. Other firms may look to increase the amount of trail commission on their books, as a way of cushioning the removal of commission on new business carried out post-implementation at the end of 2012.

Commission levels in some areas of investment advice remain high. For example, recent data collected and analysed by the FSA on commissions paid on investment bonds (i.e. single premium life assurance-based investments typically offering nominal life cover to the investor) show that commission on bonds remains consistently higher than that taken on comparable investments. High commission levels do not always mean poor value for customers – and advisers may pass some of the commission offered by firms on to customers – but it can, with other factors, be responsible for commission-driven selling.

Figure 64: High-level structure of a platform

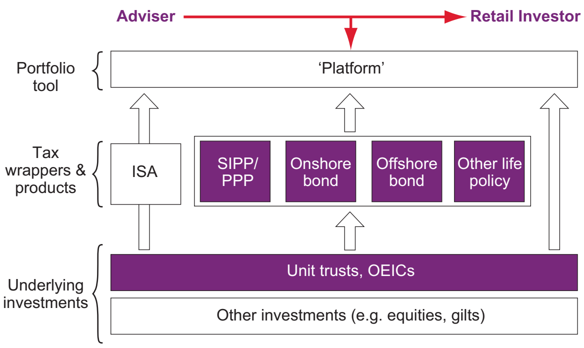
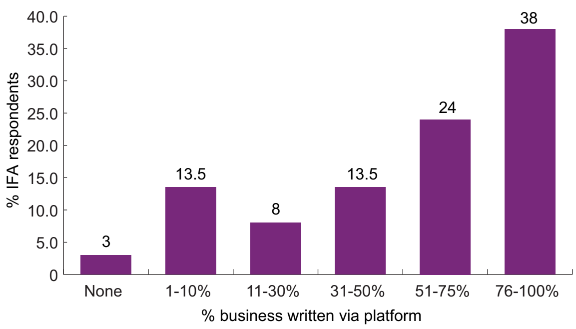


Figure 65: Percentage investment business written via a platform



Source: Defaqto Platform Report, March 2010

We have heightened our supervisory vigilance in this area and will continue to intervene where we believe high commission levels may be contributing to poor outcomes for consumers.

3.3 Systems and controls weaknesses in the network model

With current economic conditions proving extremely challenging for many firms, a number of networks are under considerable strain, with continuing pressure on income and low levels of profitability. In addition, supervisory activity with networks of various sizes continues to reveal significant issues with the control and oversight that networks exert over their appointed representatives, including monitoring procedures, levels of compliance resource and standards of due diligence carried out on incoming appointed representatives.

There is a risk that the sustainability and control problems we have observed will increase as firms and advisers prepare to implement the RDR. Several networks, in developing their strategic response to the RDR, are considering rapid expansion of adviser numbers. This will create further strain on the compliance functions that will need to ensure that robust processes and due diligence are in place when recruiting new appointed representatives. Many firms are also targeting substantial increases in product sales and are placing greater emphasis on moving into new product areas. It is not clear to us that either of these strategies are achievable on a wide scale across the market, particularly in the current economic environment and while ensuring firms meet their conduct responsibilities.

3.4 Use of platforms

As mentioned in Chapter A and in the previous section, firms are responding to regulatory changes like the RDR by changing their business models and strategies. In particular, many investment advisory firms are in the process of transitioning their business model towards offering a centralised investment proposition in preparation for the RDR.[23] In many cases this involves offering portfolio advice services facilitated by platforms.

Platforms are online service tools used by investment intermediaries (and sometimes end consumers) to view and administer their clients' investment portfolios.

23 This section focuses on risks associated with platforms. Later in this chapter we consider the risks associated with the transition of many advisory firms toward offering portfolio advice services.

There are different types of platforms depending on the range of products available, the nature of charging for the service, and the flow of money between product providers, platform services operators and adviser. Figure 64 illustrates the high-level structure of a platform.

Platforms now administer about £135bn in IFA assets, and about half of all new retail fund investment business is placed through platforms. They have an increasing importance in investment advisers' business models. For example, in Defaqto's 2010 IFA Platforms Survey, almost 40% of the advisers surveyed currently administer more than 75% of their business through a platform (Figure 65).

Platforms can bring benefits for consumers (e.g. having all their financial assets in one place) and especially firms (e.g. lower administrative costs), but not without some risks. In March 2010 we published the findings of our thematic review[24], assessing the quality of advice when recommending investments held on platforms, along with a good and poor practice report.

Our review found the quality of advice in relation to investments using platforms was mixed. Several firms had successfully integrated platforms into their businesses while consistently offering advice in the client's best interests. However, most firms were in the process of transitioning towards offering portfolio advice services and making changes in light of the RDR, but none had explicitly reviewed their oversight and risk management procedures in light of the changes to their business models and services to clients. Also, the disclosure of ongoing services was poor in most firms with, commonly, contradictions between the firm's terms of business and the suitability report regarding ongoing services to be provided.

This resulted in one firm being fined and two firms being required to undertake a past business review of investment advice using platforms.

Platform-related risks that we are monitoring include the following:

- Advisers may not adequately consider the suitability of the overall investment 'solution' (product, funds, platform and advisory services) for individual customers, instead adopting a 'one size fits all' approach;
- Firms may not adequately manage conflicts of interest in using platforms;
- Independent advisers may consider the platform as the default option and inadequately consider the whole of the market when advising individual clients. This risks unsuitable advice when a different product would have been in the client's best interests.
- Disclosure standards adopted by platform services operators, particularly regarding information on charges, may not always provide a clear or complete description of the total costs involved. A review of the disclosure documents provided by platform operators highlighted several shortcomings including a general lack of transparency around the presentation of charges.

In November 2010 we published a Consultation Paper[25] on platforms with proposals to ensure that the platforms services used to buy and manage investments after January 2013 are fully aligned with standards required by the RDR. The main proposals were to:

---

24 *Investment advice and platforms: Project findings*, March 2010, FSA.
See http://www.fsa.gov.uk/Pages/Library/Other_publications/platform_thematic_review/index.shtml

25 CP10/29, *Platforms: Delivering the RDR and other issues for platforms and nominee-related services*, November 2010, FSA.
http://www.fsa.gov.uk/pages/Library/Policy/CP/2010/10_29.shtml

- prevent product providers from making payments that advisers could use to disguise the charge the customer is paying for advice;
- ensure platforms allow their customers to transfer their investments elsewhere without having to cash them in first;
- require platforms to be upfront about the income they receive from fund managers or product providers;
- ensure that customers who invest in funds through platforms are provided with information about the fund from fund managers, and maintain their voting rights.

We shall continue to monitor developments in this market, assess the results of our supervisory activity in this area and consider whether further regulatory action is required.

Firms should not place investments on a platform where this is not in a client's best interests. They should consider the suitability of platform-based services for individual customers and recommend suitable products, whether or not they are available on a platform. Firms should ensure the oversight and risk management arrangements of their business are fit for purpose, for example in light of a change in their business model.

3.5 Portfolio advice services, discretionary portfolio management and advice on Distributor Influenced Funds

In Chapter A and in this chapter we have highlighted how firms are considering changing their business models in response to the RDR. In particular, we have seen how investment advisory firms are in the process of transitioning their business model in preparation for the RDR. In many cases this has resulted in firms adopting centralised investment propositions such as portfolio advice services (facilitated by platforms), using Distributor Influenced Funds (DIFs) or creating other ties with discretionary investment managers. All these changes are likely to be driven by firms' intentions to create additional value for their clients to justify adviser charging (particularly ongoing charges) after the RDR is introduced, but they may pose specific risks for investors.

Portfolio advice services are investment advice services provided on an ongoing basis, which typically involve recommending a range of investments to meet an asset allocation and reviewing this on a periodic basis, but that do not amount to discretionary portfolio management. As highlighted in our April 2010 update[26] on the quality of pension switching advice and in the March 2010 thematic review on investment advice and platforms[27], we have found evidence of a number of risks associated with providing these services:

- firms' systems and controls and monitoring procedures may not be updated appropriately where advisory firms develop portfolio advice services as opposed to transactional product sales;
- advisers may not have adequate competence to offer these services; and
- the additional costs of portfolio advice services may not be justified for the particular customer and may, therefore, lead to unsuitable advice being provided.

DIFs are funds typically structured as Open Ended Investment Companies, (OEICs) where the distributor (usually an adviser firm) exerts a measure of control over the fund design and management. We believe there are at least 40 firms offering DIFs to their customers, and the

26 *Quality of advice on pension switching: an update*, April 2010, FSA. See http://www.fsa.gov.uk/pubs/other/pensions_switch_update.pdf
27 *Investment advice and platforms: Project findings*, March 2010, FSA. http://www.fsa.gov.uk/pubs/other/iap_findings.pdf

market is growing. There are around £2bn of assets under management in DIFs in the UK, and over 10,000 customers have assets invested.

There are a number of reasons why adviser firms may want to exert control over funds, including reducing administration costs for the firm and increasing the value of the adviser firm. However, the possible administrative savings from DIFs might be more to the benefit of firms than customers (as DIFs generally carry high charges). They also give rise to concerns around the management of conflicts of interest. Put simply, independent adviser firms with DIFs generally have a direct financial interest in the product on which they provide advice.

The key risks associated with DIFs are:

- conflict of interest – between the incentive the advisory firm has to recommend DIFs and the requirement the firm has to ensure any advice is in the client's best interest; and
- complexity and levels of charges – it is often difficult for customers to tell what part of the service they are being charged for, and what is the value of that service and whether the fund actually offers good value for money.

As explained in Policy Statement 10/06[28], the approach we have adopted on substitutable products in our final RDR rules and guidance means that an adviser will not be able to adopt higher adviser charges for recommending DIFs and similar products, than for recommending other competing products such as third-party Collective Investment Schemes. The rules also prevent them from receiving any payment other than through adviser charges, for example for acting as a member of the governance committee of a DIF. In addition, our current rules are already clear that a DIF can only be recommended where it is suitable for, and in the best interests of, the particular client.

In our ongoing supervision of firms, we have looked at files where DIFs have been recommended. Results have been mixed, with too much advice showing signs of unsuitability or a lack of key information on which to form a final assessment about the suitability of advice. Firms with DIFs should understand that we have concerns over this market and we would expect them to pay particularly close attention to sales processes here and the quality of their advice, including their obligations under the client's best interests rule. We continue to monitor this market and expect standards to improve. If not, we may need to intervene to ensure customers receive the right outcomes.

Other services exhibiting similar issues are also appearing in the market. For example, several distributors have created ties with discretionary investment managers in which the distributor has some say in the investment strategy and receives some remuneration for ongoing governance. Firms should consider their obligations to manage conflicts of interest and conduct sales in accordance with our rules.

We have heightened our supervisory vigilance in this area as in other areas where the business model of firms is changing following the RDR implementation discussed above. We will continue to intervene where we believe these changes in the business models of firms may be contributing to poor outcomes for consumers. Firms should ensure they effectively manage the conflicts of interest and have adequate controls in place.

28 PS10/06, *Distribution of retail investments: Delivering the RDR – feedback to CP09/18 and final rules*, March 2010, FSA. http://www.fsa.gov.uk/pubs/policy/ps10_06.pdf

3.6 Firms' reward policies and practices

While the RDR has focused on tackling the potential for bias driven by commission being paid to firms, we also recognise the importance of the reward and remuneration of individuals within firms. Especially in the current environment, given the pressures in different sectors described in Chapter A, firms may consider using their reward policies to achieve specific targets in their strategies. An individual's reward may include financial and non-financial incentives and disincentives, such as salary, bonus and commission, gifts, opportunities for promotion, and may be affected by targets and performance management.

We recognise that firms need to incentivise staff to grow the business and increase profits but we expect firms to effectively control the risks such incentives may pose to consumers. Firms could either fail to identify the influence of incentive schemes on the behaviour of staff and hence the risks to the delivery of fair consumer outcomes, or not put effective controls in place to mitigate these risks.

We expect firms to treat their customers fairly, which includes managing the risks associated with reward. We identified reward as a key driver of consumer outcomes in our Treating Customers Fairly (TCF) culture framework.[29]

Recent thematic work has identified potential risks to consumers arising from the remuneration policies and practices of firms. We expect firms to ensure that they comply with our existing standards when designing their remuneration polices and practices. We have previously taken enforcement action in a number of cases where remuneration arrangements have been referred to as part of the action. For example we have taken action in relation to PPI sales failings relating to the use of high pressure sales tactics.

We are currently examining reward structures for firms' in-house sales staff, focusing on tied sales forces, to understand sales incentives firms use and assess whether they increase the risk of mis-selling and whether any such risks are adequately controlled. We will communicate our findings later in 2011.

This focus on remuneration is a core element of our broader efforts to mitigate risks associated with remuneration, which can be a powerful driver of unfair outcomes for consumers. The RDR rules on commission payment by product providers are one example of this, and another example (although principally concerned with the risks posed by remuneration practices to financial stability and prudential soundness) is our revised Remuneration Code. This seeks to ensure that remuneration policies, practices and procedures for firms are consistent with, and promote, effective risk management and include measures to avoid conflicts of interest.

3.7 Investment risk profiling

As discussed in Chapter A, the risks around investment advice could become more acute in an environment where some customers are seeking potentially incompatible combinations of high return and low risk.

Our thematic and supervisory work suggests that ineffective customer risk profiling is a problem across different firms giving investment advice and is an important driver of unsuitable advice across different firms and product areas. Of the investment files assessed by us as unsuitable between March 2008 and September 2010, half were unsuitable because the

29 *Treating customers fairly – culture*, July 2007, FSA. http://www.fsa.gov.uk/pubs/other/tcf_culture.pdf

investment selection failed to meet the risk a customer is willing and able to take. We have taken, and continue to take, tough action to address these failings with individual firms.

On 7 January 2011 we published a guidance consultation on *Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*.[30] This consultation considers:

- how firms establish and check the level of investment risk that retail customers are willing and able to take (in the wider context of the overall suitability assessment);
- the potential causes of failures to provide investment selections that are appropriate to the customer; and
- the role played by risk-profiling and asset-allocation tools, as well as the providers of these tools.

As we stated in this guidance consultation, 'Poor outcomes can occur if firms:

- fail to collect and account for all information… for example because they:
  - fail to assess a customer's capacity for loss;
  - do not have a robust process to identify customers that are best suited to placing their money in cash deposits because they are unwilling or unable to accept the risk of loss of capital;
  - use poor questions and answers to establish the risk a customer is willing and able to take;
  - inappropriately interpret customer responses to questions (particularly where firms rely on tools with sensitive scoring or attribute inappropriate weighting to answers); or
- use vague, unclear or misleading descriptions or illustrations to check the risk that a customer is willing and able to take.'

The purpose of the proposed guidance in this consultation is to help firms improve the standards by which they are providing investment advice or discretionary management services to retail customers. We expect firms to consider the outcome of this guidance consultation and act appropriately.

3.8 With-profits funds operation

As discussed in Chapter A, the recent recession saw falling asset values (some of which have been recovered), widening bond spreads and low interest rates. These pose significant challenges to firms offering defined or partially defined liability products, such as with-profits policies. With-profits providers have to balance maintaining adequate solvency levels with giving their consumers a fair deal.

With-profits products still represent a significant portion of the savings market in the UK. At the end of 2009, they represented £330bn of assets under management, compared to a total of approximately £1,800bn of funds held in life and pension schemes (excluding £450bn in insurer-administered occupational pensions). With-profits products are commonly used for pensions and other investments.

30 Guidance Consultation 11/01, *Proposed guidance on Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection*, January 2011, FSA. http://www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_01.shtml

Complexity in their operation, lack of transparency and potential conflict of interests inherent in the provision of with-profits products can sometimes make it difficult for consumers to fully understand these products and their features, increasing the risk that they may not meet their needs and expectations.

In 2010, we carried out a review[31] of how senior management in firms have implemented the current regulatory regime for with-profits, which has been in place since 2005, and in particular whether firms are appropriately managing their commitments to their with-profits policyholders and treating them fairly.

We assessed 17 firms, which represented approximately 80% of the with-profits market by assets.

We found that the majority of firms did not demonstrate that their practices were consistent with well run with-profits businesses in one or more areas that we assessed, potentially exposing a very significant number of with-profits policyholders to risk. Our two main areas of concern were:

- ineffective governance of with-profits funds, especially in how independent challenge is provided by firms' with-profits committees (or independent persons), which means that policyholders' interests may not be properly protected; and
- significant weaknesses in the quality of consumer communications – we were not satisfied that all firms are doing enough to ensure that policyholders receive sufficiently comprehensive, timely and clear information to help them understand their policies.

As a result of the review, firms have been directed to make immediate changes to their practices across the operation of with-profits funds to better protect policyholders' interests, in particular to improve governance arrangements and post-sale policyholder communication. We will be monitoring firms' responses closely, and will consider disciplinary action if firms do not address the concerns. Two firms have been referred to our Enforcement Division for further investigation.

The review also found that some aspects of the rules around with-profits could be further strengthened to provide greater protection for policyholders. This will be the subject of further policy work and we will set out any proposed changes in a Consultation Paper in 2011.

3.9 Increasing popularity of complex investment products

In Chapter A we mentioned how some relatively new investment products, which are growing in popularity among investors, may be evolving in ways that increase their design complexity and reduce consumers' understanding of their risks. We discuss how these products are evolving, and what is driving increased complexity below.

3.9.1 Traded life policy investments

In Chapter A we highlighted the possible reactions of consumers to low interest rates and equity volatility. In this environment, consumers may consider products that promise to offer higher yields which are relatively uncorrelated to equity market volatility. Firms have responded to the requirements of these investors by designing and offering increasingly

31 *With-profits regime review report*, June 2010, FSA. http://www.fsa.gov.uk/pubs/other/withprofits_report.pdf

complex products aiming to achieve the desired returns, and in some cases have drawn on the product innovation experience in other countries.

Traded Life Policy Investments (TLPIs) are pooled investments that have US life insurance policies as their main underlying asset – otherwise known as senior life or viatical settlements – sold on the secondary market. TLPIs are complex products that can take the form of unregulated collective investments. TLPIs are frequently marketed on the basis that they have no correlation with other asset classes, particularly equities. The risk of any particular TLPI will depend on that product's particular features. The key risks to a customer's capital present in typical TLPIs include:

- actuarial risk – the TLPI is reliant on actuarial values when acquiring the underlying life policies, which may prove unreliable;
- premium payment/life expectancy risk – the life insured may live longer than expected, resulting in the TLPI needing to pay more premiums;
- market risk – there may not be a properly functioning tertiary market for valuation purposes or into which the issuer can re-sell life policies to raise funds; and
- jurisdiction risk – including currency exchange rate and limited application of FSCS coverage or alternative compensation arrangements.

These products also appear to have levels of commission (paid by the provider to the distributor) and fees (paid by the customer e.g. on the basis of the fund performance) that are relatively high compared to other products.

The fact that the return on these products is not correlated to stock market volatility makes them appear quite appealing to investors. Nevertheless, in many instances these products involve a significant risk compared to mainstream investment products. We consider they are unlikely to be suitable for a majority of retail clients, in particular:

- those whose financial situation and investment objectives call for little risk of significant loss of capital or income;
- those who may need to realise their investments quickly; and
- where the recommendation does not result in the customer having a well diversified portfolio.

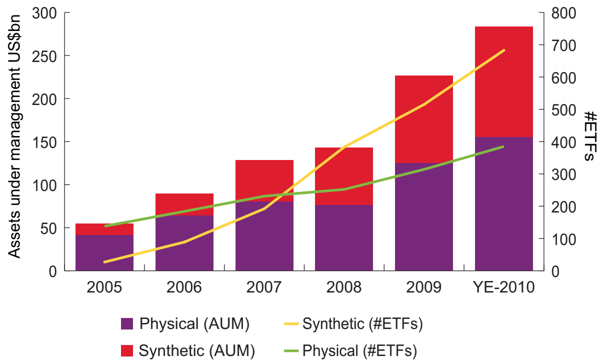
Figures from some providers suggest that in 2009, TLPI accounted for approximately £2bn of assets under management, although a robust estimate of the size of this market is not available. Regulatory action in the UK, coupled with negative press following FSA intervention[32] and the collapse of structured product provider Keydata with its exposure to traded life settlement bonds, is likely to have reduced the size of the UK market, at least for some providers.

3.9.2 Exchange Traded Funds (ETFs) and other exchange traded products

We have some concerns about ETFs, a product that has grown in popularity among retail investors in recent years and has rapidly changed in its complexity.

32 See speech by Peter Smith at the European Life Settlement Association in February 2010, available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0224_ps.shtml

Figure 66: European ETF growth: physical and synthetic replication



Source: ETF Landscape, Industry Review, Year End 2010, BlackRock

An ETF is an open-ended fund, listed on an exchange, which tracks a basket of securities, usually an index or a benchmark. They started as a quite simple product, first developed as a means of tracking equity and bond index returns with the added advantages of lower fees and real-time, all-day pricing and liquidity (because they are traded on exchanges) compared to traditional index-tracking funds.

Over time, there has been a large expansion of ETFs both in terms of scope – there are now ETFs available to cover a wide range of geographic and sectoral equity and bond indices – and complexity. Examples of the different types of ETFs include leveraged ETFs, inverse ETFs and ETFs with active rather than passive stock management – which all may present different risks to the investor.

There are other types of vehicles listed on UK exchanges, such as Exchange Traded Notes (ETNs), including Exchange Traded Commodities (ETCs), that may be sometimes marketed and perceived by investors as being equivalent to ETFs. ETNs take the form of asset-backed bonds issued by companies listed in tax efficient jurisdictions in the EU. Like ETFs, ETNs offer exposure to a wide range of asset classes via an exchange-traded instrument. ETCs are a subset of ETNs that are most prominent, and that typically invest or seek to replicate investment in a commodity, e.g. gold.

There are two ways in which ETFs and other exchange traded products can provide investors with the underlying index returns:

- Physical replication – market exposure is obtained by buying all or a sample of the index constituents in appropriate proportions.
- Synthetic or swap-based replication – market exposure is obtained by entering into a swap transaction with a counterparty who agrees to pay to the fund the return generated by the assets tracked by the fund. This introduces additional counterparty risk for the end customer.

Figure 66 illustrates the progressive growth of ETFs and the growing proportion of these products designed on a swap basis.

At the end of 2010 the market capitalisation of LSE-listed ETFs was approximately US $66.7bn.[33] If Europe follows the US experience, retail investors may adopt ETFs as

33 ETF Landscape, Industry Highlights, Year End 2010, BlackRock.

standard portfolio holdings. In the UK, the implementation of the Retail Distribution Review (RDR) may also lead to wider adoption of ETFs, by removing commission bias from investment advice, which may indirectly increase the promotion of ETFs.

Since the complexity of ETFs has changed quite quickly and materially it is not clear that retail investors fully understand their underlying risks. In addition, complex ETFs are relatively new products for many retail investors and their advisers. This lack of familiarity could exacerbate the products' risks. As with any other product, we would remind consumers and their advisers to fully consider and understand the risks posed by investing in a particular ETF before investing.

Counterparty and collateral risk is one of the more important risks relating to ETFs and other exchange traded products.[34] Potential conflicts of interest may also arise in how these products are structured.

In addition, many of the funds underlying ETFs listed in London are domiciled elsewhere in the EU, usually Ireland or Luxembourg. As such, those ETFs are primarily supervised and covered by the relevant investor protection and compensation schemes of their country of domicile, which may differ from the protections offered in the UK. There is the risk that retail investors may not always be aware of these differences where they exist.

We are concerned that marketing and promotional material for complex ETFs or other exchange-traded products directed at retail investors may not always adequately reflect all the various risks inherent in these products.

We have heightened our supervisory vigilance in this area and will intervene where we believe the sale of complex ETFs or other exchange-traded products is contributing to poor outcomes for consumers.

3.9.3 Self-invested personal pensions

Self-invested personal pensions (SIPPs) started life as a niche up-market product but have grown in popularity among investors in recent years.

SIPPs are a form of personal pension plan that can give people saving for their retirement more control over where their money is invested than conventional managed personal pensions. Investors have greater choice to decide in what funds or assets to invest and can change them when they wish, usually incurring a dealing charge.

SIPPs come in different forms. Some offer access to a limited number of investments, generally funds and shares and have relatively low costs. Other SIPPs offer the option of access to a broad range of assets and investments including, for example, commercial property and unquoted shares. However, the range and nature of investment types available within these SIPPs means they can be significantly more expensive.

When purchasing a SIPP there are a number of things consumers should consider including: the cost of the products compared to alternatives; the match between the underlying investments and their attitude to risk; and whether they intend to use the additional flexibility offered by the SIPP.

34 It should be noted that not all risks are common to all Exchange Traded Products – e.g. the investment risks in ETFs are different to those in ETCs/ETNs, and the counterparty risks may also be different, given that UCITS underlying ETFs have to comply with UCITS requirements.

SIPPs also present risks at a more operational level. Some of these risks were highlighted in the thematic review[35] we conducted in 2009 on small SIPP operators. Examples of the issues identified in this area include:

- problems with firms' systems and controls, including a lack of robust procedures for carrying out important functions like reconciliations of SIPP member bank accounts with the firm's SIPP provider, annual valuation of members' assets and retaining proof of title of clients' investments; and
- potential conflicts of interest where the SIPP operator has permission to give advice on SIPPs as well as to administer them.

SIPPs have also been used by some advisers as wrappers for exotic, risky and potentially poor value unregulated products, such as Unregulated Collective Investment Schemes (UCIS). In our July 2010 review of the sale of UCIS, nearly half of all UCIS sales considered were within SIPP wrappers. This may be because the advisers mistakenly believed that some of restrictions on marketing UCIS to retail customers do not apply if the UCIS is placed within a SIPP. We have warned advisers about this, but consumers should take great care when considering placing exotic products and funds in their SIPP.

3.10 Unregulated collective investment schemes (UCIS)

The search for yield in some consumer segments discussed in Chapter A may be one of the drivers for the increasing popularity of UCIS[36] among investors. UCIS are an area of growing concern for us as evidence is emerging that they are increasingly being sold to customers who are not eligible or appropriate for this type of investment.

UCIS are described as unregulated because they are not subject to the same restrictions as regulated Collective Investment Schemes (CIS), e.g. in terms of their investment limitations and how they are run. UCIS can invest in assets that would in many cases not qualify for investment within a regulated fund (for example, because they are riskier, less liquid or difficult to value). Some of the exotic funds we have seen include geared emerging market property, luxury and consumable goods, and various renewable energy schemes.

UCIS cannot be promoted to the general public, but can be marketed and sold in specific circumstances. Although the schemes themselves are not authorised or recognised, persons carrying on regulated activities in the UK in relation to UCIS (including providing personal recommendations, arranging deals and establishing, operating and managing schemes) will be subject to FSA regulation. However, customers may not be covered by the ombudsman service or the FSCS.

The risks associated with such funds are not always easy for advisers and consumers to understand. In addition, the governance arrangements and financial structure of the schemes may themselves cause risks for investors. UCIS are frequently structured in a way that is different from regulated CIS. Unlike regulated CIS, UCIS may not be subject to investment and borrowing restrictions aimed at ensuring a prudent spread of risk. As a result they are more generally considered to be a higher-risk investment.

35 http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/sipp_report.pdf
36 UCIS should not be confused with 'UCITS', which are a type of authorised collective investment scheme that comply with a European Union Directive and can be marketed across the EU.

The unregulated nature of these products makes it difficult to gauge the impact within the UK, but our interaction with firms in this segment suggest estimates in the billions for UCIS promoted to UK investors directly and via IFAs and platforms.

Our key concerns are that:

- investment managers, often operating within opaque offshore structures, are advising on and managing UCIS sometimes without due regard for whether products end up in the portfolios of the wrong customers or the long-term effects on the end client;
- intermediaries are promoting UCIS to retail clients without explicit regard to statutory restrictions on such activities;
- UCIS are promoted to customers who are not eligible for this type of investment and intermediaries lack understanding of individual UCIS and what they invest in; and
- consumers are receiving unsuitable advice to invest in UCIS even when provision of such advice is permitted.

In light of these issues, we recently undertook a thematic project on the promotion and advice processes for the sale of UCIS.[37] This project found a widespread lack of awareness on the part of firms, both investment managers and advisers, of the statutory restrictions on the promotion of UCIS to the general public. We have produced a good and poor practice report[38] to help firms understand our expectations when introducing UCIS to their advice process and plan some further work in this area later this year.

Firms should not inappropriately promote UCIS investment to retail investors. Sale of UCIS is a regulated activity, so normal suitability and appropriateness requirements and the best interest rule apply. While we often do not have regulatory jurisdiction over the content of UCIS structure, it is important that where we do, the design of these products does not create inappropriate risks for investors.

4. Potential concerns

In this section we consider risks that might emerge in the future, given the macroeconomic trends that may influence firm and consumer behaviour. We expect firms to consider these issues to avoid consumer detriment. We will use this analysis to help focus our supervisory activity on areas of potential future concern.

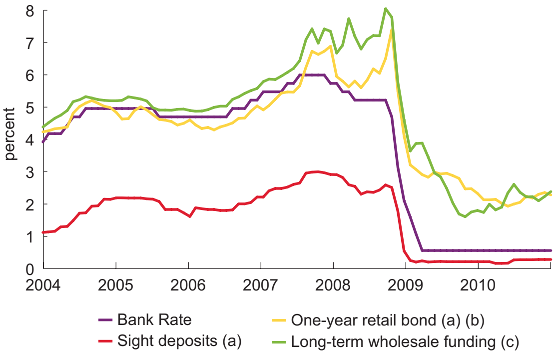
4.1 Fee income generation in banking

As we discussed in Chapter A, the crisis has materially changed the profile of mortgage profitability, with pressures coming from the relatively high cost of wholesale and retail funding relative to the Bank Rate and falling returns on the mortgage back book (Figures 67 and 68). In addition, traditional sources of non-interest income, such as PPI, have gradually disappeared or materially reduced, largely the result of regulatory intervention (Figure 69).

In light of these combined pressures and historical sources of fee income, banks are developing their strategies to find new sources of non-interest income. This section analyses these strategies, and discusses where firms may generate poor outcomes for consumers by pursuing such strategies in a way that does not sufficiently take into account their customers' needs.

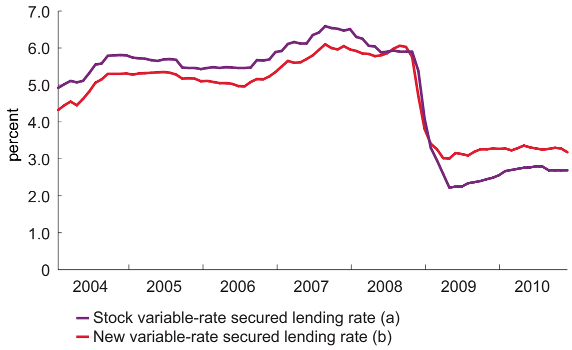
37 *Unregulated Collective Investment Schemes: Project Findings*, July 2010, FSA. http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/findings.pdf
38 *Unregulated Collective Investment Schemes: Good and poor practice report*, July 2010, FSA. http://www.fsa.gov.uk/smallfirms/your_firm_type/financial/pdf/ucis_report.pdf

Figure 67: Cost of different funding instruments
(repeated from Figure 31)



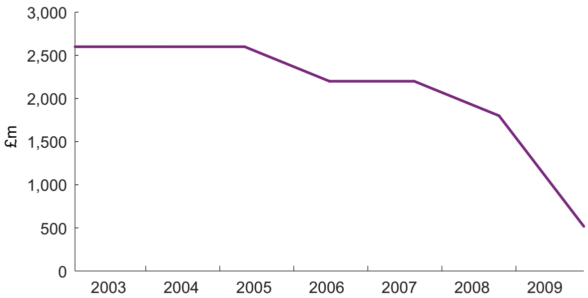
Source: Bank of England, Bloomberg, BBA, Markit and Bank of England calculations
Note: (a) The sight deposit and one-year retail bond rates are weighted averages of rates from banks and building societies. (b) The one-year retail bond rate is the cost of a floating-rate one-year retail deposit, i.e. the cost of a one-year fixed-rate bond net of a one-year interest rate swap. (c) The long-term wholesale funding cost is proxied by the sum of 3-month LIBOR plus an average of the 5-year CDS premia for the major lenders.

Figure 68: Divergence in lending rates to households
(repeated from Figure 20)



Source: Bank of England
Note: (a) The stock lending rate is the effective secured lending rate prevailing on all loans on lenders' balance sheets. (b) The new lending rate is the effective secured lending rate prevailing on new lending each month.

Figure 69: Distribution income from PPI
(repeated from Figure 36)



Sources: Competition Commission

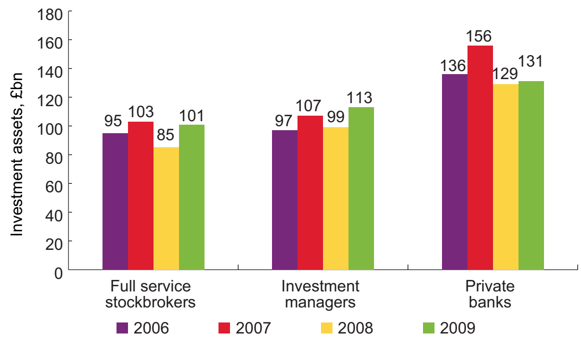
These strategic areas have been identified using our regular analysis of firms' strategies and business models. While we have classified this as a potential concern, evidence of misconduct is starting to emerge from some firms in some of these areas, although not yet in a widespread, systemic way.

4.1.1 Private banking and wealth management

Many banks sell wealth management products and services to retail customers, both through retail banking and their private banking arms. Private banking clients usually have access to a wider range of products and have a more customised service, but some of these products are also more complex. According to data from Compeer and Mintel, the value of investment assets held in 2009 by private banks was £131bn (Figure 70), and the sector generated a total of around £1,867m in revenue (Figure 71).

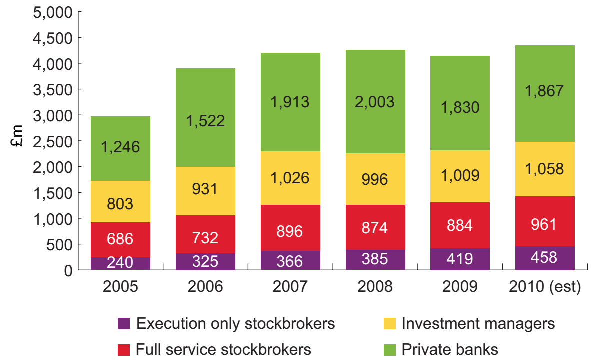
Private banking revenues have suffered during the crisis, due to the diminished wealth of high net worth individuals, the decline in interest income due to the Bank Rate cuts, and a considerable decline (24%) in fees and commissions related to one-off sales of investment products including in-house or third-party investment products such as structured products, Venture Capital Trusts (VCTs) or hedge funds. Sales of structured products may have been particularly affected by regulatory intervention on these products (see Section 2.5).

Figure 70: Value of investment by firm type



Source: ComPeer UK Wealth Management Industry Report

Figure 71: Revenue by firm type



Source: ComPeer UK Wealth Management Industry Report

However, there are recent signs that banks with wealth management functions are considering measures to increase the contribution these arms make to the overall business.

There are a number of potential incentives for banks to increase wealth management's contribution to income streams. While only a minority of the UK population have enough investible assets to be eligible for private banking and wealth management services, there is a relatively substantial number of consumers with investible assets valued at £50,000 or more (Mass Affluent and Affluent groups) that could be targeted by high street banks offering lower-tier private banking and asset management services (Figure 72).

Figures 72 – Distribution of investible assets among UK population, 2010

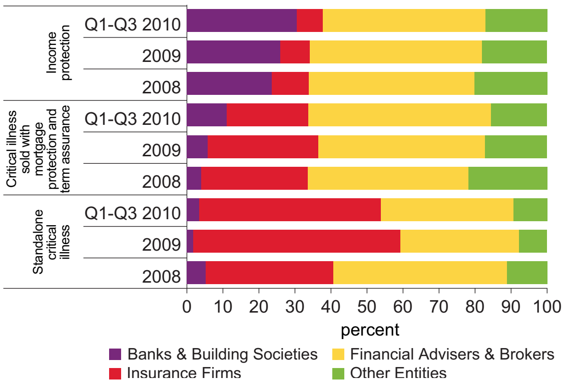
	Investible assets	% of adult pop. aged 21+	Number ('000)*	Type of advice sought
HNW^	£500K+	0.9	421	– detailed financial planning, tax issues, asset management & wealth preservation
Ultra Affluent^	£250K-499.9K	2.0	935	– financial planning – direct equity investment
Affluent	£100K-249.9K	4.8	2,243	– financial planning – investment
Sub-total	**£100K**	**7.7**	**3,598**	
Mass Affluent	£50K-99.9K	4.9	2,290	– general investment & retirement planning
Aspirational	£30K-49.9K	6.2	2,897	– general investment & retirement planning
Total	**£30K+**	**18.8**	**8.786**	

Source: Mintel estimates based on IPSOS MORI Survey and ONS Population statistics
Notes:
*Based on GAD population data of 46.7 million adults aged 21+
^Due to low sample sizes the number of ultra affluent and HNW individuals is not precise. These figures are presented as a guide and are not definitive.

In addition, some wealth management business may not be as capital intensive as other banking business lines, and usually does not require the same level of investment in systems and technology.

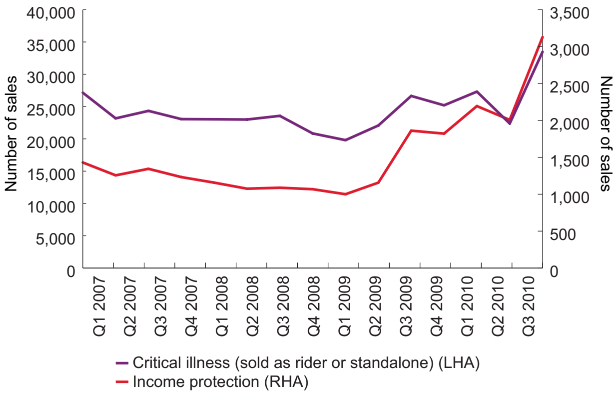
We carried out some analysis on wealth management activities in a number of firms (including several independent wealth managers that are not subsidiaries of banks), which identified poor practices, including increasing clients' risk levels, unwarranted use of complex, illiquid, high-cost products, the use of convenient statistical data that understates particular risks, and poor record keeping. We are now carrying out further investigation in other firms of some of the issues we identified.

Figure 73: Share of total pure protection sales by selling firm category (repeated from Figure 42)



Source: FSA Pure Protection PSD

Figure 74: Number of sales of protection policies by banks (repeated from Figure 43)



Source: FSA Pure Protection PSD

The retail banking channel has also been increasingly used to sell relatively complex investment products such as structured products, usually capital-protected but sometimes also capital-at-risk. Some wealth management products were designed to be sold to sophisticated clients and are, therefore, relatively complex and sophisticated when compared to products most banking customers are familiar with. It is particularly important, when banks decide to grow their wealth management business, that they have regard to the suitability of these products to any enlarged customer base they intend to target.

The potential risks we therefore see in this area are:

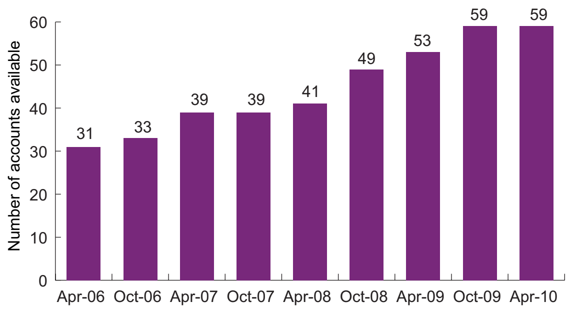
- Banks may encourage existing private banking clients to take more risk with their savings and investments than is wanted or appropriate through the sale of complex or illiquid products. There is a risk that relationship managers with aggressive sales incentives may be more inclined to highlight benefits and downplay risks of the products they are trying to sell.
- Banks inappropriately sell to Affluent and Mass Affluent customers, either by up-selling them into private banking or by offering, via their retail banking arm, wealth management products that are not suitable to customer circumstances. Poor risk profiling (see section 3.7) may have already resulted in the up-risking of some retail customers. An example of this would be a retail banking customer with relatively large savings held in deposits being recommended an investment in a structured product, without the seller fully investigating the circumstances of the customer's wealth or their investment objectives.

4.1.2 Protection products and potential PPI replacements

Following regulatory intervention on PPI, the adverse publicity surrounding this product, and the resultant decrease in this important source of revenue, banks are increasingly likely to be considering how to develop other protection solutions to run alongside credit facilities such as mortgages, term assurance contracts, or stand alone policies.

As discussed in Chapter A, banks' sales of pure protection products – including Critical Illness Cover (CIC) and Income Protection (IP) – increased over the course of 2009 and in early 2010, as did their share in the distribution of these products (Figures 73 and 74).

Figure 75: Number of added value accounts available



Source: Defaqto Retail Banking Report, April 2010

Some protection products currently in the market, such as CIC and IP, have the potential to meet some of the protection needs of consumers previously targeted by PPI providers. Neither CIC nor IP (in particular long-term income protection) have the product features that contributed to making PPI sales so widespread. Unlike PPI, they are both individually underwritten at the point of sale, i.e. the risk underwritten is assessed at that stage and the premium is calculated accordingly for each customer. This makes the process of selling and concluding a contract relatively expensive for the firms and lengthy compared with some more typical PPI sales processes.

However, we have observed specific issues around the sales of CIC and other pure protection products as currently designed. We have conducted research into the sale of CIC over the past year, and published our findings of this research in our ICOBS review in June 2010.[39] In November 2010 we wrote a Dear Compliance Officer letter to all firms selling pure protection products, requesting that they implement and maintain adequate policies and procedures sufficient to ensure compliance with ICOBS.[40] We requested that firms review their sales processes and procedures and confirm these are sufficient to ensure compliance with all the relevant requirements in ICOBS. The letter also reminded firms of their overarching obligation to comply with the Principles.[41]

In addition, there is a risk that the design and distribution of these products could evolve in such a way as to pose problems in the future, e.g. if their underwriting and sales process was changed to make them more profitable for firms at the expense of a higher decline rate on claims for consumers.

Entirely new products might also be introduced in the market. For example, debt freeze or waivers are contractual terms within a loan or credit product under which the lender agrees to waive its right to seek (either some or all of a) repayment should a specified adverse event happen to the borrower. In return, the borrower might pay a higher interest rate on the loan.

While these products have some very similar characteristics to credit insurance products from the customer's perspective, we consider that they do not usually constitute insurance in a legal sense and are instead regulated under the rules for the sale of various lending or credit products. However, they may present similar risks to consumers as with sales of PPI. We are working with the OFT to ensure that firms' use of such product features in relation to both

39 *Insurance: Conduct of Business Sourcebook (ICOBS) post-implementation review: statement of findings*, June 2010, FSA. http://www.fsa.gov.uk/pubs/other/icobs_review.pdf
40 http://www.fsa.gov.uk/pubs/other/oral_disclosure.pdf
41 PRIN 1.1.9G

consumer credit activities (which fall outside our regulatory perimeter) and mortgages does not lead to poor outcomes for consumers, and to consider how any risks of consumer detriment might be mitigated.

Finally, stand-alone protection policies may also be designed or targeted to consumers in inappropriate ways, e.g. by cross-selling them in an inappropriate way to branch customers (see the section below on cross-selling for further information on when cross-selling may create a risk for consumers).

We expect firms to be able to clearly demonstrate that customers' needs are at the heart of product design and distribution for any protection solutions they plan to develop or sell.

4.1.3 Packaged accounts

Another option for banks to increase their fee income is to increase the number of products like current accounts that charge a fee in exchange for additional features.

Packaged accounts are fee-bearing current accounts bundled with a number of other products, such as travel insurance and other customer benefits, and are usually designed to target as broad a range of consumers as possible. The volume of packaged current accounts has grown sharply in recent years and these have been sold across all age groups, income brackets and socio-economic groups (Figure 75). Based on figures provided by some banks, we estimate that approximately a quarter of all current account customers had a packaged account at the end of 2009.

In our 2010 FRO we stated that: 'Packaged accounts may offer value for money for some consumers, but they may not benefit all. Consumers could be better off purchasing products individually or not at all. And some may find that where the add-ons are insurance products, they do not provide the expected level of cover.'

Consumer research suggests that these products have some positive aspects, e.g. for the convenience they offer to some consumers. However, consumers should consider whether they represent value for money for them. It is important that firms are clear about how our standards apply to packaged accounts. We will be conducting further work in this area during 2011.

4.2 Bundling of investment and deposit products

The pressures on interest income and historical sources of fee income discussed above and in Chapter A may also affect banks' product manufacturing strategies.

Some banks and building societies are offering 'bundles' of fixed-term deposit accounts combined with investment products. The bundles are usually designed so that the deposit accounts carry more attractive interest rates than alternative deposit accounts and have a shorter duration than the associated investment products. The following diagram illustrates an example of the possible structure of a bundle.

Bundle:
- Extra 1.5% interest on savings product if bought as part of bundle

Deposit product:
- One-year savings bond
- Minimum deposit of £1,000
- Interest rate 3%
- FSCS-backed
- Can be purchased on stand alone basis

Investment product:
- Five-year investment bond
- Minimum investment of £3,000
- Capital at risk
- Can be purchased on stand alone basis

Notes:
- Both savings and investment products typically available on stand alone basis.
- Financial promotion focused on savings product, with much wider target market.
- Savings products can also be easy access accounts or cash ISAs.
- Minimum 'combined investment' figures often applied.

Firms may offer such bundles to attract retail deposit funding, to raise income per customer or to grow market share. In some circumstances these bundles can also lead to good outcomes for consumers, such as higher returns or increased convenience.

Bundling can, however, lead to:

- increased complexity for consumers, due to the multiple products involved and therefore greater volume of information; and,
- potentially increased switching costs, as switching away from a provider may mean switching more than one product.

The likelihood of a poor consumer outcome can be exacerbated by bundling deposit and investment products that have different appropriate target markets. These risks may be further heightened by the attractive deposit rate, which could be used to lure customers for whom the bundled investment product may be unsuitable.

We believe a desirable outcome would be one where firms do not bundle products with disparate appropriate target markets or product risk profiles. It is crucial that where the bundled investment product poses an increased risk of mis-selling, firms put in place strong point-of-sale and other controls that ensure that consumers purchase products that meet their needs.

4.3 Cost-cutting and efficiency improvement initiatives

In addition to plans to grow fee income in response to the current environment, banks' strategies also show targets for significant cost reduction, in both front and back office functions. Many of these strategies highlight functions such as risk, compliance and training as key areas for cost cutting.

Firms' strategies, particularly in banking, also include an increased desire to improve efficiency. For example, some banks and building societies are looking to improve the efficiency of their distribution channels by shifting lower value day-to-day transactions on to the internet and using high-cost branches for higher value product sales. At the same time, some banks want to lower their branch numbers and reduce the scope of services offered in branches.

Another way banks want to improve efficiency is through better client segmentation. By getting a better idea of the value of each customer to the business (which is usually related to the number of products they have bought and the size of balances they hold) banks hope to be able to target their resources both on high-value customers and on lower-value customers with the potential to become more valuable.

While cost control and higher efficiencies are generally of benefit to customers, the combination of aggressive sales targets and cost cutting in key controls functions may increase the risk of product mis-selling. Changes to distribution channels (e.g. shifting lower value day-to-day transactions on to the internet) and a greater focus of resources on perceived higher value customers may also have a detrimental effect on some customers, particularly vulnerable groups such as the elderly and those on low incomes, already affected by the environmental pressures described in Chapter A. We are monitoring firms' strategies in these areas to ensure that customers do not suffer detriment.

Similar risks may be present in other firms, such as insurers, as discussed later in this section.

4.4 Cross-selling

One consistent theme that we have noted from our analysis of several banks' and building societies' retail banking strategies over the past year is a desire by those firms to raise their cross-selling rates, i.e. to sell more products to each individual customer.

Cross-selling is a well-established commercial practice for banks and building societies to improve their profitability. Current accounts and mortgages are the usual vehicles for cross-selling strategies. There is very limited switching of current accounts and customers interact frequently with the firm that holds their primary current account, making it an ideal vehicle for a firm that intends to cross-sell. Some firms also make mortgages a cross-selling vehicle and, as banks seek longer-term deposits from customers, savings deposits may become seen as cross-selling opportunities.

There are several reasons why banks and building societies are focusing on cross-selling strategies now. As noted in Chapter A, there are a range of economic, market and regulatory pressures on retail banking profitability in the UK. In addition, focusing on existing customers for whom banks already have some information reduces the risk for the bank from the sale (e.g. the risk of credit impairments).

Cross-selling may benefit customers in some circumstances. If a bank has a more complete view of a customer's income, expenses and savings it is more likely to make an appropriate lending decision rather than allow that customer to become over-indebted. In addition, the cost advantages to firms of cross-selling may be passed on to customers.

However, cross-selling may create increased mis-selling and product design risks for consumers. For example, if a bank or building society with a limited product range has an explicit cross-selling strategy, the firm may have the incentive to persuade its customers that its limited product range meets a wide range of their needs. Furthermore, firms with cross-selling strategies may use their knowledge of their existing customers to actively target particular characteristics (e.g. larger deposit balances) rather than particular needs. Cost-cutting may exacerbate such mis-selling risks, e.g. if firms cut costs on systems that would allow them to identify their customers' real needs.

Cross-selling may also increase product design risk. A bank or building society with an explicit cross-selling strategy, in trying to offer its customers a wider range of products, could enter new product areas that are not familiar to the majority of its advisers or in which it has inadequate systems and controls. Related to this, firms may have the incentive to design products for their cross-selling potential rather than because they seem to meet any particular customer need.

Firms should be aware that, through our usual supervisory activities, we will be alert to these risks to consumers.

4.5 Business model change following the RDR

As mentioned in Chapter A, the RDR will lead to fundamental reform of the investment advice market. The number of people currently seeking advice, as a proportion of the population, is small. If more people are to seek advice in the future, then they must both trust the advice and view the service as good value for money. The RDR addresses both these issues by improving the likelihood of trust and confidence in the market and by making clear to consumers the cost of advice and the nature of the service they are going to receive.

Our primary concern is that firms make changes to their business in sufficient time to implement the RDR. There is a substantial risk that some firms will leave it too late to be compliant by the implementation date, either because their business models have not adapted to the new charging regime, or because advisers have not achieved an appropriate level of qualification.

However, we also understand the significant changes that will be required for many firms, both product providers and distributors, and that these changes might give rise to risks. For example, most adviser firms will have to create new business models to deal with the loss of commission income on new product sales, and many providers will have to identify new strategies to get their products to market. Some of these changes may lead to potential new areas of risk for consumers unless actively managed.

Examples of possible reactions to the RDR that may, if realised, increase the risk of poor outcomes for customers include the following:

- **Sales biases –** While the RDR addresses potential commission bias, a sales bias is likely to persist in cases where the adviser charges fees contingent on a product sale or where charges are paid for ongoing advice regardless of whether or not products are sold. In the latter case, consumers may be disinclined to pay for advice to 'do nothing', which may lead to more churn. Likewise, more expensive advisers may feel compelled to advise on sophisticated products or services as a way of justifying their higher fees.
- **Ongoing service –** The requirement to provide an ongoing service to justify ongoing fees may incentivise firms to move to portfolio advice or discretionary management services and inappropriately make more transactions on an account than necessary. This may potentially increase costs for consumers, both in terms of transaction fees and ongoing advice services, even when it does not necessarily provide additional benefits for the customer. If the products fail to match the customer's risk profile or the costs of the products and services are inappropriately high for the client's needs and circumstances, it may also increase the risk of unsuitable advice.
- **Provider influence –** In the post-RDR environment, providers should rely on the inherent quality and price of their products and post-sale services to achieve market share. However, some may seek to avoid the ban on commission by offering other incentives to advisers, such as business or consultancy services, although inducements rules should mitigate this. There is a risk that this may continue to bias the sales process.
- **Compliance –** Business model change by definition involves new processes and new ways of conducting business. This will put strain on advisers' compliance functions. We expect some advisers to seek appointed representative status within networks as a strategy for dealing

with the RDR. This, in turn, will stretch compliance functions in networks, which will also be trying to adapt to the new regulatory regime. The risks in this regard discussed in the Retail Intermediaries Sector Digest (part of the 2010 FRO) remain relevant.

It is vital that firms' systems and controls, including competence of employees, keep pace with any changes in their strategy and business model, and with any new services the firm is offering. We will be working with the industry to ensure these risks are minimised.

4.6 Firms' responses to other regulatory developments

A number of other regulatory developments discussed in Chapter A and being introduced over the next three years may have an impact on areas of the financial services industry. Some of these may give rise to new or transition risks which we will look to monitor. The following sections give some examples of the type of risks that may arise.

4.6.1 Solvency II

As discussed in Chapter A, Solvency II will have a fundamental impact on the insurance industry. All firms in scope will need to review their operations and, given the far-reaching nature of the directive, we anticipate that most firms will need to make substantial changes.

In particular, it is possible that insurers may respond to Solvency II by seeking to change their product offering, e.g. by altering their product terms, or withdrawing from certain product lines (see Chapter A, section 4.3.1). There may be risk of consumer detriment in this area if consumers are not appropriately informed of potential changes to the product features or if the new emerging products are less suitable to their needs.

4.6.2 Mortgage Market Review (MMR)

The principal risk we see is that, in the absence of the MMR, there could be a return to the lending and selling behaviours seen in the past.

However, there is also a risk that, to avoid new rules introduced by the MMR, some mortgages that would otherwise not be allowed by the MMR will be issued as second-charge loans or as Buy-to-Let mortgages, neither of which are currently within our scope.[42]

There may also be a rush to issue self-certification mortgages before they are prohibited, with demand coming from the rising number of consumers in financial difficulty, although this is likely to be limited by the funding constraints for self-certification mortgage providers. Finally, there may be risks for mortgage consumers who have their mortgages sold on to an unregulated entity.

4.6.3 Pension reforms

As noted in Chapter A, the government will progressively introduce reforms to workplace pensions starting from 2012.

Auto-enrolment, i.e. the automatic enrolment of an employee in a workplace pension scheme unless the employee expressly opts out of the scheme, is an important element of the pension reforms. There is the possibility that advisers could incorrectly recommend an employee opts

42 On 26 January 2011 the government announced a package of measures intended to enhance consumer protection in the mortgage market. These measures will, among other things, transfer the regulation of new and existing second-charge residential mortgages from the Office of Fair Trading to the FSA and ensure consumer protections are maintained when a mortgage book is sold by an FSA-authorised mortgage lender to an unregulated firm. The statutory instruments will be published later in 2011. In advance of this, the FSA will begin work to implement these measures.

out of a workplace pension scheme to which they have been automatically enrolled and use a personal or stakeholder pension scheme instead. This would result in the employee losing out on the employer contribution they are entitled to.

4.6.4 UCITS IV

One of the innovations in the latest version of the EU's Undertakings for Collective Investments in Transferable Securities Directive (UCITS IV) is the replacement for the Simplified Prospectus with the Key Investor Information Document, which will include a variety of information about a UCITS fund including a risk and reward indicator. The indicator is based on volatility and does not take into account all possible risks. Advisers should continue to ensure any fund recommended is suitable for the particular investor from the perspective of their attitude to risk.

4.7 Changing business models in the life insurance sector

As examined in Chapter A, there are significant pressures in the life insurance sector and, as in banking, insurance companies are reviewing their strategies.

As firms start to refocus their businesses they may decide to sell or 'run off' parts of their business. At the same time, firms will be looking to reduce costs and maximise returns. This creates a risk that non-core parts of the business receive less investment – both financially and in terms of management attention – leading to an increase in consumer detriment in terms of the performance of funds, particularly in closed books of business, service and communications.

There is also the risk that some firms may look to undertake an aggressive growth strategy to increase profits and earnings. While this is not a risk in itself, it may come at the expense of treating customers fairly, therefore creating consumer detriment. This strategy presents an enhanced risk of the mis-selling of new business, manufacturing poorer performing or more expensive products, as well as the risk of sub-optimal product design and servicing capabilities.

In addition, as the life sector evolves, it is possible that firms will change their product mix. This may be as a reaction to Solvency II (see section above) or a result of other factors like static or declining demand, increased competition from substitute products, or reducing profitability, especially in capital intensive products. The change in product mix may include a reduction in the manufacture of capital intensive or less profitable products (e.g. variable annuities, with-profits or unit-linked business), the re-pricing of existing products or other changes in product terms, or through product innovation. As mentioned in Chapter A, Section 4.3, while substitutable products exist in many product lines, there may be a risk of consumer detriment if consumers are not appropriately informed on potential changes to the product features or if the new emerging substitutable products are less suitable for their customers.

The annuity market is a particular example of this. Solvency II is likely to have an impact on the incentives of some insurers in providing annuity products. In addition, the government's recent proposal to raise and then remove the age limit on the compulsory purchase of annuities may change the incentives to purchase an annuity for wealthier people. While more flexible than most standard annuities, alternative products can expose customers to more risk and, in most cases, higher charges. Alternative products are suitable for some consumers but it is clearly important that alternatives to annuities continue to be sold appropriately.

4.8 Tax changes and their implication for financial products

As discussed in Chapter A, the Emergency Budget introduced a small number of changes to the tax structure, and the relative rates of tax applied to different financial products.

Overall, these changes do not amount to a radical change in the incentives for either firms or customers, but firm and customer responses to the tax changes announced in the Budget may give rise to a risk of poor consumer outcomes.

For example, tax changes, particularly raising the rate of Capital Gains Tax for higher rate taxpayers, may change the relative merits of different products in favour of higher risk investments such as Enterprise Incentive Schemes (EIS). It is important that financial advisers recommending these investments remain focused on ensuring that the products offered to customers are in line with their attitude to risk and overall circumstances – not just possible tax benefits.

Annex

Index of figures and boxes

Glossary

BBA	British Bankers' Association
BCOBS	Banking Conduct of Business Sourcebook
BCR	Banking Conduct Regime
bn	billion
BoE	Bank of England
bp	basis point
BTL	Buy-to-Let
CFEB	Consumer Financial Education Body
CIC	Critical Illness Cover
CIS	Collective Investment Scheme
CML	Council of Mortgage Lenders
CP	Consultation Paper
CRD	Capital Requirement Directive
CSR	Comprehensive Spending Review
DIF	Distributor Influenced Fund
EIS	Enterprise Investment Scheme
ETC	Exchange Traded Commodity
ETF	Exchange Traded Fund
ETN	Exchange Traded Note
EU	European Union
FSA	Financial Services Authority
FRO	Financial Risk Outlook
FSCS	Financial Services Compensation Scheme
GDP	Gross Domestic Product
GI	General Insurance
HMT	Her Majesty's Treasury
ICOBS	Insurance Conduct of Business Sourcebook
IFA	Independent Financial Adviser
IFS	Institute of Fiscal Studies
IMA	Investment Management Association
IMD	Insurance Mediation Directive
IP	Income Protection
ISA	Individual Savings Account
KID	Key Investor Information Document

LSE	London Stock Exchange
LTI	loan-to-income
LTV	loan-to-value
MCOB	Mortgage Conduct of Business
MiFID	Markets in Financial Instruments Directive
MLAR	Mortgage Lenders and Administrators Return
MMR	Mortgage Market Review
m	million
NEST	National Employment Savings Trust
OEIC	Open Ended Investment Company
OFT	Office of Fair Trading
ONS	Office of National Statistics
PPI	Payment Protection Insurance
PRIP	Packaged Retail Investment Product
PS	Policy Statement
PSD	Payment Services Directive
PSD	Product Sales Data
RBS	Royal Bank of Scotland
RCRO	Retail Conduct Risk Outlook
RDR	Retail Distribution Review
SIPP	Self-Invested Personal Pension
SLS	Special Liquidity Scheme
SVR	Standard Variable Rate
TCF	Treating Customers Fairly
TLPI	Traded Life Policy Investment
TPA	Third Party Administrator
UCIS	Unauthorised Collective Investment Schemes
UCITS	Undertakings for Collective Investments in Transferable Securities
VCT	Venture Capital Trust
WAS	Wealth and Assets Survey

PUB REF: 004041

The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk