Financial Services Authority

Retail Conduct Risk Outlook
2012

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Foreword

The financial services industry must ensure it achieves a fair deal for consumers. They are reliant on the industry to provide them with a range of vital services. So the way firms are structured, how they operate, the products they develop and how they are sold, must all be aligned with their customers' needs.

However, there are many factors, such as continuing global economic uncertainty, low confidence and indeed regulatory change that are putting huge pressure on firms. This is creating risks to consumers getting the fair deal they are entitled to.

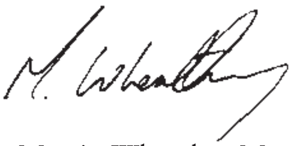
In this Retail Conduct Risk Outlook (RCRO), we set out our assessment of the most significant retail conduct risks. It is essentially our view of where the potential dangers lie in the next 12-18 months. Some risks have already materialised and are obvious to all of us. Others have not yet emerged so clearly, but are ones that we believe could crystallise going forward.

In Chapter A, we explain the economic and environmental conditions that firms and consumers are currently operating in. It provides context for Chapter B which sets out the main risks that require careful attention over the next 12-18 months.

We ask you to review the RCRO and have regard to those risks which are relevant to the sector(s) in which you operate. You should assess whether your firm has taken sufficient action to meet the challenges represented by the risks highlighted in the RCRO. It is especially important for firms looking to venture into new areas in pursuit of new income streams. The RCRO will help you understand the landscape you are operating in and to take action to monitor and control the relevant risks. The aim is to ensure the risks (as set out) do not lead to poor outcomes for consumers.

Our 2012/13 Business Plan, which will be published shortly, will also be of interest as it will set out more broadly how we intend to deliver our consumer protection objectives.

During this time we will continue to focus our attention on designing the new Financial Conduct Authority (FCA). The FCA will put consumers' needs at its heart and will focus even more on ensuring there is a fair deal between firms and their customers. The RCRO is one of the steps towards achieving this and will inform the development of the new regulator.



Martin Wheatley, Managing Director, FSA
March 2012

Executive summary

Introduction

The Retail Conduct Risk Outlook (RCRO) presents our view of the 15 highest priority conduct risk areas that we believe require particularly careful firm and regulatory focus over the next 12-18 months.

Scope: This document sets out the priority risks arising from firms' conduct in their direct relationship with retail customers, or where firms have a direct duty to retail customers. This document does not contain a general discussion of wholesale conduct risks (risks that may arise because of firms' conduct in their relationship with other firms), risks arising from financial crime or risks in relation to the protection of client money or safe custody assets (client assets). The document is also limited to issues that fall within our statutory duties. For example, we have not discussed risks in the unsecured credit market, which is currently regulated by the Office of Fair Trading.

Retail conduct risk identification: Our view of the key risks draws on both the analysis of the environment and behaviours discussed in Chapter A of this document, as well as our wider regulatory intelligence and internal risk analysis and identification work. We have then used this information to assess which risks we regard as the highest priority in the markets that we regulate.

Structure of this document: In Chapter A we discuss how firms and consumers have responded to the various macroeconomic and environmental factors, the effects of existing, new and forthcoming regulation, and other market developments. We also outline how firms operating in different sectors, i.e. retail banking, asset management, life insurance, general insurance, retail intermediaries, and consumers are likely to respond to the above factors. This sets the context for the risk discussion in Chapter B. Chapter B then presents our view of the 15 key retail conduct risk areas, drawing on the analysis of the environment and behaviours discussed in Chapter A.

Chapter A: The environment

In Chapter A we discuss a number of important environmental trends affecting both firms and consumers participating in the retail financial services market.

The outlook for the financial services industry is closely linked to the prospects for the **UK macro-economy**. In a challenging economic environment, households have seen their incomes and personal finances affected by macroeconomic changes, such as fiscal consolidation or higher inflation, and many remain vulnerable to further distress. Real household income declined in 2011, negatively affected by price and tax increases. For some households, flat debt levels and low interest payments on secured debt are helping offset this fall, with a decrease in the share of income spent on debt interest payments. In the past two years, the savings ratio has fallen, but this trend changed in 2011, possibly in light of increasing economic uncertainty. Despite the low interest rates and forbearance facilities provided to borrowers, early signals suggest that greater repayment difficulties in the mortgage markets could materialise again in 2012. Below these aggregate trends, however, the experience of actual households varies greatly.

For firms, environmental conditions vary by sector. A number of themes, however, stand out in each sector:

- **Regulatory change** continues to be an important driver of firms' strategies and business models across a number of sectors.
- In **retail banking**, margins remain compressed. Competition among banks for retail deposits is still strong, with economic uncertainty from the sovereign debt crisis further increasing banks' wholesale cost of funding. Lower than expected impairments have had positive impacts on bank profitability, although the real level of impairments may be masked by forbearance. In a context of tight bank profitability, banks' strategies increasingly include cost-cutting plans in both front and back office functions.
- In **asset management**, net retail sales of funds were just over £18bn in 2011 declining from £30bn in 2010, with investment flows favouring bond and balanced funds. Assets under management in Absolute Returns Funds reached around £20bn at the end of 2011, with a significant year-on-year increase of approximately 27%. Sales of index tracker funds were the highest on record on the back of increased desire for passive strategies.
- The unprecedented extent of concurrent changes affecting **life insurers** continues to put significant pressure on their business models, possibly accelerating the contraction of the sector. The 'Test Achats' case is one of several factors, with low nominal interest rates, increasing longevity and Solvency II capital requirements, adding upward pressures on prices of life products, particularly annuities.
- **General insurers**' earnings remain under pressure from low investment returns and increasingly intense price competition in core markets (e.g. motor) compounded by the increasing importance of distribution through aggregators.
- **Retail intermediary** trends are dominated by issues in the different markets in which they operate. Preparing for the RDR remains the key challenge for financial advisers, with a large number of IFAs implementing new business models which are RDR compliant. Market conditions remain particularly challenging for mortgage intermediaries. Changes to regulatory requirements on the distribution of insurance and the forthcoming Solvency II requirements are also affecting General Insurance brokers.

For consumers, four themes dominate:

- The search for both yield and security in a low interest rate and high market volatility environment continues.
- Consumer confidence, both in their financial position and the wider financial outlook, generally remains low, possibly as a result of a declining real income, fiscal consolidation,

ongoing market uncertainty and increasing levels of unemployment. However, consumer experience varies among different segments of the population.

- The changing environment does not appear to have resulted in significant changes in product penetration between 2010 and 2011, but some product categories (e.g. savings) experienced different patterns for different product types (e.g. with penetration of instant access accounts falling while cash ISAs maintained similar levels of ownership).
- Financial pressures have been affecting some consumers' spending patterns, including on financial products. Where consumers reduced spend on financial products, particularly in insurance, this was in some instances achieved by shopping around for less expensive financial products, rather than reducing product holdings. Increased financial pressures have also been affecting some consumers' ability to save and invest, with declining holding of savings and investment products and a fall in the average value of investments. However, even in the face of increased financial pressure, most consumer segments, where they can afford to, seem to be focusing on debt reduction and/or consolidation.

Chapter B: The risks

In a development from the RCRO 2011, we have grouped risks into 15 broad risk categories to make clearer the risks that we regard as the highest priority. For each risk category, we set out the specific risks (where applicable) that we regard as key. Here we provide an overview of each risk category. Chapter B provides a detailed assessment and an overview of our methodology. The risk categories are set out below alphabetically.

1. Aligning business models to the fair treatment of consumers

This section analyses how firms' business models are responding to economic or business pressures, and the risks this may create for customers. In most cases, business model change can either be positive or negative for customers. For example, cost-cutting can keep costs down for customers or result in poor service standards.

Specific risks in this section are:

- Firms' reward policies and practices
- Use of technology in payments
- Changing business models in the life insurance sector
- Cost cutting and efficiency improvement initiatives in deposit takers
- Cross-selling
- Divestments, acquisitions and new players in retail banking

2. Complexity in retail investment products and services

This section updates the RCRO 2011 analysis of complex products, i.e. products that are by their nature complex (such as traded life settlements or unregulated collective investments) or products that are being developed in ways that increase their complexity. Complex products are more likely to be mis-sold than traditional investments, which reinforces the need to have appropriate systems and controls in place around the quality of the design, marketing and distribution of these investments.

Specific risks in this section are:

- Development and marketing of structured investment products
- Unregulated collective investment schemes
- Exchange traded products
- Private banking and wealth management
- Traded life policy investments
- Absolute return funds

3. Firms' responses to regulatory and/or legislative change

This section updates our 2011 analysis of firms' response to regulation. In addition to the issues raised last year, we also discuss the impact of the Test Achats European Court of Justice ruling on gender pricing in insurance.

Specific risks in this section are:

- Responses to the banking conduct regime
- Business model change following RDR
- Mortgage Market Review
- Gender pricing in insurance
- Transition to the RDR
- Solvency II
- Pension Reform

4. General insurance

Compressed investment returns, strong downward price pressure from aggregator websites and the loss of some revenue streams, suggests that general insurance firms may look to other means to remain profitable. This section discusses how these trends either make it more difficult for consumers to assess the true utility of a product, or have the potential to create a gap between consumers' expectations and how general insurance products actually perform.

Specific risks in this section are:

- Consumers' focus on initial premium
- Products of limited value
- Add-ons
- Payment protection products

5. Governance of funds in life offices

In addition to updating our 2011 analysis of with-profits funds operation, this section discusses the risk profiles of life assurance funds. Here we highlight the importance of the adequate disclosure of the risk profile of funds to customers, and managing those funds to ensure they stay within the stated objectives and risk profile.

Specific risks in this section are:

- Communication and management of the risk profile of life assurance funds
- With-profits funds operation

6. Host authorised corporate directors

This section discusses the risk of consumer detriment where the Host ACD lacks the specialist skills and systems needed to safeguard investors in complex funds.

7. Inadequate complaints handling

This section updates the RCRO 2011 risks on complaints handling in major banks and the risks surrounding complaints and redress for Payment Protection Insurance.

Specific risks in this section are:

- Complaints handling in major banks
- Payment protection insurance

8. Investment propositions

This section updates the RCRO 2011 analysis of risks associated with platforms (with a new discussion of 'corporate wraps') and centralised investment propositions such as portfolio advice services, discretionary portfolio management and distributor influenced funds.

Specific risks in this section are:

- Use of platforms
- Centralised investment propositions

9. Investment risk profiling

This section updates the RCRO 2011 analysis of risk profiling. It notes that most of the drivers of the risk still persist and that there remains recent evidence of ineffective customer risk profiling across a range of different firms giving investment advice.

10. Investor compensation protection

Where an investor buys an investment product from an investment firm in another EEA member state, and that firm fails, the level and scope of investor protection may be lower. This section discusses the factors which advisers and consumers need to be aware of when making these decisions.

11. Mortgages

This section updates the RCRO 2011 analysis on risks in the mortgage market. It also contains a new analysis of mortgage product innovation. Innovation can deliver benefits for consumers but it can also result in increased levels of complexity, thereby creating potential detriment to consumers.

Specific risks in this section are:

- Unfair terms in mortgage contracts
- Unfair treatment of mortgage customers in arrears
- Capital repayment of interest only mortgages at maturity
- Mortgage product innovation
- Misuse of buy-to-let mortgages

12. Pensions and retirement planning

This section updates the RCRO 2011 analysis of the Self Invested Personal Pension (SIPP) market. It also contains an analysis of the practice of offering incentives to deferred defined benefit scheme members to transfer into a personal or stakeholder pension, and the risks associated with giving advice on such arrangements. We also analyse changes in the decumulation (annuities and comparable products) market. As annuity rates fall, and rules requiring the purchase of an annuity are removed, this section discusses the developments in the decumulation market and the potential risks when offering advice on the range of options consumers may have at retirement.

Specific risks in this section are:

- Self-invested personal pensions
- Enhanced transfer value – pension transfer
- Decumulation

13. Product bundling

This section updates the RCRO 2011 analysis of packaged accounts and the bundling of investment and deposit products.

Specific risks in this section are:

- Packaged accounts
- Bundling of investment and deposit products

14. Projections

Projections are the means by which firms give consumers an indication of the possible future returns on their investment products. This section discusses the risk that firms do not revise rates downwards from the maximum allowed by FSA rules, where a product is unlikely to achieve returns in line with these maximum rates.

15. Systems and controls weaknesses in the network model

This section updates the RCRO 2011 analysis of systems and control weaknesses in network models. With the RDR implementation deadline now much closer, the pressures on networks are likely to grow. Consequently, this risk remains an area of supervisory focus for the FSA.

Issues from RCRO 2011 we no longer see as highest priority

The RCRO is designed to set out the highest priority conduct risks and these risks may change from year to year. The following three risks were discussed in the RCRO 2011, but we no longer consider these to be among the key highest priority risks:

1. Developing and marketing structured deposits
2. UCITS IV
3. Tax changes and their implications for financial products

This does not mean we are not concerned about these areas or that firms should not be concerned about the related risks. We provide an overview of each of these risks in Chapter B.

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. Hence, in compiling this document, we have given due consideration to equality and diversity issues. However, it 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). 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 we identify in the document and in our supervisory work.

Chapter A – The environment

1. Introduction

In this chapter 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 how consumers' financial positions and product holdings have been affected by the environment and considers the implications for different consumer segments.

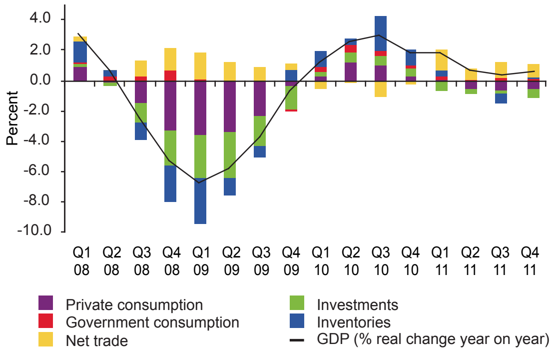
Environmental conditions and responses from firms and consumers provide useful context to understand where and how future retail conduct risks may arise. The analysis in Chapter A therefore sets the scene for the retail conduct risks highlighted in Chapter B.

2. Macroeconomic background and outlook for households

The outlook for the financial services industry is closely linked to the prospects for the UK macro-economy. Financial services firms and consumers are affected by changes in the wider economy, but the opposite is also true, with the macro-economy impacted by developments in the financial services sector. In a challenging economic environment, many households have seen their incomes and personal finances affected by macroeconomic changes, such as fiscal consolidation or higher inflation, and remain vulnerable to further distress.

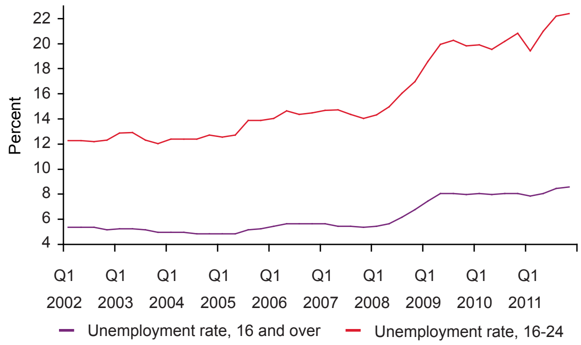
The purpose of this section is to discuss the key macroeconomic trends in the UK that are more relevant to consumers and may impact on their interactions with financial services providers. This section provides an aggregate view of the household sector, while in section 5 we discuss in more detail the diversity of consumers' experiences in the current environment.

Figure 1: Contributions to real UK output growth



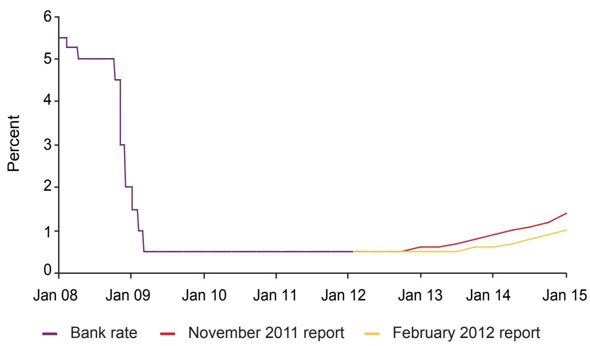
Source: ONS

Figure 2: Unemployment rate by age group



Source: ONS

Figure 3: Market expectations on the Bank Rate



Source: Bank of England (Inflation Report, February 2012)

2.1 The UK economy

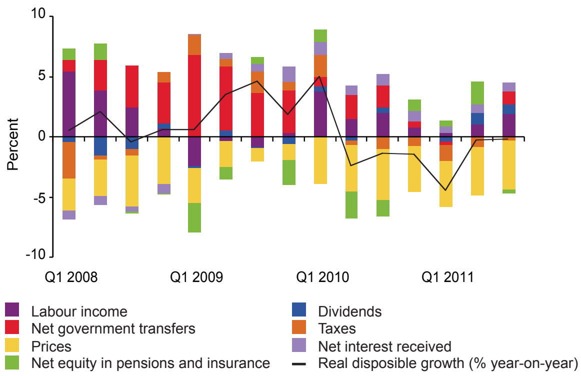
In 2011, the UK economy experienced low growth (see figure 1). As in the deepest period of the recession in 2008/9, low levels of private consumption and investment drove this fall in output growth, while net trade and government consumption showed a positive contribution to output growth. The economy experienced a sharp fall in GDP during the recession (approximately 7% of GDP was lost in 2008/9), and at current growth rates it will take some time to return to pre-recession levels.

Employment was relatively resilient during the crisis, falling substantially less than might have been expected given the scale of the GDP contraction. However, in 2011 the unemployment rate increased to above 8%, and it is particularly high, approximately 22%, among the 16-24 age group (see figure 2).

The Bank of England Bank Rate has not moved since early 2009 and market expectations are that it will remain low over the next few years (figure 3). Although inflation rose steadily to above 5% in 2011, it fell to 3.6% in January 2012. The Bank of England expects it to fall back to around the 2% target by the end of 2012, partly because of the decline in the contributions of VAT, energy and import prices.[1] In February 2012, the Monetary Policy

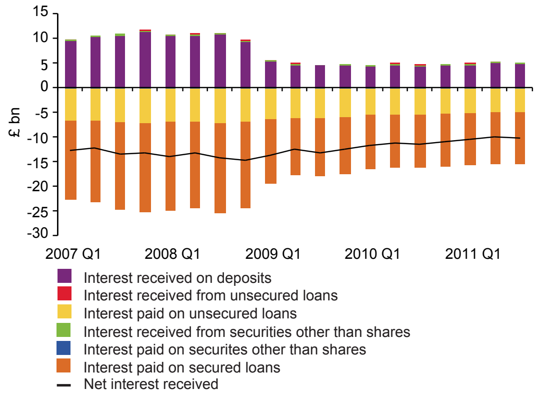
1 Bank of England Inflation Report, November 2011.

Figure 4: Contributions to year-on-year growth in real disposable household income



Source: ONS

Figure 5: Interest paid and received by households



Source: ONS
Note: Values are unadjusted for FISIM (Financial Intermediation Services Indirectly Measured). Figure includes Non-Profit Institutions Serving Households (NPISH).

Committee voted to begin another round of asset purchases[2], providing further monetary stimulus into the economy to boost nominal spending by lowering borrowing costs.

Several economic forecasts (e.g. from the Bank of England, Office for Budget Responsibility, OECD and IMF) indicate that output is expected to remain low in the near term and its annual growth rate may remain below 2% until 2013. Several factors, including the sovereign debt crisis in Europe, banks' ongoing balance sheet pressures, declining real household income and a tighter fiscal policy, might keep investment and net trade subdued and put further pressure on household consumption.

2.2 The household sector

2.2.1 Income, expenditure and savings

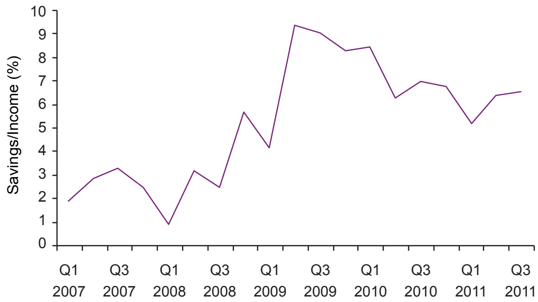
Understanding trends in household income and its sources is important to identify challenges in the current financial position of households, which in turn may affect their demand for financial services. In this section we present trends in household income, expenditure and savings at an aggregate level, while in section 5 we discuss the financial position of different consumer segments.

Household income changed little in real terms (i.e. adjusted for inflation) in 2008 (see figure 4). It recovered in 2009 due to a positive contribution of net government transfers and taxes. However, from 2010 onwards, it has been negatively affected by higher inflation (e.g. VAT, energy and import prices), low wage growth and tax increases.

The persistently low Bank Rate has impacted consumers differently. Some households continue to benefit from a reduction in interest payments on secured debt and some unsecured debt (see figure 5). But the low bank rate has also reduced interest received (e.g. on deposits) by households, affecting those who hold higher amounts of assets compared to debt (e.g. older age groups). However, the stronger competition for deposits among banks, with gradually rising rates offered on deposits, has driven net interest received (the difference between interest received and paid) above pre-crisis levels.

2 Total asset purchases are currently worth £325 billion after assets purchased worth £200 billion were authorised between March 2009 and January 2010, assets purchased worth £75 billion were authorised in October 2011, and assets purchased worth £50 billion were authorised in February 2012.

Figure 6: UK household savings ratio



Source: ONS

Figure 7: OBR savings ratio forecast (November 2011)

Source: OBR (Economic and Fiscal Outlook, November 2011)
Note: The series is presented as four-quarter rolling averages.

Household consumption and saving behaviour is crucial to understand the demand for, and use of, financial products (e.g. debt, saving and investment products). Between 2000 and 2008, the savings ratio was at historically low levels. At the beginning of the crisis, as economic uncertainty increased, weak consumption from households resulted in a rise in the savings ratio (see figure 6).[3] Combined with moderate nominal income growth, this increased the supply of savings and helped households accumulate financial assets and, to a small degree, reduce debt stocks. By 2009, the savings ratio had reached levels closer to its pre-2000 long-term average. It fell again from mid-2009 onward, until the beginning of 2011. This fall may have been a result of improved household confidence, easing credit conditions, or households trying to maintain stable consumption levels in a period of reduced real income.

Several factors will affect the outlook for household savings in the short to medium term, such as the degree of uncertainty about future incomes and job prospects, asset prices, credit conditions, or monetary policy. The Office for Budget Responsibility (OBR) expects the savings ratio to continue to fall in the next four years (see figure 7). However, the savings ratio rose in the second and third quarters of 2011 and might continue to do so in the coming months if precautionary saving rises in light of the greater uncertainty surrounding the UK economy and the current depressed levels in household consumption.

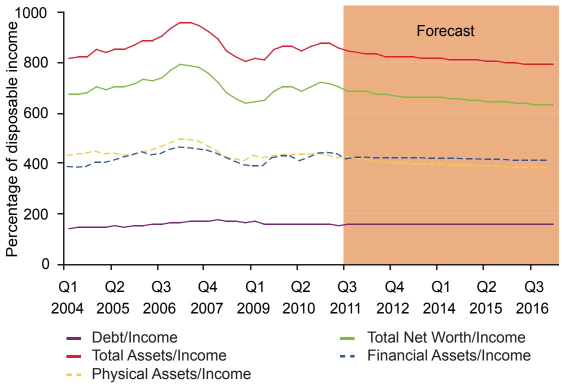
2.2.2 Household accumulation of financial assets

Despite a fall in 2009, household financial assets in relation to disposable income have remained quite stable in the last two years (2010/11) (see figure 8), with market prices the main driver of changing value. In relation to GDP, households' net acquisition of financial assets has been increasing since 2009 (see figure 9). The value of households' total assets has been affected by changes in physical assets, in particular housing. House prices increased steadily before the crisis, fell by close to 20% in 2008/9[4] and have remained relatively flat since.

3 The savings ratio measures the share of disposable income saved by households. It should be noted, however, that household saving is not directly measured in the National Accounts and is instead calculated as a residual item by deducting household consumption expenditure from disposable income. Since the ratio is derived as a residual, it is subject to errors and omissions in the measurement of its components. In addition, its calculation does not take into consideration other expenditure such as debt repayment or investment. Caution should therefore be exercised in drawing conclusions on saving behaviour by looking at this ratio alone. It should be considered in the context of other variables such as the changing pattern and composition of household assets and liabilities (discussed in section 2.2.2).

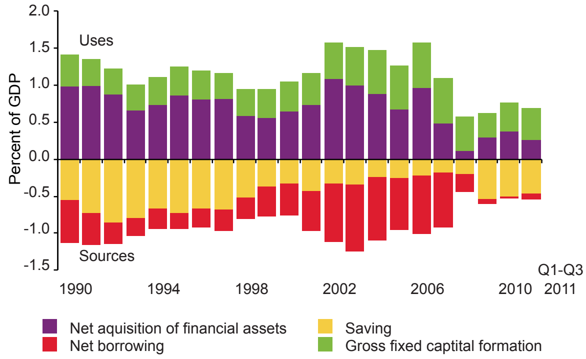
4 Based on historical house price indices from Halifax and Nationwide.

Figure 8: Households assets and liabilities as a proportion of disposable income



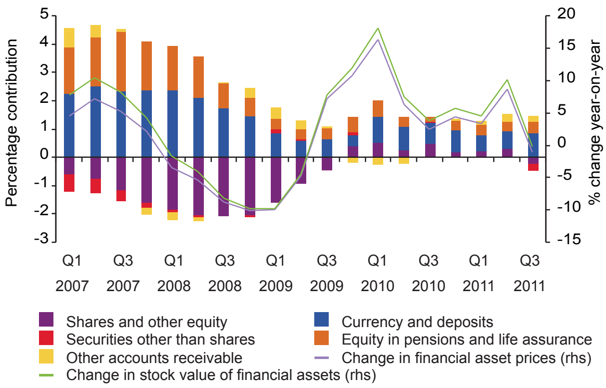
Source: OBR (Economic and Fiscal Outlook, November 2011)

Figure 9: Households sources and uses of funds



Source: ONS, Bank of England (Bankstats)

Figure 10: Contributors to change in stock value of financial assets

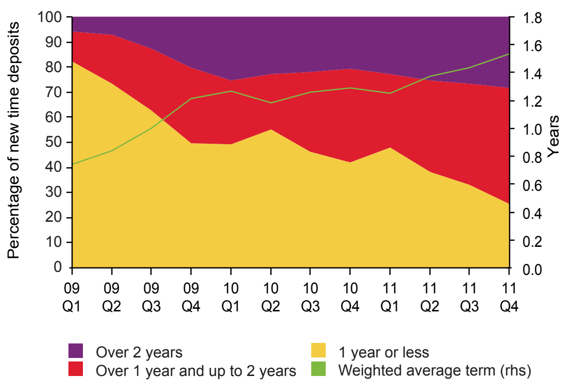


Source: ONS
Note: Values on the right-hand side axis are much higher than on the left-hand side axis. Changes in asset prices and in the total value of financial assets are referenced to the rhs axis. The two trends show that changes in the stock value of financial assets are mostly driven by changes in asset prices.

The fall in the values of physical and financial assets, together with relatively stable debt levels, has led to a reduction in household net worth (a measure of household net holding of assets and liabilities) (see figure 8). Net worth still remains positive, but substantially lower than in its pre-recession peak. The OBR expects household net worth to fall as a share of disposable income over the forecast period because the value of assets is expected to grow more slowly than incomes, while liabilities are expected to rise more quickly.

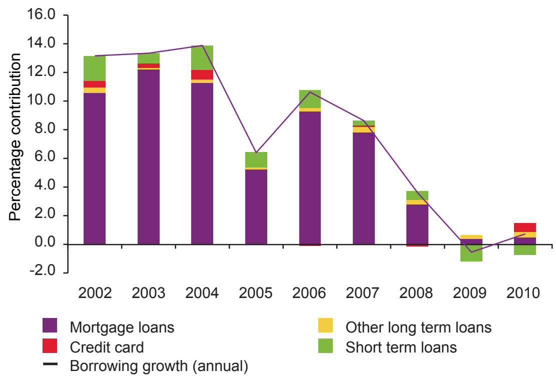
Since the beginning of the recession, a crucial driver of households' decisions on accumulating financial assets has been a flight to safety. Currency (i.e. notes and coins in circulation) and deposits, as well as pensions and insurance, saw positive flows, while shares and other equity experienced significant outflows. Price volatility was the main contributor to change in the stock value of financial assets, while household investment decisions reveal, compared to prices, a less volatile behaviour (see figure 10). In 2011, households' tendency towards holding relatively safe assets continued, while economic uncertainty remained. A more granular analysis on the financial product holdings among different consumer segments is developed in section 5.

Figure 11: New fixed maturity deposits held by households



Source: Bank of England

Figure 12: Contributions to annual growth in borrowing



Source: ONS

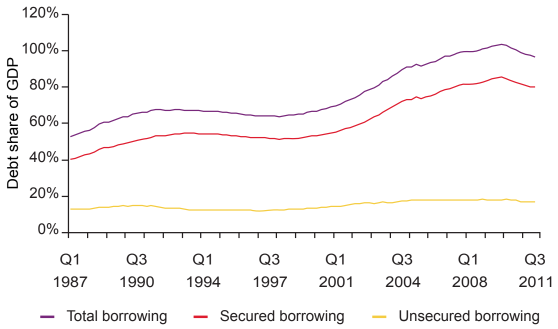
A second crucial element in households' investment decisions has been an ongoing search for yield in financial assets. This search for yield might have been encouraged by the low interest rate environment since late 2008 and – more recently – above-target inflation. While this search initially focused on equity investment, it has more recently shifted to deposits as market volatility increased. Within time deposits, those with longer maturities and higher yield have become more appealing, with the weighted average term increasing substantially in the past two years (see figure 11). But banks have also been increasingly interested in supplying longer-term deposits to improve their liquidity positions. With market expectations on the Bank Rate continuing to be low for the next few years (see figure 3), consumers may continue to keep searching for financial assets offering high yields for some time.

2.2.3 Household debt

Total debt (both secured and unsecured) grew steadily in the years running up to the financial crisis. Secured debt (e.g. mortgages), which accounts for around 82% of total debt, grew at an annual average rate of more than 11% from 2001 until mid-2008 according to the Office for National Statistics (ONS). Unsecured debt (e.g. credit cards, personal loans) also grew sharply in the same period, but at a lower rate (9% year on year).

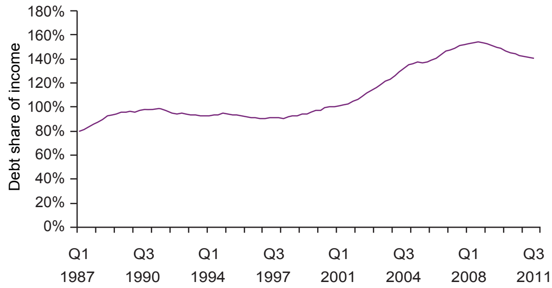
However, as the crisis started to affect households' finances, total debt stabilised. Since late 2008 until 2011, total debt was almost flat, growing less than 1% on average. The very slow growth in secured debt has been the main contributor to the flat growth in total debt, while unsecured debt has shown a more volatile behaviour, with significant declines in 2009 and in 2011. Mortgage volumes, which in the pre-recession period were the main contributor to borrowing growth, now make a small contribution, and short-term loan volumes have a negative contribution (see figure 12). However, debt levels remain high and households are therefore still vulnerable to shocks to employment income or interest rates. In addition, consumer research commissioned from GfK-NOP and discussed in section 5 of this chapter found an increase in the value of total debt among retirees between 2010 and 2011, a development that may suggest an increase in the number of elderly consumers that are finding it difficult to repay their debt at retirement.

Figure 13: Household debt as a share of GDP



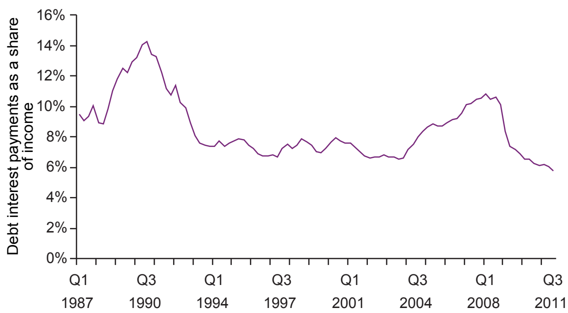
Source: ONS, FSA estimates

Figure 14: Household total debt as a share of post-tax income



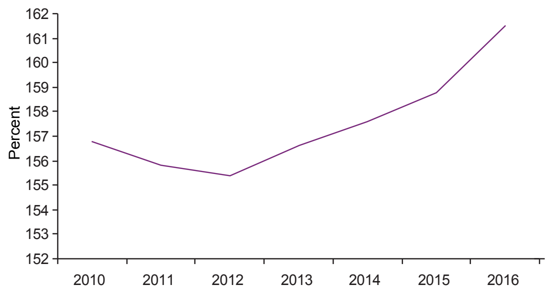
Source: ONS, FSA estimates

Figure 15: Household total debt interest payments as a share of post-tax income



Source: ONS, FSA estimates

Figure 16: OBR projection of household debt as a share of disposable income (November 2011)



Source: OBR (Economic and Fiscal Outlook, November 2011)

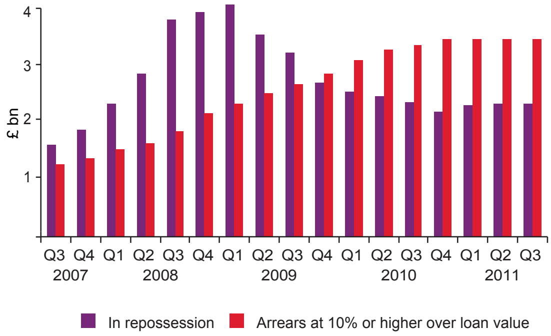
Along with the almost flat growth in debt, the rise in nominal income and GDP immediately after the crisis resulted in household leverage (measured either as the debt to income or debt to GDP ratio) declining from its record high during the recession (see figures 13 and 14). As a result of a flat debt level and lower nominal interest rates, the share of income spent on debt interest payments has decreased since 2008 (see figure 15).

The OBR November 2011 projections on household debt over the period 2011 to 2016 reflect the expectation that household consumption and investment in physical and financial assets will rise more quickly than disposable income. As households seek to sustain their standard of living, the difference between household income and spending is projected to be made up by borrowing, increasing both the level of debt and the debt to income ratio (see figure 16). The OBR projection is premised on the expectation of steadily easing credit conditions. Credit availability showed some improvement in 2010 and 2011 (see figure 17), but further easing may be affected by overall economic uncertainty and tighter wholesale funding conditions in the UK and the Euro area. Section 4 discusses in more detail recent trends in retail banks' lending to households.

Figure 17: Availability of household credit

Source: Bank of England (based on Credit Conditions Survey)
Note: Net percentage balances are calculated by weighting together the responses of those lenders who answered the question by their market shares. Positive balances indicate that lenders, on balance, reported credit availability to be higher than over the previous three-month period, or that the terms and conditions on which credit was provided became cheaper or looser respectively.

Figure 18: Balance on cases in arrears and repossessions



Source: FSA MLAR

The low interest rate environment has, on average, made mortgages more affordable for borrowers, although households' ability to benefit from low rates has depended on both the terms of their existing mortgage and ability to access new deals. However, while mortgages may be more affordable for some consumers, the increases in other expenses (reflected in higher inflation) have now eroded some of these benefits for many households.

The number of new mortgage arrears and repossessions strongly increased at the beginning of the recession. In mid-2008 several governmental and regulatory initiatives were taken to limit repossessions. Forbearance facilities provided to borrowers have contributed to lower levels of arrears and repossessions compared to the 1990s recession, together with the lower level of interest rates and unemployment relative to that period. However, the level of arrears is significantly higher in some parts of the UK, for example, in Northern Ireland, Wales and the north of England. In addition, not all borrowers in arrears are able to recover and get back on track with their mortgage payments. This is particularly true in the case of severe mortgage arrears: for example, a large majority (81%) of borrowers who in August 2009 were in severe arrears of more than six months still had arrears or payment shortfalls in December 2010 – February 2011.[5]

Despite the historically low interest rate environment, a small rise in repossessions in 2011 and the continued increase of mortgages with very high levels of arrears (10% or higher of the loan value) may signal the fact that greater mortgage repayment difficulties may be starting to materialise again in 2012 (see figure 18). Challenging economic conditions, the recent unemployment increase, the reduction in real household income, and the public spending cuts are all likely to have an impact on household finances. Any future rise in interest rates may also significantly affect the still very high indebtedness of UK households, as well as on the number of arrears and repossessions.

5 See Chapter 6 and exhibit 6.19 in FSA Mortgage Market Review Data Pack, December 2011. http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/cp/mmr_datapack2011.pdf

3. Regulatory background and outlook

This section sets out significant developments in the regulatory environment and how these may affect both firms' behaviour and consumers. We have summarised those issues likely to have an impact on firms in the next 18 months followed by an overview of the longer term developments.

3.1 Key regulatory changes in the next 18 months

3.1.1 The Retail Distribution Review (RDR)

The changes resulting from the RDR will come into force in January 2013. The Review has been a major policy initiative, with consequences for all participants in the market for retail investment products. Launched in 2006, the rules were published in 2010 and – as explained in RCRO 2011 – addressed three major areas:

- How intermediary firms describe their service to consumers, as either independent or restricted.
- How intermediary firms are remunerated for advising on retail investment products, requiring the introduction of adviser charging in place of commission.
- The level of qualification and ethical and professional standards of retail intermediaries.

These changes are designed to address some of the long-standing issues that have persisted in the market for many years and given rise to substantial consumer detriment. The rules have been clear for some time and we have an implementation workstream to support firms through the transition.

There remain a number of areas of policy focus. We intend to review rules surrounding capital for personal investment firms to relieve pressure on firms as they prepare for the RDR and to ensure that the rules align with the FCA's intention to focus on an orderly wind-down of such firms. Some further work remains on platforms, where we are conscious of the industry's desire for certainty and the need to understand the consequences of decisions we make.

We are fully aware of the need to coordinate our policy development with a number of related EU initiatives in these areas. In its draft revised Markets in Financial Instruments Directive (MiFID II), the Commission has published proposals to strengthen regulation, increase transparency, improve investor protection, reinforce confidence, reduce unregulated areas and ensure that supervisors have adequate powers. MiFID II will also include new selling standards for some Packaged Retail Investment Products (PRIPS). The Commission is also preparing proposals for a revised Insurance Mediation Directive (IMD), which aims to raise standards for all entities selling insurance. The IMD will also include new proposals on sales standards for insurance PRIPS. We remain committed to high levels of consumer protection in the UK and are confident that our policy initiatives are compatible with the EU proposals.

3.1.2 The Mortgage Market Review (MMR)

We continue our MMR which is a wide-ranging review of mortgage regulation with two broad aims: a mortgage market that is sustainable for all participants and a flexible market that works better for consumers.

After a Discussion Paper in 2009, we rapidly strengthened our rules for arrears handling and announced our intention to extend the approved persons regime. We published initial Consultation Papers on responsible lending and distribution and disclosure. Following these consultations, we published a comprehensive Consultation Paper in December 2011[6], which outlined updated proposals in a consolidated package. Overall, these proposals seek to:

- Reduce the tail of poor lending that was particularly evident in the lead up to the financial crisis, while not unnecessarily restricting consumers' ability to take out significant but affordable mortgages. Specifically, we are proposing to require lenders to verify income and undertake a detailed assessment of the consumer's ability to repay the loan.
- Ensure consumers are appropriately engaged in the sales process and receive products that are suitable for their needs and circumstances. This includes the proposal for the vast majority of sales of mortgage products where there is spoken interaction with the consumer to be advised and a re-focusing of our disclosure requirements.

These proposals are the product of significant analysis, particularly on where the appropriate balance lies between protecting consumers from the harm of having an unaffordable mortgage while maintaining an appropriate level of access to affordable mortgage finance. We will reflect on consultation feedback in 2012 and expect to finalise our rules, but we do not propose to implement these before the summer of 2013. However, if there is widespread support for particular proposals, for example in relation to mortgage arrears charges, we may implement some aspects sooner.

In addition, at a EU level, the European Commission put forward a proposal for a directive on mortgage credit, published in March 2011, which seeks to ensure responsible lending and borrowing and to restore consumer confidence by providing a high-level framework of protection for consumers across the EU.

3.1.3 Rules governing compensation schemes

Recent cases of compensation have led to a number of calls to review compensation schemes arrangements. Meanwhile, in 2010 the European Commission proposed changes to the Deposit Guarantee Schemes Directive (DGSD) and the Investor Compensation Schemes Directive (ICSD). It also launched a public consultation on options to improve protection for insurance policyholders, including the possibility of setting up insurance guarantee schemes in all Member States. Negotiations on the DGSD and ICSD continue, with the DGSD being the furthest advanced. The changes proposed to the DGSD include some significant potential changes to the funding of the FSCS, arrangements for which also need updating to reflect the split of responsibility for the FSCS between the FCA and the Prudential Regulation Authority (PRA). We intend to consult on the changes shortly after the final DGSD is published. But if negotiations are further delayed, the need to consult on the funding arrangements of the FSCS, including from changes due to regulatory reform, may take precedence and we would consult separately on these. The timeframe for agreement on changes to the ICSD and a potential Insurance Guarantee Schemes Directive are not yet clear.

6 http://www.fsa.gov.uk/library/policy/cp/2011/11_31.shtml

3.2 Long-term policy developments

3.2.1 The new UK Regulatory Architecture and the creation of the FCA

In 2010, the government announced its proposal for a new model of financial regulation in the UK, with regulatory responsibility being divided between the Financial Policy Committee, the PRA and the Financial Conduct Authority (FCA). The government expects the FCA to intervene more strongly in retail financial services markets. The proposed new powers, in relation to product intervention and financial promotions, would enable the FCA to act more swiftly to prevent retail consumer detriment. The legislation to create this new model is currently progressing through Parliament, with the aim of being implemented from 2013.

We welcome the government's decision to transfer responsibility for the regulation of consumer credit to the FCA. We, alongside the government, are now working to develop a regime that will ensure regulation is proportionate for the different segments of the consumer credit market.

Separately, the government has also announced its intention to transfer responsibility for regulating second charge lending to the FSA. The timing for any transfer remains under consideration.

On 12 September 2011, the Independent Commission on Banking published its final report, which included recommendations for structural and non-structural reforms to the UK banking sector to promote financial stability and competition, including by increasing transparency across retail banking products. In its December response, the government said that the OFT and the FCA should work together and with the financial services industry to improve transparency. We are currently considering how this should be done.

3.3 Prudential issues with possible retail conduct implications

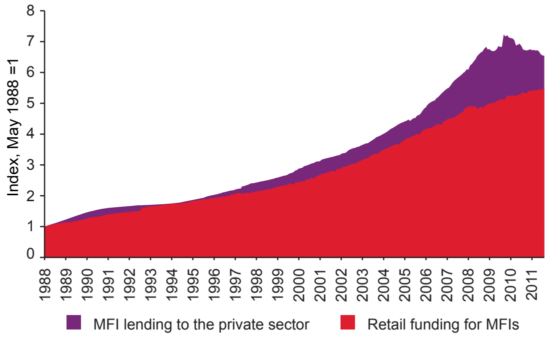
3.3.1 Capital Requirements Directive IV (CRD IV)

In July 2011, the European Commission issued its legislative proposals – referred to as CRD IV – for how the EU will meet the international agreement to implement the Basel III package of prudential reforms for banks through a re-write of the Capital Requirements Directive (CRD). The Basel III Framework seeks to, among other things, enhance the quality and quantity of capital (by, for example, strengthening the criteria to be satisfied by regulatory capital) and introduce two new liquidity ratios (to encourage the holding of higher levels of high-quality liquid assets). As such, CRD IV represents a package of major reforms of the EU's prudential requirements for banks and building societies, while also applying to many investment firms within the EU. As such, we are conscious that simply reading the new CRD IV requirements designed for banks across to all types of investment firms within its scope may not always be the most appropriate way to address the prudential risks these firms might present to consumers and market participants. However, the timeline is tight if the EU legislation is to meet the start of the Basel phase-in arrangements that start from 1 January 2013.

3.3.2 Solvency II

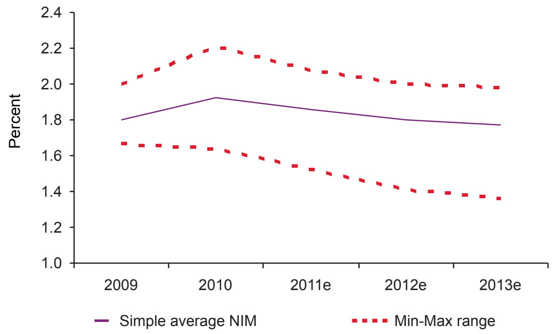
While Solvency II is regarded as a mainly prudential directive concerned with ensuring capital is more sensitive to the risks insurers carry, it also has a number of wide-ranging consequences for the way in which insurers treat their policyholders. One of the most significant changes will be for unit-linked business, where the range of assets insurers can use will widen as a result

Figure 19: The retail funding gap[7]



Source: Bank of England

Figure 20: Net interest margin in five large banks



Source: Citi (Research Report, February 2012)

of Solvency II. This poses conduct issues because it is the policyholder and the beneficiary, not the insurer, that bears the investment and other risks related to unit-linked contracts. We are reviewing the rules relating to unit-linked business and we are proposing to alter them to ensure that they meet the requirements of Solvency II, while maintaining the appropriate level of consumer protection. Transposition of the revised rules into the Handbook is planned for the start of 2013 and they will take effect from the beginning of 2014.

4. Firms and the supply of financial products

In this section we consider key trends emerging in firms operating in different sectors of the financial services market. In particular, the following sections look at key trends in the retail banking, asset management, insurance and retail intermediaries. These trends include firms' responses to financial, competitive or regulatory challenges from the current environment. Some of these trends provide important context to the risks discussed in Chapter B.

4.1 Retail banking

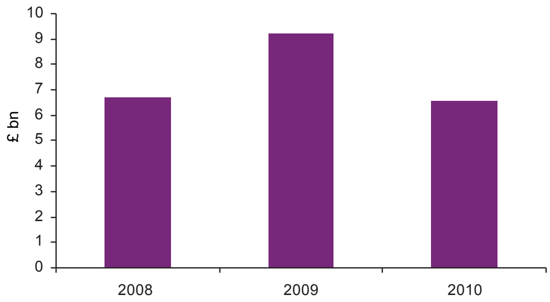
UK banks have improved their resilience since the beginning of the financial crisis by increasing their capital ratios, building up larger liquidity buffers, undertaking stress testing exercises and achieving a major reduction in the official funding support provided to them in 2008 and 2009. The financial crisis also evidenced the necessity to strengthen and enhance the safety of the banking system. To help achieve this objective, new regulatory requirements were established, as discussed in the previous section on the regulatory outlook.

Since the beginning of the summer, conditions in funding markets have changed. A generalised risk aversion has emerged, primarily as a result of developments in the Euro area. UK banks have experienced a reduction in the term of funding and a clear shift toward secured over unsecured funding, while their retail funding gap remains high (see figure 19). In this context of strong funding competition, retail margins of UK banks remain compressed (see figure 20). From 2010 onwards, spreads on deposits have continued to increase, while spreads on mortgage lending have been decreasing slightly.[8]

7 MFIs are Monetary Financial Institutions. The retail funding gap is calculated as the difference between net lending to the private sector and retail deposits from the private sector. It is indicative of MFIs' reliance on retail funds (as opposed to other sources, such as wholesale funds) to finance their lending: the greater the gap, the stronger the reliance on other funding sources.

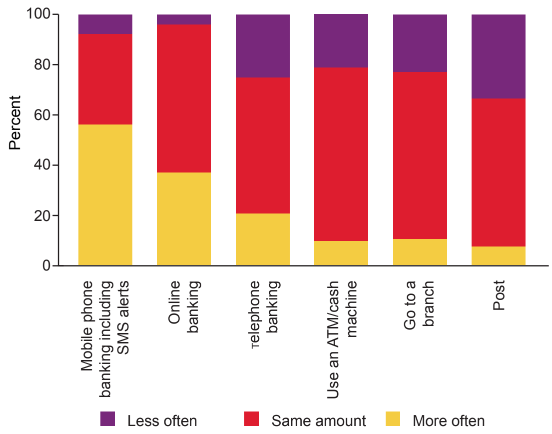
8 Spreads on deposits are measured as the difference between a weighted average of time, sight and cash ISA interest rates and the Bank Rate. Spreads on mortgages are the difference between the effective interest rate on new mortgages and the Bank Rate.

Figure 21: Retail impairment charges of five large UK retail banks



Source: Annual reports of five large UK retail banks

Figure 22: Use of technology to manage own finances (in relation to 12 months ago)



Source: Monitise – Future Foundation (Emerging trends in mobile banking, 2010)

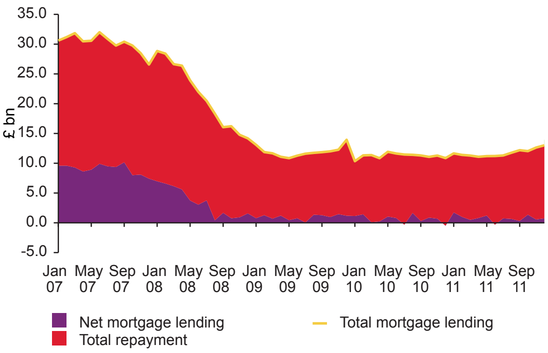
One key recent driver of banks' profitability has been the significant fall in retail and wholesale impairment charges. Banks' financial statements show that retail impairment charges started decreasing in 2010 (see figure 21), by more than 29% over the previous year, after an increase of around 38% in 2009[9], as banks adopted a more prudent risk appetite and UK economic conditions improved. Impairment charges may continue to decrease, in part because of more stable house prices and low interest rates. But this trend may reverse if adverse shocks to the UK economy (e.g. lower house prices or higher unemployment) arise in the future.

Additionally, the real level of impairments may be masked by forbearance. Banks are accommodating lower monthly mortgage payments for some customers experiencing periods of temporary financial difficulty. The FSA forbearance review suggests that between 5% and 8% of UK mortgages are subject to forbearance. This forbearance is welcome at this time, although it could have the effect of either delaying accounts from falling into reported arrears figures or, for those already in arrears, delaying further deterioration. This in turn means that reported arrears become an incomplete measure of the underlying impairment. The FSA has issued guidance to lenders to ensure that adequate impairment provisions are established for such accounts.

In the context of tight bank profitability, banks' strategies increasingly include cost-cutting plans in both front and back office functions, as well as other ways to improve efficiency (e.g. improved client profiling and segmentation to better target their services). Another way to increase profitability is by improving efficiencies through, for example, technology innovation. The use of internet and mobile banking has substantially increased in recent years, especially among the young (see figure 22). Some of the potential risks of cost-cutting and efficiency improvement initiatives for consumers are discussed in section 3.1.1 in Chapter B, while section 3.1.4 presents risks associated with the use of new payment technologies.

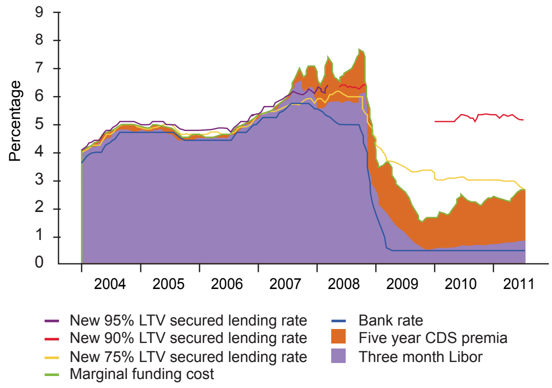
9 Data only includes retail impairment charges of the five largest retail banks in the UK.

Figure 23: Net and gross mortgage lending – monthly flows



Source: Bank of England

Figure 24: New household secured lending rates, Bank rate and an estimate of the marginal funding cost



Source: Bank of England, Bloomberg, British Bankers' Association and Markit Group Limited (Inflation Report, August 2011)

4.1.1 Mortgage lending

Since 2009, the volume of new lending has remained significantly lower than at the peak of the market, but also remained stable. Some debt principal repayment continues, leaving net new mortgage lending near zero (see figure 23). One of the main drivers for this fall in lending has been a significant decrease in the level of remortgaging, which at the peak of the market accounted for nearly half of all mortgages sold (as consumers looked for better deals or to take equity out of their properties). It is now about a third of new sales. Another important factor has been the reduction in the availability of interest-only mortgages from lenders, particularly for first-time buyers. While the sale of interest-only mortgages rose sharply between 2002 and 2007, peaking at a third of all mortgage sales in 2007, they now account for around 15% of regulated mortgage sales.[10]

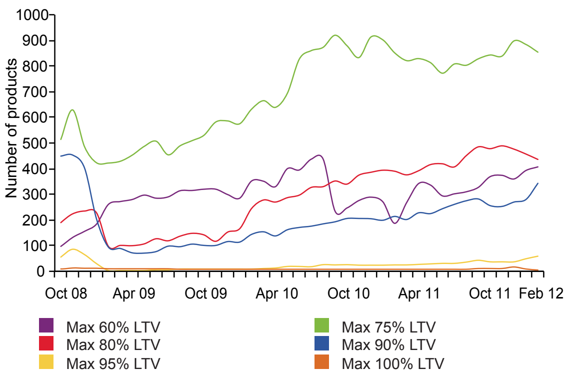
The increase in funding costs from late 2009 has been an important reason why mortgage spreads, despite the recent decrease, remain elevated (figure 24). Spreads are particularly large on higher loan-to-value (LTV) mortgages, as banks maintain high new lending rates on more risky products (e.g. higher LTVs and part of the buy-to-let (BTL) mortgage market), to improve revenues. Banks also charge higher rates on new secured lending, which on average remains more profitable than the mortgage back book.

Future changes in mortgage spreads may be driven by higher funding costs for banks, for example if the greater economic uncertainty from the euro area sovereign debt crisis further increases the risk premium in wholesale funding costs, and the strong competition for retail funds continues to push retail funding costs up.

In the past year, there has been an increase in the number of mortgages offered at higher LTVs (see figure 25). However, the vast majority of all mortgage products offered remain below 85% LTV, whereas before the crisis mortgage products at 90% LTV or above represented the majority of mortgages offered. In addition, the number of BTL loans has also increased (see figure 26). The BTL market is viewed as a potential growth area by lenders, in part as tenant demand in the rental sector remains strong, and tends to offer better margins. We discuss in section 3.11.4 of Chapter B risks for consumers associated with BTL products.

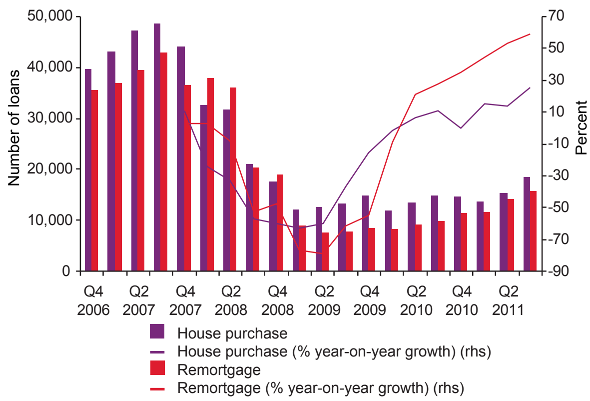
10 FSA Product Sales Data (PSD). For further discussion of interest-only mortgages see Chapter 11 of the FSA Mortgage Market Review Data Pack, December 2011. http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/cp/mmr_datapack2011.pdf

Figure 25: Loan-to-value availability – total products



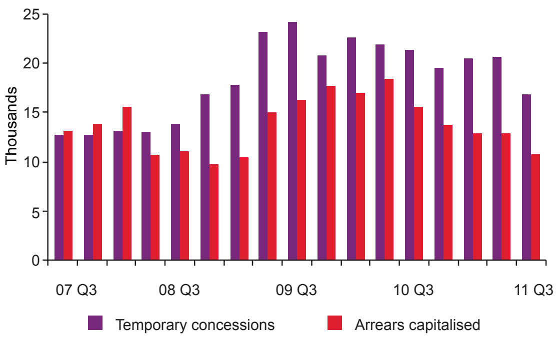
Source: Moneyfacts (Treasury Reports, September 2011)

Figure 26: Buy-to-let loans by purpose



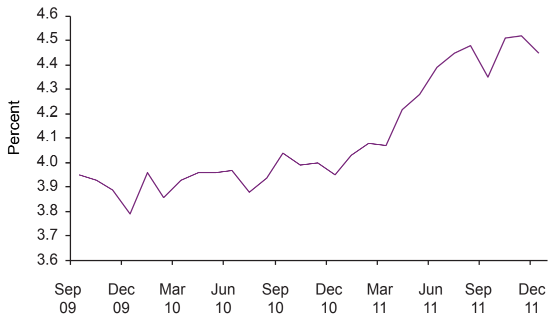
Source: CML

Figure 27: Number of temporary concessions and arrears capitalised



Source: FSA
Note: This data only reflects the incidence of reported forbearance activity on accounts over 1.5% in arrears (a very small subset of all accounts in arrears).

Figure 28: Monthly interest rate on time deposits[11]



Source: Bank of England (Bankstats)

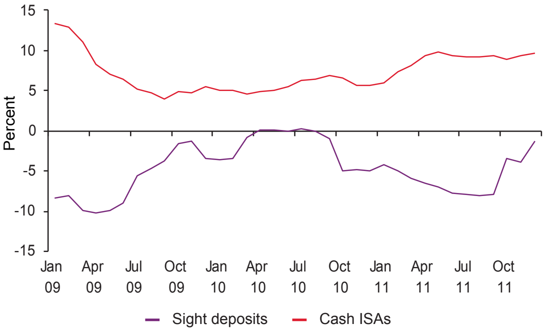
The level of mortgage repossessions has remained stable in the last two years after peaking in early 2009. As mentioned in section 2.2.3, this was partly a result of governmental and regulatory initiatives taken in mid-2008. Following these interventions, both capitalisation of arrears and temporary concessions[12] increased for customers with higher levels of arrears.[13] It has since slightly decreased (see figure 27). Some types of temporary and permanent forbearance facilities have substantially decreased (transfer to interest only and term extensions), while other types have increased (reduced and nil payment concession). We discuss in section 3.11.2 in Chapter B the risk posed by inappropriate use of forbearance measures by lenders.

4.1.2 Deposits and savings

Competition among banks to raise retail deposits remains strong as they represent one of the main sources of funding for banks. However, competition differs significantly depending on the type of deposit. Competition for term deposits is particularly intense, with rates offered by banks for this type of deposit continuing to increase (despite the small fall in late 2011, see figure 28). Cash ISA deposits are also strongly increasing (with growth rates near 10%), in light of the tax advantages that these products offer to consumers (see figure 29).

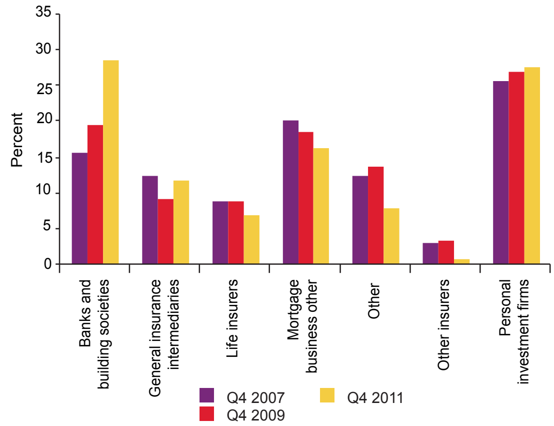
11 Excludes time deposits at mutual institutions.
12 Temporary concessions are lenders' agreements with the borrower whereby the monthly payments are either suspended or less than they would be on a fully commercial basis. Capitalisations are formal arrangements to add all, or part of, a borrower's arrears to the amount of outstanding principal.
13 Customers with accounts over 1.5% in arrears. See note in figure 27.

Figure 29: Growth rates of sight deposits[14] and cash ISAs



Source: Bank of England (Bankstats)

Figure 30: Market share by selling type in selected quarters of Pure Protection Contracts



Source: FSA Pure Protection Contracts PSD

Contrary to the above, sight deposits, which had sharply decreased in value at the beginning of the crisis and then recovered toward the end of 2009 and in 2010, have fallen in 2011(see figure 29).

4.1.3 Fee income

As discussed in the RCRO 2011, a number of conduct risks are related to the evolution of fee income-generating products in banking. Some sources of non-interest income in banking, such as Payment Protection Insurance (PPI), have gradually disappeared as a result of regulatory intervention. However, banks and building societies notably increased their market share of pure protection products, focusing on alternative protection products (see figure 30). The gain in market share for banks and building societies was significant across all three types of protection products, and particularly in Income Protection and Critical Illness sold as a rider benefit (see table 1). From late 2008 onwards, sales (made by all types of firms) have remained broadly stable. But more recently, pure protection transactions have been expanding (at 4.3% year on year in the first quarter of 2011). This is mainly driven by the increase in Critical Illness sold as a rider benefit.

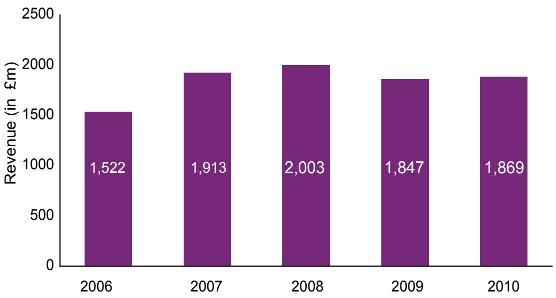
Table 1: Market share of each product by type of selling firm

Market share (%)	Critical illness sold as a rider benefit		Income protection		Standalone critical illness	
	2009/10	2010/11	2009/10	2010/11	2009/10	2010/11
Banks and building societies	27	33	7	14	2	4
General insurance intermediaries	9	10	10	10	4	7
Life insurers	6	6	24	16	42	41
Mortgage businesses	17	15	17	19	15	14
Other	12	10	12	11	5	5
Other insurers	2	1	2	2	13	9
Personal investment firms	27	26	28	27	19	21

Source: FSA Pure Protection Contracts PSD, August 2011

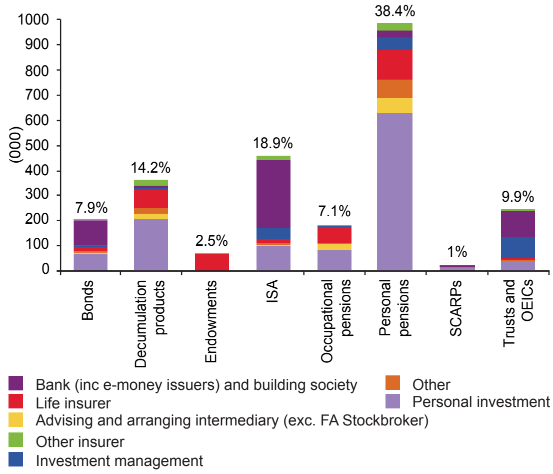
14 Excludes sight deposits at mutual institutions.

Figure 31: Total private banking revenue



Source: ComPeer (Premium and affluent Banking, UK, September 2011)

Figure 32: New product sales by product type and selling firm, January to December 2011



Source: FSA Retail Investments PSD, August 2011
Note: Banks and Building Societies include e-money issuers. Advising and arranging intermediaries exclude Financial Advisers and Stockbrokers. Broadly, a personal investment firm is a firm for whom the most substantial part of its gross income is derived from a) advising on investments, or arranging deals in investments, in relation to packaged products; and b) managing investments for retail customers. % refers to market share over total sales.

There has been an increasing trend in the sale of other fee income products, such as packaged accounts (e.g. current accounts that charge a monthly fee in exchange for additional benefits) over the last few years. According to Defaqto research commissioned by the FSA, in 2011 (from January to August) there was a small increase in the monthly account fees for this type of account (see table 2). The provision of some benefits have been withdrawn from the market (e.g. holiday or travel discounts), while providers appear to be increasingly offering other types of benefits (e.g. text messaging events, travel insurance, mobile phone insurance and motor breakdown insurance). Some of the risks in relation to packaged accounts are discussed in section 3.13.1 in Chapter B.

Private banking revenues have grown modestly since the beginning of the crisis (only 1.2% in 2010, see figure 31). The economic slowdown is limiting growth in new premium and private banking account numbers, in part owing to a reduction in the pool of qualifying customers. Continued economic instability is likely to keep client activity at a low level. This will subsequently have an impact on (premium and affluent) banking revenue growth.

Table 2: Monthly fees of packaged bank accounts

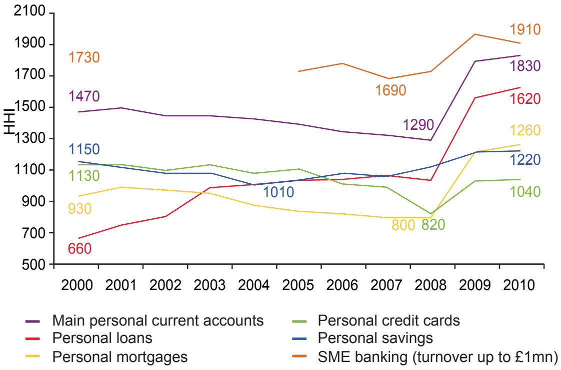
Monthly account fees	Proportion of accounts that charge a monthly fee		Average monthly account fee, fee-paying accounts (£)		Amount of Change (£)	Difference (%)
	1 Jan 2011	31 Aug 2011	1 Jan 2011	31 Aug 2011		
Added value	82.5%	97.9%	£12.56	£13.10	£0.55	4.4%
Premier added value	73.3%	73.3%	£25.04	£25.95	£0.91	3.7%
Total	**45.0%**	**46.7%**	**£14.92**	**£15.58**	**£0.66**	**4.4%**

Source: Defaqto research
Note: While added value accounts are aimed at the wider customer base, premier added value accounts are aimed at customers with high annual incomes, typically in excess of £75,000.

The market share of banks and building societies differs substantially by investment product type. Most investment bonds, stock and share ISAs and the majority of Unit Trusts and OEICs continue to be sold by banks and building societies (see figure 32).[15]

15 This figure excludes platform sales, which could exaggerate the market share of banks and building societies against intermediaries such as personal investment firms, which are more likely to use platforms.

Figure 33: Concentration levels in retail banking measured using Herfindahl- Hirschman Index



Source: Independent Commission on Banking, Final Report Recommendations, September 2011; Commission analysis of SME banking data from the Competition Commission (2000), TNS(2005-2009)and Charterhouse (2010), and personal banking data from GfK FRS
Note: Main PCAs are those that survey respondents holding more than one current account indicated was their 'main' account. SME banking data were taken from the Competition Commission, TNS and Charterhouse. Market shares (by number of customers) for SMEs with a turnover of<£1mn were used as these were available for the longest time period. Where market shares are also available for larger businesses, these were similar to the shares for this sub-section. The TNS RI Small Business Banking Survey data uses respondents' subjective opinion of a definition based on 'main bank'. In the view of at least one bank this has a potentially misleading effect on any subsequent assessment, analysis and calculations of the 'SME market' based on the data. 2009 and 2010 data do not include the RBS and LBG divestitures, which have not yet been completed.

4.1.4 Competition

The crisis has had an impact on the level of competition in UK retail banking. As a potential indicator, concentration levels in most retail products (e.g. lending and deposits) have increased (there have been 14 mergers and acquisitions in UK banks and building societies since April 2008) and remain at historically high levels (see figure 33). Divestiture plans and new entrants could partly reverse this trend. The recent Independent Commission on Banking (ICB) recommendations on structural reforms – such as separation between retail and wholesale banking (retail ring-fence), enhanced loss-absorbency capacity (for instance, through higher capital ratios for large UK ring-fenced banks) and proposals to facilitate customer switching in current accounts – may have potentially significant long-term impacts on profitability, funding costs and market contestability for retail banks and change the future competition dynamic in the sector.

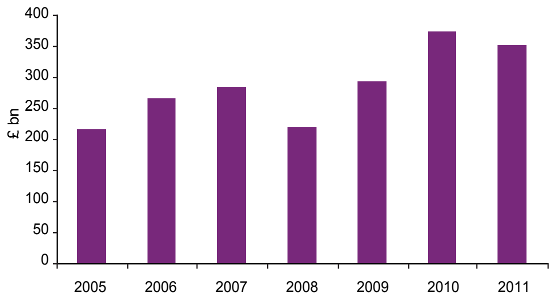
Mortgage lending in 2010 was dominated by the six largest lenders who accounted for over 80% of all mortgages sold.[16] However, competition in some parts of the mortgage market seems to have increased, with lending rates and spreads on lower loan-to-value (LTV) mortgages, over funding costs, falling in the last two years (see figure 24). Evidence of this intensified competition is also demonstrated by the rapid pace of change in the mortgage market, with providers updating or replacing whole portfolios of products often on a monthly or more frequent basis. On the other hand, higher rates of return on buy-to-let (BTL) mortgages may be in part due to higher levels of concentration in this market, with new business dominated by a few lenders.

4.1.5 Regulation

Regulatory changes discussed in section 3, such as the MMR and the RDR, are likely to modify the retail banking landscape as banks rethink their business models. In addition, the provision of CRD IV implementing higher regulatory capital and liquidity recommendations will result in banks trying to increase their revenue to offset the higher funding costs that they will face. For example, new domestic mortgage spreads could increase. Historically, banks facing higher capital requirements have made greater increases in the spreads on business

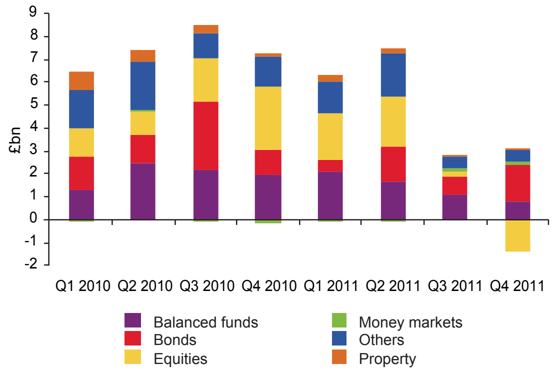
16 2010 estimated market share in gross mortgage lending from CML.

Figure 34: Retail funds under management



Source: IMA

Figure 35: Quarterly net retail sales of authorised funds



Source: IMA

lending to exploit higher elasticity of demand in this sector, thereby shrinking their balance sheets as a way of achieving higher ratios of capital to risk-weighted assets. Moreover, lowering the ratio of business lending to other lending decreases the average risk in banks' portfolios from the regulatory perspective. This is because commercial borrowers are on average treated by regulation as riskier than household borrowers, which further helps the medium-term shift to higher regulatory capital ratios. These balance sheet adjustments are likely to occur in the short and medium term because banks face restrictions in accessing new equity capital. In the long term, after capital ratios have adjusted, banks will be able to reduce lending spreads and grow their balance sheet provided fresh capital is available.

4.2 Asset management

4.2.1 Trends in product supply and innovation

Low interest rates, relatively high savings rates and high inflation sustained the 'search for yield' theme among retail investors discussed in the RCRO 2011. These factors combined with increased asset price volatility to create a challenging operating environment for asset managers in 2011. Against this background, retail funds under management in authorised funds (unit trusts and OEICs) maintained a positive growth path in early 2011 before declining in the second half of the year to reach £363bn at December 2011(see figure 34). Asset managers' revenues remained high, although cost pressures from higher headcounts and variable compensation arrangements appear to have kept industry operating margins below pre-credit crisis levels.

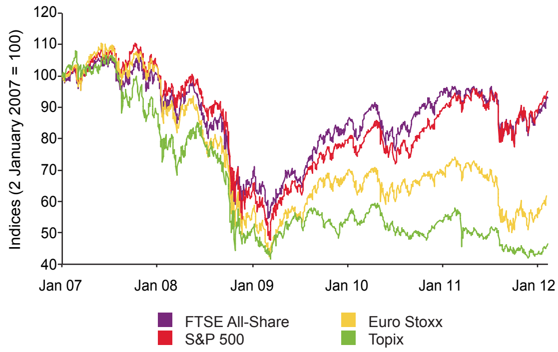
Net retail sales of asset management products were just over £18bn for 2011 – broadly similar to pre-credit crisis levels but below the average £30bn registered for 2009 and 2010. Volatility in retail flows deepened during the second half of the year as waning investor confidence triggered outflows from equity sectors (see figure 35). This domestic performance was consistent with the sharp equity outflows registered at the European level amidst the sovereign debt crisis.

Fund charging levels appear to have stayed reasonably stable in 2011. However, debate continues in the industry on the level of fund charges. Weak investment returns, increasingly price-sensitive investors and growing availability of lower cost passive funds could make investors more focused on charges, potentially exerting downward pressure on them. For

Figure 36: Net retail sales of UK and non-UK Equity Funds

Source: IMA
Note: Includes Funds of Funds.

Figure 37: Movements in International Equity Indices



Source: Defato Platform Report 2011

example, funds with higher Total Expense Ratios (TERs) such as multi-manager funds, may find it more difficult to charge higher fees in an environment of poor investment returns. Moreover, changes in regulation, including the RDR and proposals for platforms, are likely to have an effect, with anecdotal evidence suggesting that many fund managers are currently looking to strip out both trail commission and platform charges from the annual management charges (AMC) leaving a 'clean' share class.

As equity market volatility continued, balanced funds and bond funds were the best selling assets in 2011, accounting for approximately 57% of the year's net retail sales. In contrast, net sales of equity funds were £3bn in 2011, less than half the levels seen in 2010. Although investors' asset choices broadly represented a continuation of cautious behaviour, these shifts might be indicative of a 'flight to safety' in light of the equity market volatility and poor stock market performance.

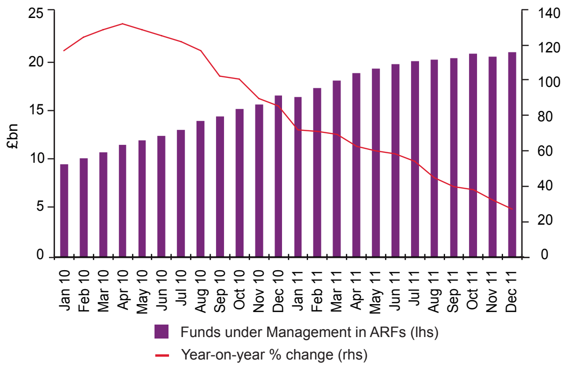
Although equities continued to be the primary investment asset class, the long-term trend of reallocating equity flows from UK equity into non-UK equities and other emerging market securities intensified in 2010 and continued in 2011 (see figure 36). For example, flows into global growth, global emerging and Asia Pacific (ex Japan) funds accounted for two thirds of new equity flows in 2010. However, the elevated risk appetite registered post-2008 has been less consistent in 2011, as declining markets prompted significant net equity outflows, including from emerging markets during 2011 (see figure 37).

Meanwhile, investment flows to tax-advantaged investments declined from the record levels seen in 2010. Net investment ISA sales were £4.1bn in 2010, driven by the increase in the ISA allowance (from £7,200 to £10,100 in Oct 2009 for over 50s and April 2010 for everyone else). By comparison, ISA sales dropped to £3bn in 2011. Still, the combination of increased ISA limits in April 2012 and tax pressures on the wealthy may encourage investors to maximise assets held in tax-advantaged accounts in the year ahead.

Asset managers continued to develop products that appear to offer better performance under volatile market conditions and potential to deliver investors' demand for higher returns, capital protection and diversification. New funds launched during the year have been focused toward the Unclassified, Global and Specialist IMA sectors.

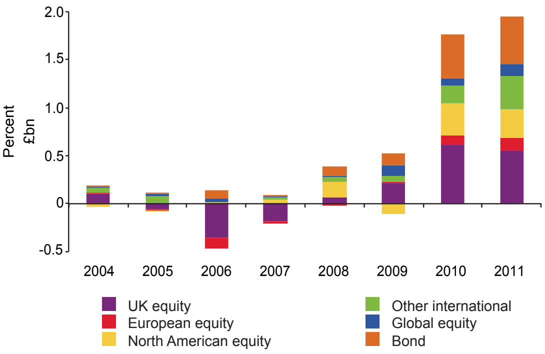
According to the IMA, some 153 funds were launched during 2010/11, with a significant focus on 'outcome-oriented products' targeted at both retail and institutional investors.

Figure 38: UK Domiciled Absolute Return Funds



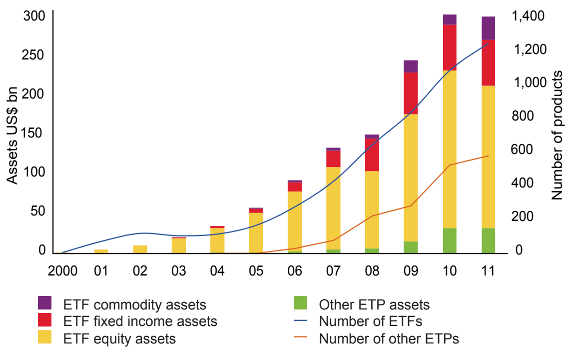
Source: FSA, IMA

Figure 39: Net retail sales of tracker funds by index type



Source: IMA

Figure 40: European ETP multi-year asset growth

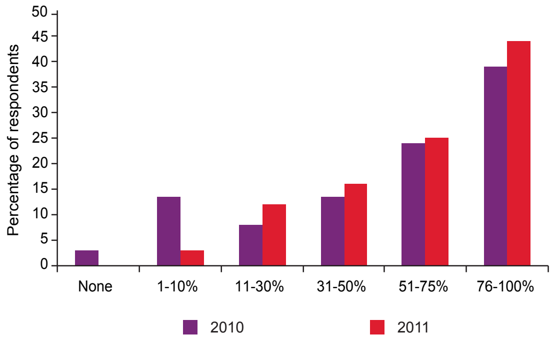


Source: BlackRock Investment Institute, Bloomberg

Absolute Return Funds (ARFs) are examples of these products. The number of funds in the absolute return sector increased from 17 in 2008 to 78 at December 2011, of which nine were launched in 2011. Net retail sales of ARFs were under £1bn in 2011, compared with £2.3bn in 2010. However, Funds under Management (FuM) in UK domiciled ARFs peaked at just over £20.9bn in 2011, a year-on-year increase of 27% coming on the back of the promotion of these products as hedges against weakening markets (see figure 38). More than half of these funds lost money in 2011, which perhaps contributed to the declining rate of growth in funds under management. The risks associated with ARFs are explained in section 3.2.6 in Chapter B of the document.

Retail interest in tracker funds continued to grow as a result of increased appetite for low-cost diversification. Although passive funds represent a comparatively small proportion of retail funds under management, research indicates that an increasing number of passive funds are being launched. Consequently, net retail sales of trackers reached £1.9bn for 2011 – their highest on record. About 95% of these funds track equities, but the proportion invested in UK equity trackers has decreased from approximately 51% in 2009 to 28% in 2011, although still higher than levels seen in 2008 (see figure 39). Continued growth in the availability of passive funds is expected to sustain the debates about the merits of active versus passive fund management and the level of industry charges.

Figure 41: Percentage of business placed via platform



Source: Defaqto Platform Report 2011

Investors also have tended to access a wide range of passive investments by means of Exchange Traded Products (ETPs). As discussed in the RCRO 2011, the European market for ETFs and other ETPs has grown rapidly, albeit from a relatively small base. It reached approximately £193bn[17] in AuM in December 2011, despite some slow-down in growth in the past year (see figure 40). UK-listed ETPs represent about 1.5% of UK managed assets. The risks associated with a subset of ETPs, Exchange Traded Funds (ETFs), were discussed last year and an update is provided in section 3.2.5 in Chapter B of this document.

In the second half of 2011, market volatility had a negative impact on investment managers' sentiments about their business situation.[18] A continuation of the weak retail investor demand seen in the second half of 2011 could be a challenge for the sector's revenue performance in 2012. In response to these income pressures, asset management firms are likely to continue their focus on core activities and areas of greatest strength while tightening control over operating expenditure. In addition, firms' product supply and strategies may continue to be influenced by retail investors' search for both higher yield and reduced risk exposure in the current low interest rate environment.

4.2.2 Trends in distribution

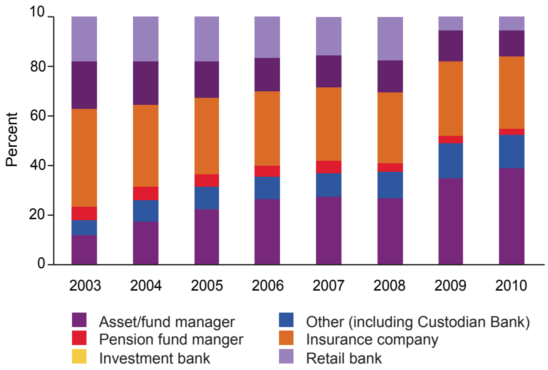
Platforms continued to influence distribution patterns in the funds industry, accounting for about 45% of gross retail sales in 2010.[19] Approximately £168bn of assets were under administration on UK platforms at September 2011, up from £150bn at January 2011 and £100bn at January 2010.[20]

As shown in figure 41, advisers are increasingly relying on platforms, with 2011 survey evidence suggesting that 69% of advisers currently using a platform place more than half of their business with it. This compares with 66% of advisers that placed more than half their business through platforms in 2010. Unit trusts and OEICs remained advisers' investment vehicles of choice on platforms, with 70% of invested assets allocated to unwrapped collectives or ISAs.

Platforms may contribute to a change in distribution dynamics in the sector as the boundary between wealth managers and some IFAs becomes increasingly blurred, particularly with IFAs using platforms to provide portfolio advice, rather than purely transactional advice.

17 USD300bn converted at Bank of England year-end spot exchange rate in December 2011.
18 CBI/PwC Financial Services Survey December 2011.
19 Market Briefing: Platforms. Defaqto April 2011.
20 The Platforum and Defaqto, November 2011.

Figure 42: Ownership of Asset Management firms by UK Assets under Management



Source: IMA

Meanwhile, the flexibility offered by platforms to investors to move between funds may shorten investment holding periods, which may add to commercial pressure for asset managers.

4.2.3 Competition trends

The industry structure remained un-concentrated. The long-term trend has been a concurrent withdrawal of bank-owned asset managers and a rise in independent/autonomous asset managers. Divestment activities in 2008/9 significantly reduced the presence of retail banks in the sector (see figure 42). In general, merger and acquisition activity in the sector slowed post-2008, with mostly small acquisitions occurring in 2010/11. Still, global asset management firms (including those operating in the UK) appear to be looking to cross-border acquisitions to support their growth plans over the coming year[21], especially as domestic competition intensifies. Emerging markets including Eastern Europe, Asia and Latin America feature strongly in the target regions for acquisitions.

Competition appears to remain active among the top ten firms, with only six firms remaining in that group since 1995. Although the number of funds has increased over the last five years, the top 100 funds have accounted for an increasing share of gross sales, which points to the importance of both brand and performance in the industry.

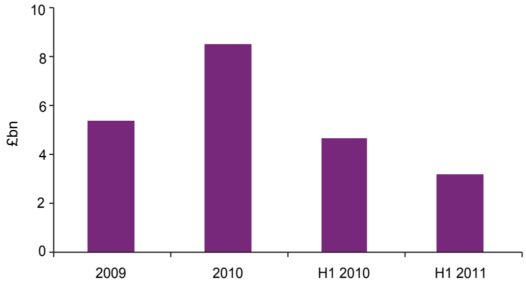
At the same time, increased cross-border activity could drive significant change for both fund manufacturers and distributors, especially with the introduction of UCITS IV. For example, the number of cross-border funds launched increased by 10%[22] in 2010 and early indications are that this trend continued in 2011. Notably, a number of Asian asset management firms have established Europe-based UCITS funds for distribution in Europe as a result of growing demand for emerging market products from European investors. North American asset managers are also increasingly leveraging the UCITS brand to access European markets. In section 3.10 of Chapter B we discuss some of the potential risks arising from differences in the level and scope of investor compensation protection across states.

4.2.4 Responses to regulation

The RDR, UCITS IV, MiFID II and CRD IV, as well as other European regulatory initiatives, are likely to challenge current operating models and may affect firm profitability within the

21 Strategies for a new growth cycle: PWC, March 2011.
22 Strategies for a new growth cycle: PWC, March 2011.

Figure 43: IFRS profit before tax of eight large UK insurance groups



Source: published IFRS financial statements of eight large UK insurance groups

sector. For example, the RDR is expected to further encourage IFAs to outsource parts of the investment advice process, especially fund selection activities, to discretionary fund managers (DFMs) with reports suggesting that just over a quarter of advisers have already outsourced to a discretionary manager.[23] Similarly, wealth managers may be increasingly moving away from advisory to discretionary management services.

Separately, the Alternative Investment Fund Managers Directive (AIFMD) has significant implications for alternative asset managers, including managers of hedge funds, private equity and listed funds (AIF Managers or AIFMs). As mentioned in the DP12/1,[24] implementation of the AIFMD will significantly alter the regulatory framework under which (potential) AIFMs currently operate, manage and/or market alternative investment funds in the UK and across the EU. It will change how AIFMs operate their businesses, how they interact with third-party service providers under delegation (outsourcing) and depositary arrangements, administration and external valuers.

In addition, UK asset managers have to grapple with an increasingly globalised regulatory framework. In particular, asset managers may need to consider the implications of US regulations such as the Dodd-Frank Act and Foreign Account Tax Compliance Act on their strategies in that market.

4.3 Life insurance

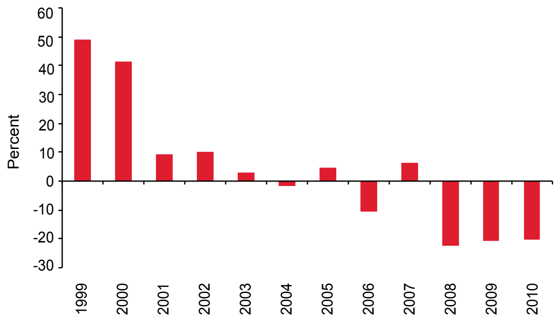
4.3.1 Environment facing life firms

The extent of concurrent changes affecting life insurers that we highlighted in RCRO 2011 remains exceptional. While the changing environment presents both opportunities and threats, it may drive continued restructuring in the sector and possibly accelerate its contraction.

Some improvements in economic and market conditions in 2010 (e.g. the recovery in GDP growth) positively affected some insurers' profitability (see figure 43). However, ongoing pressures may make it challenging to sustain the sector's recovery. For example, high asset price volatility and low economic growth continue to create short to medium-term balance

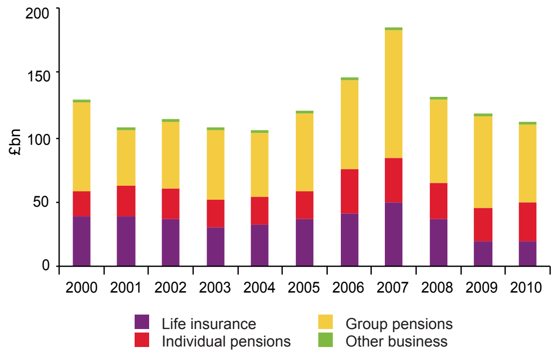
23 Outsourcing to a DFM – a shift in the adviser/client relationship, Defaqto, November 2011.
24 DP12/1: Implementation of the Alternative Investment Fund Managers Directive, January 2012, FSA. http://www.fsa.gov.uk/static/FsaWeb/Shared/Documents/pubs/discussion/dp12-01.pdf

Figure 44: UK life insurance sector net business flows



Source: FSA Returns – All Life Firms
Note: Net business flows are the excess of premium inflows over claims incurred as a % of claims incurred.

Figure 45: Total premium by type of insurance



Source: ABI

sheet pressure. They also limit the demand for life investment products by consumers, with a negative impact on insurers' revenues.

The trend of net business outflows from the sector highlighted in the RCRO 2011 continues (see figure 44), reflecting a mix of long-term factors (e.g. increased payouts as more people retire and live longer, a reduction in the sales of policies over the last decade and high and/or rising levels of lapses) coupled with increasing competitive pressures from alternative savings and investment providers.

Annuity providers remain particularly vulnerable to renewed widening of credit spreads on bond portfolios and continuing increases in longevity. Higher inflation may also increase the liability exposure of firms with inflation-linked annuity products, exposing potential weaknesses in asset-liability matching where firms do not hold backing assets appropriately linked to inflation.

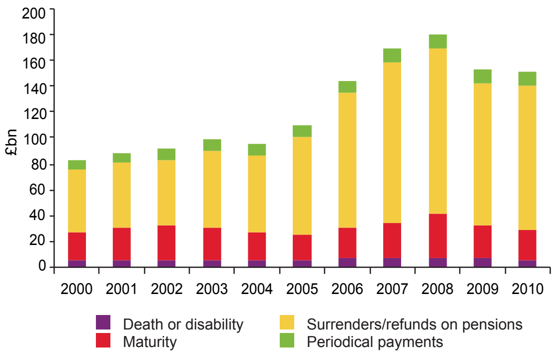
Environmental challenges may lead insurers to enhance their cost-saving strategies, e.g. by outsourcing more of their administrative functions, or to find new sources or channels for their business, e.g. by providing 'white label'[25] products to third parties. Some of these changes have the potential to increase further the complexity of the life insurance value chain. In section 3.1.3 in Chapter B we discuss some of the risks associated with the changing business models in the life insurance sector.

4.3.2 Trends in product supply and innovation

Premiums for life and pensions business were £110bn[26] in 2010, a reduction of 7% from 2009. Life premiums were relatively stable (although at historically low levels), while pension premiums decreased by 8% (see figure 45). In terms of outflows (see figure 46), payments by insurers in 2010 amounted to £151bn, a 1% decrease on 2009. The vast majority of these payments – around £110bn – were surrenders of pension policies.[27]

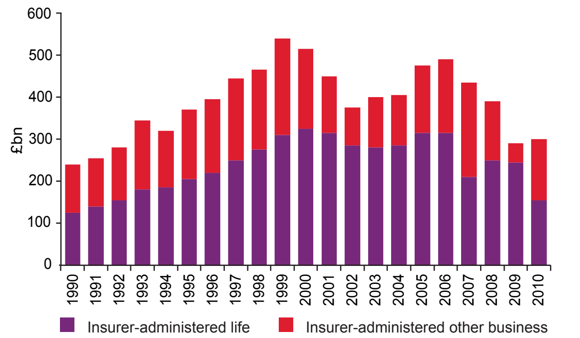
25 'White label' policies are insurance policies designed and underwritten by an insurer that other companies (e.g. retailers) rebrand to make it appear as if they are their own.
26 ABI UK Insurance Key Facts 2011.
27 Around £91bn of these surrenders are transfers of pension funds to other insurers or pension fund managers.

Figure 46: Payments by UK insurers



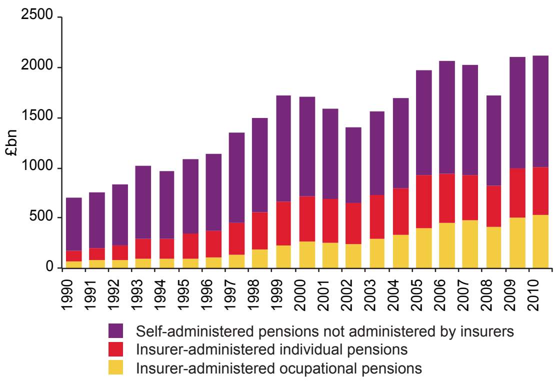
Source: ABI

Figure 47: Funds held in life business



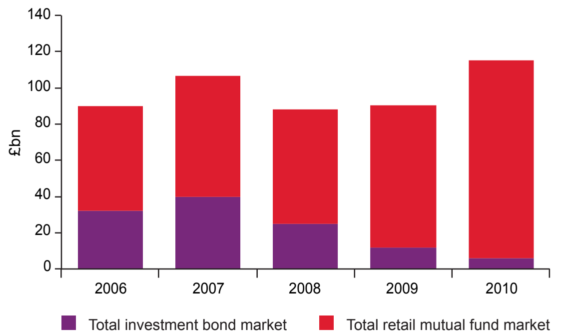
Source: ABI
Note: All values have been deflated using a Gross Domestic Product deflator to convert them into real terms and are shown in 2009 prices. The total of all insurer-administered funds in the above table will not be equal to the total invested assets figure published separately by the ABI, because the above table includes funds held in all FSA authorised life and pension funds and excludes overseas business.

Figure 48: Funds held in pension schemes



Source: ABI
Note: All values have been deflated using a Gross Domestic Product deflator to convert them into real terms and are shown in 2009 prices. The total of all insurer-administered funds in the above table will not be equal to the total invested assets figure published separately by the ABI, because the above table includes funds held in all FSA authorised life and pension funds and excludes overseas business.

Figure 49: Funds in Investment Bonds v Retail Mutual funds



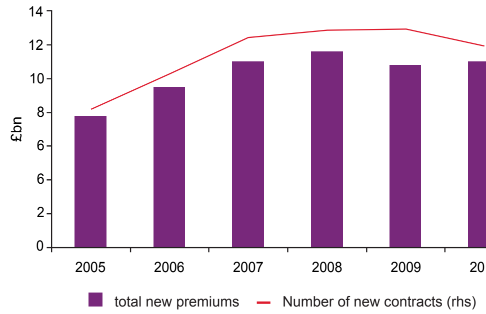
Source: Datamonitor, 'UK Guaranteed Bonds 2011' Report

Money held in insurer-administered life funds fell by 37% year-on-year to £155bn, the lowest level since 1992, but this fall was compensated for by a significant recovery in insurer-administered 'other' business (including e.g. life insurance companies' reserves), which recovered in 2010 after a significant fall in 2009 (see figure 47).

Funds held in pension schemes administered by insurers remained broadly stable at approximately £1trn, representing almost half of the total money held in pension funds in 2010 (see figure 48). In 2010, total investment in insurer-administered individual pension schemes (including personal pensions, group personal pensions and stakeholder pensions) decreased slightly to £475bn. Around 70% of insurer-administered pension funds were invested in linked-based products, such as unit-linked investment funds, while the share of with-profit investment has continued to decline from 21% in 2005 to 14% in 2010.

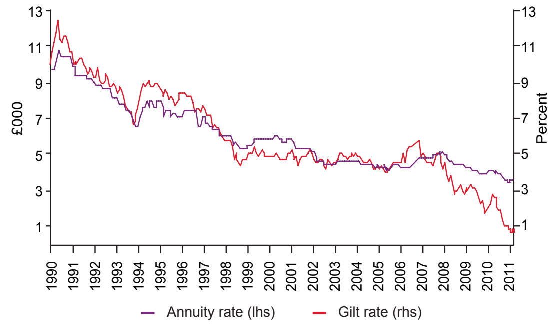
The investment bond market experienced another challenging year in 2010. Single-premium new business for investment bonds was approximately £10bn in 2010, representing a decline of over 24% from 2006 to 2010 (see figure 49). Sharp declines in new business premiums started in the midst of the financial crisis and sales continued to decline in 2010, driven by the difficult economic climate and changes to capital gains tax in 2008 that reduced their tax advantages

Figure 50: Total new premiums and number of new contracts for new pension annuity business



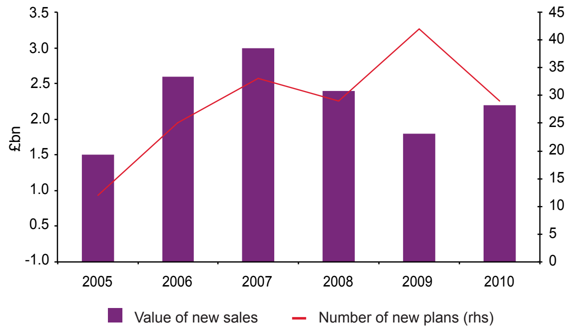
Source: Mintel (based on ABI data)

Figure 51: Annuity rate and gilt rate



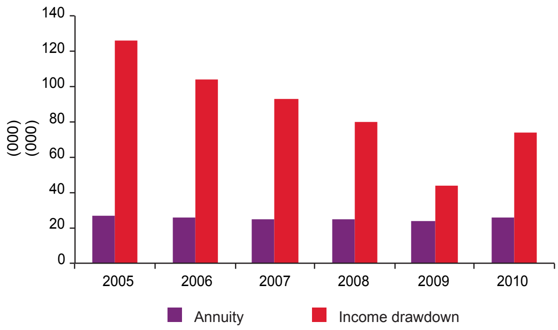
Source: Mintel (based on data from The Annuity Bureau)
Note: The above graph depicts the annual annuity rate for a male aged 65 with a wife aged 62. The cost of the Compulsory Purchase Pension Annuity is £100,000. The annuity is paid monthly in arrears without proportion, is guaranteed for 5 years and pays a 50% spouse's pension. The annuity escalates at 3% per annum.

Figure 52: New sales of income drawdown



Source: Mintel (based on ABI data)
Note: Income drawdown data refer to insurance-administered drawdown plans only; some funds held in SIPPs, wraps and platforms are not included.

Figure 53: Average payments into income drawdown premium



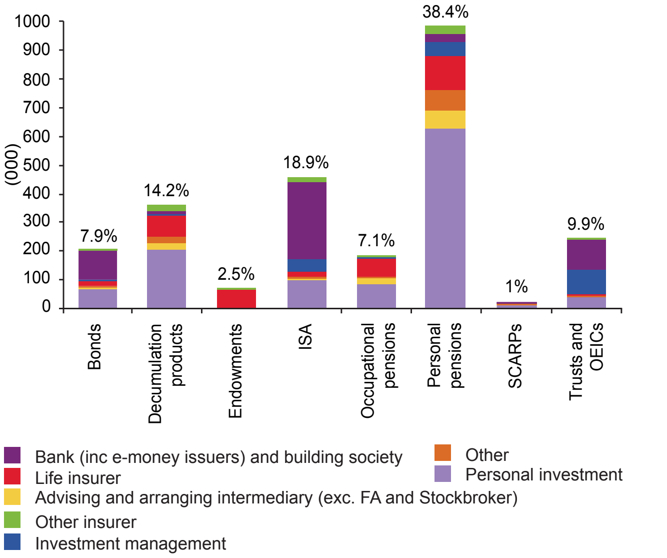
Source: Mintel (based on ABI data)

over unit trusts and OEICS. Investment bonds now represent a small proportion of total new retail investment compared to gross retail sales of unit trusts and OEICS.

Pension annuity sales also declined in 2010 to 426,000 (from 462,000 in 2009), possibly as a result of more people deferring the purchase of an annuity due to uncertain market conditions and low interest rates. The value of new pension annuity premiums held up, increasing slightly on the previous year to £11bn (see figure 50). The downward trend in volume sales is expected to continue as increasing longevity and the long-term decline in gilt yields continue to exert downward pressure on annuity rates (see figure 51). There was a noticeable decline in the number of higher-value annuities sold in 2010. Most pension annuities are bought with small amounts – 74% were bought with funds below £30,000 in 2010. Conventional level annuities remain the most popular type of product, although non-conventional annuities – such as flexible/investment-linked and enhanced products – continue to gain market share.

Uncertainty surrounding the future legislative landscape affecting retirement income solutions may also have contributed to a reduction in the sales of insurers' drawdown plans. The number of sales of these products fell by 30% in 2010, although total new premium increased (see figure 52). While average payments into income drawdown plans recovered in 2010 (see figure 53), reflecting improved confidence in the markets, they are still down on 2008, when the financial crisis sparked a particularly sharp fall in premiums for these types of products. In section 3.12 of Chapter B we discuss some of the risks associated with pension and decumulation products.

Figure 54: New product sales by product type and selling firm, January to December 2011 (repeated from figure 32)



Source: FSA Retail Investments PSD
Note: Banks and Building Societies include e-money issuers. Advising and arranging intermediaries exclude Financial Advisers and Stockbrokers. Broadly, a personal investment firm is a firm for whom the most substantial part of its gross income is derived from a) advising on investments, or arranging deals in investments, in relation to packaged products; and b) managing investments for retail customers. % refers to market share over total sales.

4.3.3 Distribution trends

IFAs remain one of the main distribution channels for many life and pension products (see figure 54). However, some insurers are increasingly considering direct distribution where this provides a more cost-effective way to reach retail customers.

Banks are also an important distribution channel for some life products (e.g. investment bonds) often through joint ventures or distribution agreements. While these arrangements have mainly focused in the past on protection business, distribution of life investments through bank branches is an important channel for life insurers.

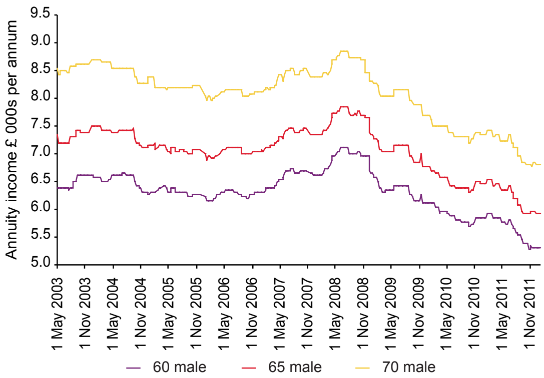
Platforms are another significant channel for life insurers, either directly to retail clients or more frequently through IFAs' use of platforms. Some platforms were launched and are owned by life insurers and are increasingly seen as a way for life providers to derive value at different levels in the product value chain, including the product distribution stage.

4.3.4 Competition trends

The environmental challenges set out in this chapter might increase consolidation in the sector and create a more concentrated sector. However, some product areas that have been relatively concentrated (e.g. alternatives to annuities) may at the same time become increasingly competitive as more firms consider moving into these markets in response to the possible declining profitability of their traditional business.

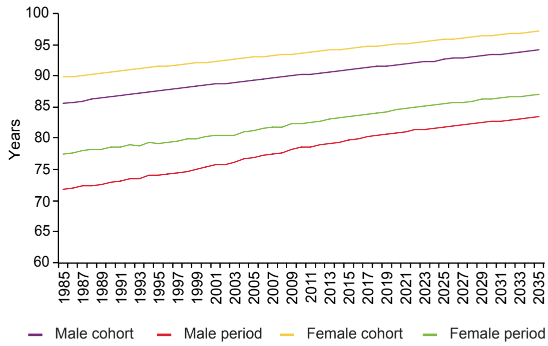
In parallel, implementing the RDR may increase existing competitive pressures from alternative savings and investment providers as IFAs may expand the range of investment products considered in their recommendations to clients.

Figure 55: Annuity rates – annuity index



Source: Hargreaves Lansdown
Note: Based on male, single life annuity, 5 year guarantee, level, monthly advance, £100,000 purchase price, top provider on Hargreaves Lansdown panel.

Figure 56: Period and cohort expectation of life at birth



Source: ONS
Note: Based on historical mortality rates from 1985 to 2010 and assumed calendar year mortality rates from the 2010-based principal projections. Period life expectancy at birth is the average number of years a person would live, if he or she experienced the age-specific mortality rates at the time of their birth throughout their life. In contrast, cohort life expectancy at birth is calculated using age-specific mortality rates which allow for known or projected changes in mortality throughout a person's life.

4.3.5 Life firms' responses to regulation

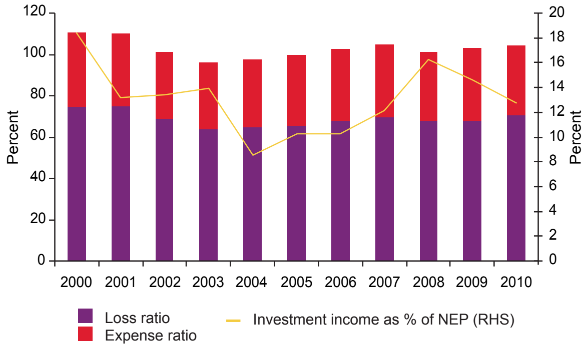
The confluence of RDR, Solvency II and the introduction of the National Employment Savings Trust (NEST) brings opportunities to some firms but also represents a significant challenge for the sector.

Pension reform is expected to have a broadly positive impact on UK life insurance firms. However, there will also be challenges for the sector. For example, some life insurers may be able to increase revenue through auto-enrolment, driven by expanding membership in existing group personal pensions and occupational pensions, as well as creating new schemes. However, pressures may arise, e.g. because of the potential increase in lapses in personal pension plans, as current policy-holders are auto-enrolled into employers' sponsored pension schemes and may choose to stop contributing to their personal pension. Experience of similar reforms in other countries suggests the largest players may particularly benefit.

Following the European Court of Justice (ECJ's) judgment in the 'Test Achats' gender case, insurers will no longer be able to use gender as a factor in the calculation of premiums and benefits from 21 December 2012. A key impact of the ECJ judgment for life insurers will be on product pricing in their annuity business. ABI estimates suggest men approaching retirement could see a reduction of up to 8% in annuity rates, which are already in decline (see figure 55). The 'Test Achats' case is one of several factors – including low nominal interest rates, increasing longevity (see figure 56) and Solvency II capital requirements – that may contribute to upward pressures on the pricing of life products and annuities in particular.

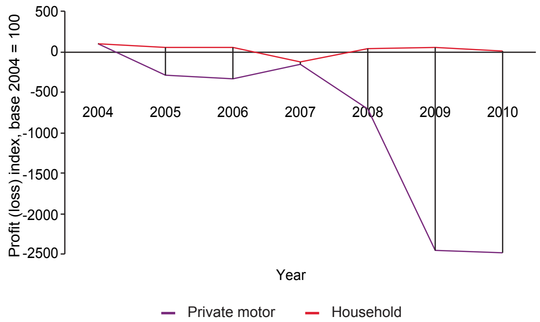
Another important development has been removing the requirement for the compulsory purchase of pension annuities by age 75 from 6 April 2011. Providers will be able to broaden the range of products offered to their customers, giving consumers the ability to tailor investment products more closely to retirement income needs or preferences. This may change the incentives and timings of purchase, particularly for more affluent consumers. Life firms might consider entering or expanding their presence in alternative product markets – such as limited period annuities, with-profit annuities, variable annuities and income drawdown – as more consumers consider these types of products.

Figure 57: UK General Insurers' combined ratio and investment income



Source: FSA returns
Note: Combined ratio below 100% indicates profitability.

Figure 58: Private motor and household underwriting profit (loss)



Source: S&P Capital IQ Synthesys based on FSA returns

4.4 General insurance (GI) and protection insurance

4.4.1 Trends in GI firms

Challenging economic conditions continue to exert pressure on retail general insurers. The need to match assets to liabilities – mostly claims payments – means general insurers' investment strategies are, by necessity, conservative and based on assets such as cash, bonds and gilts, which are historically low-risk, but increasingly low-return. The search for yield may drive some insurers to consider riskier but potentially higher reward investment strategies, which could imbalance portfolios, leading to liquidity exposure through asset/liability mismatch.

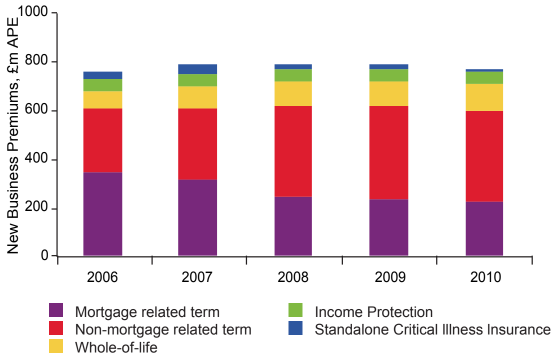
A generally constrained investment environment and intense competition in personal general insurance lines challenged earnings at market level in 2010 and 2011 (see figure 57). Underwriting performance has been under particular pressure in private motor insurance (see figure 58) because of claims cost inflation. Reduced margins have led some insurers to increase revenue derived from ancillary income streams such as premium finance, administration fees and the sale of low-cost add-on products. The government has announced its intention to ban referral fees in personal injury cases, which means firms will not be able to rely on this revenue stream in the future.

4.4.2 Trends in product supply and innovation

Private motor insurance premiums increased in 2010 as insurers attempted to reverse deteriorating underwriting results driven by a range of factors, including higher costs for bodily injury claims and fraud. Reviews of insurers' product portfolios continued at market level throughout 2011 as insurers adjusted their product offerings and limited exposure to higher risk segments.

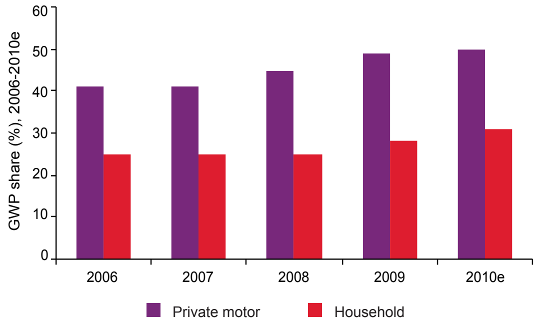
Home insurance premiums increased slightly in 2010. Despite severe weather events in 2010 and 2011, competitive market forces in discretionary lines such as household contents may restrict insurers' ability to achieve rate increases in target segments. GI customers are increasingly price-sensitive, influenced by constraints in household expenditure and commoditised distribution models (e.g. price-comparison websites) that often focus consumer attention on price as the primary consideration (see also section 5.2 in this chapter). In section 3.4.1 of Chapter B we discuss risks for consumers associated with a greater focus on initial premium in general insurance products.

Figure 59: New protection business by type



Source: Datamonitor, ABI

Figure 60: Motor and Home insurance direct distribution



Source: Datamonitor, UK Personal Insurance Distribution 2011 Report

Critical illness, health and income protection lines may also be exposed to demand-side pressures. Demand may particularly reduce where cover is linked to debt products (see figure 59). Although consumer focus on saving or reducing debt may negatively affect the sale of protection products, falling demand in some segments may be at least partially offset by an increasing desire for security and certainty in others.

4.4.3 Distribution trends

The self-service volume-driven model delivered by price comparison websites and direct insurance writers (i.e. insurers that deal with their insured customers without the use of agents or brokers) continues to dominate the UK private motor insurance market. Direct insurers account for a large share of personal motor insurance premiums (see figure 60). Risk underwriting remains the fundamental source of income for most insurers, but reliance on online distribution models to both reduce costs and generate ancillary revenue streams is increasingly important.

Intermediaries (including mortgage and insurance brokers) generate the largest share of home insurance and protection premiums. In home insurance, intermediaries have a major cross-selling advantage, since a significant proportion of policies are sold with new mortgages. This link also benefits banks and building societies, who achieved a 26% distribution share in 2010. In protection lines, 'non-intermediated' sales play a relatively small part in distribution, possibly because consumers may lack confidence to arrange these types of products themselves or because protection cover policies tend to be generally 'sold' rather than proactively 'bought' by consumers.

As discussed in the retail banking section, banks also play an increasingly important role in distributing certain types of life and protection products.

4.4.4 Competition trends

The wide range of insurers and intermediaries (including price comparison websites) participating in heavily commoditised retail lines helps stimulate price competition in the sector.

In some classes, the competitive environment has forced many firms to take aggregated exposures beyond their risk appetite. This has led insurers to realign their portfolios to avoid adverse selection in higher risk segments, such as younger drivers (in motor) or certain geographical areas (e.g. in household). Younger drivers were subject to particularly sharp premium increases in 2010 and 2011, raising concerns about the availability of compulsory coverage. Reduced competition in the younger driver market is leading insurers to develop new ways of pricing risk through technological innovations.

The challenging rating environment means insurers are increasingly focused on achieving competitive advantage through reducing claims and operational costs. In addition to outsourcing administrative and claims functions, First Notification of Loss (FNOL)[28] processes to gain early control of claims are increasingly important components of many firms' cost-cutting strategies.

Competition is also focusing increasingly on the way in which insurers interact with customers. Social media and new technologies, such as apps, are increasingly important tools as firms seek to better engage and retain their customers.

4.4.5 Responses to regulation

Over the next few months insurers will need to review their pricing and underwriting approaches to take account of the recent ruling by the ECJ banning the use of gender as a risk factor in determining pricing and benefits from December 2012. This judgment is likely to result in increased premiums for some customer segments and lower premiums for others. It may also prompt greater innovation in product design, e.g. through the use of alternative risk rating factors, marketing focus and pricing structures as providers seek to differentiate themselves in the marketplace.

4.5 Retail intermediaries

4.5.1 Environment facing retail intermediaries

The trends identified for retail intermediaries within Chapter A of the Retail Conduct Risk Outlook 2011 have continued and the issues discussed last year remain relevant.

The Retail Intermediary sector consists of around 13,000 directly authorised firms and 33,000 appointed representatives[29] operating across the investment, mortgage and general insurance markets. The vast majority are smaller firms, although there are some larger firms, including both networks and firms operating at national level. The downward trend in overall number of intermediaries continued from 2010, with a further reduction of 4% in 2011. Similarly to 2010, the significant number of firm closures for mortgage intermediaries primarily accounted for the overall decline in the number of retail intermediaries.

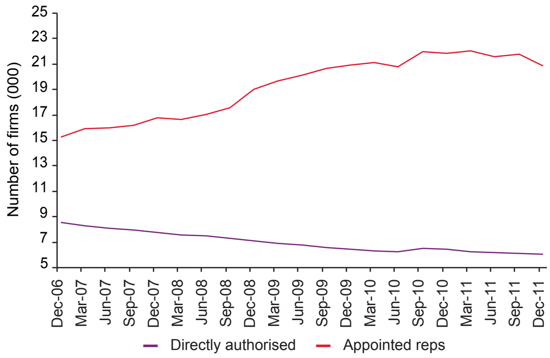
General Insurance (GI) intermediaries

Figure 61 shows that the largest group of intermediaries operate in general insurance – including firms whose primary business is general insurance mediation as well as those who sell general insurance alongside other non-financial products, for example, retailers and motor dealers. Growth in the number of GI intermediaries in recent years has been driven by increasing numbers of appointed representatives. However, this trend slowed during the second half of 2011, which brought about a 5% drop in the overall number of GI intermediaries from 2010. This may reflect tight demand conditions.

28 First Notification of Loss is the first stage in the claim lifecycle for a GI policy, where the insured first provide their insurer with information on an incident or claim.

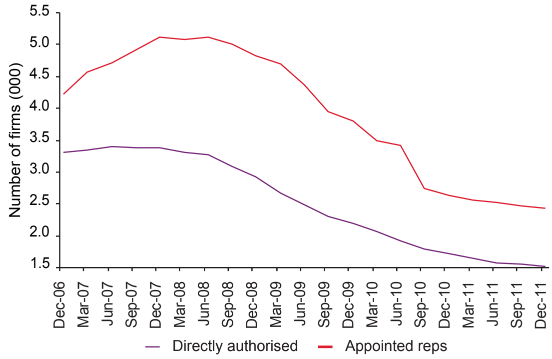
29 The definition of an appointed representative is set out in s39 of the Financial Services and Markets Act 2000 (FSMA) and is contained in the Glossary to the FSA Handbook. Broadly speaking, these are firms who carry out regulated activities but are exempted from authorisation because another firm who is authorised has accepted responsibility for these activities.

Figure 61: General insurance intermediary trends by primary category[30]



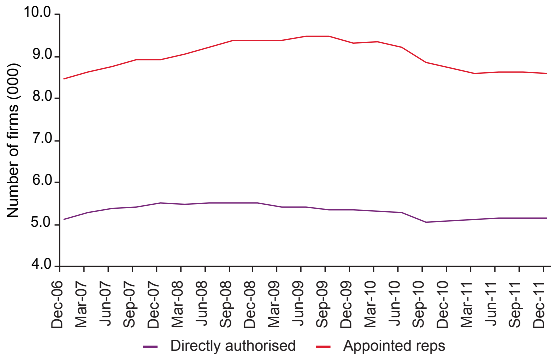
Source: FSA

Figure 62: Mortgage Intermediary trends by primary category[30]



Source: FSA

Figure 63: Financial Adviser trends by primary category[30]



Source: FSA

Revenues for GI intermediaries, however, have remained largely resilient partly due to increasing premiums and more products being sold via the internet. The majority of retail insurance purchases continue to be compulsory products such as motor and buildings, and discretionary core products such as contents and travel insurance.[31] However, some GI intermediaries are also increasingly relying on low-cost, high-margin 'add on or optional' insurance products (e.g. breakdown and keys cover) to generate income and differentiate policies. Our concerns in relation to general insurance products are discussed in section 3.4 in Chapter B.

There has also been growing evidence of some retail intermediaries using fraudulent practices for commission-based insurance products, i.e. misappropriation of client premiums or claw-back commissions. We continue to take a robust and proactive approach in addressing this trend, including enforcement action, sharing intelligence with external stakeholders, and working with insurers to challenge their systems and controls and anti-financial crime measures.

While operating performance improved over the review period, significant challenges still remain for GI intermediaries. Growth and regulatory compliance are considered important issues that may impact future revenues/profitability and sustainability within these firms (see figure 64).

30 Figures include wholesale firms.
31 Datamonitor's UK Insurance Broker Survey 2011.

Mortgage intermediaries

Weak domestic economic growth, falling house prices and reduced levels of mortgage funding stagnated the mortgage market, with gross lending in 2011 estimated at around £138bn, compared to £135bn in 2010 and £363bn in 2007.[32] These conditions together with low levels of consumer confidence stemming from fears of unemployment and tight credit conditions, meant some mortgage intermediaries were hard-pressed to sustain a profitable and compliant business during 2011. Consequently, the number of mortgage intermediaries continued to decline from 2010, with a further drop of approximately 10% in 2011 (see figure 62).

Economic conditions also influenced product supply within the sector. For example, concerns over borrowers' inability to repay interest-only mortgages at the end of the term have resulted in lenders restricting interest-only mortgages to lower LTV borrowers. Consequently, intermediaries relying on selling interest-only mortgages solely to make mortgage repayments affordable have seen reduced business opportunities in this area.

Similarly, the specialist lending market remained subdued as a result of the virtual closure of the securitisation markets. At the peak of the market, specialist lenders accounted for a significant share of mortgages, with intermediaries responsible for over 90% of sales of specialist mortgages.[33] However, since the start of the financial crisis, gross mortgage lending by specialist lenders has contracted sharply – and more rapidly than for mainstream lenders – with the share of total gross mortgage lending accounted for by specialist lenders falling from 18% in March 2007 to just over 3% in December 2009.[34] Many firms depending on this type of business have now left the market, although there are concerns that many may still be operating in the unregulated sectors of the market – second charges, BTL, bridging finance and debt management.

Conversely, mortgage intermediaries currently active in the market have diversified and no longer simply undertake mortgage sales, but now look to widen income streams by offering customers advice on a range of products, such as life and protection. Others have adopted strategies to sell niche products to the mass market with the design of some mortgage products focusing on first-time buyers and vulnerable groups, including the elderly with equity in their homes. These activities have elevated our concerns around suitability and quality of advice (discussed in section 3.11.4 in Chapter B). Separately, buy-to-let lending has maintained an upward trend as a result of the increased demand for rental properties, which has provided mortgage intermediaries with an additional income stream.

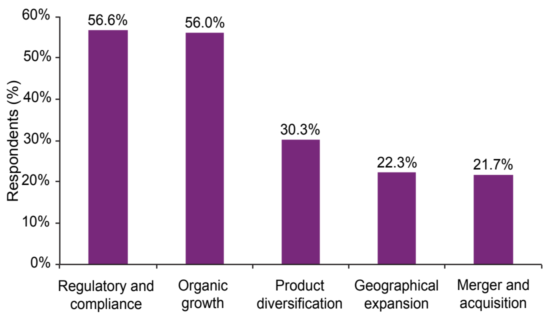
Survey findings suggest that the persistent uncertainty in market conditions continues to have an impact on mortgage intermediaries (see figure 65). This reiterates concerns that developing and maintaining a sustainable and compliant business model will likely remain challenging for mortgage intermediaries, particularly for network models.

Financial advisers

The number of financial advisers in the market remained relatively stable when compared to 2010 at approximately 13,700 firms, consisting of appointed representatives (60%) and directly authorised firms (40%). The trend shows that although the difficult market conditions have led to about an 8% decline in the financial adviser market from its peak in 2008, the overall sector has remained relatively stable in 2011 (see figure 63).

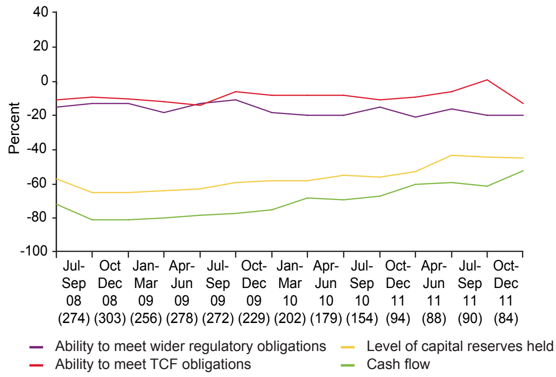
32 Bank of England.
33 FSA Product Sales Data.
34 Trends in Lending, February 2010, Bank of England.

Figure 64: Important issues facing general insurance intermediaries



Source: Datamonitor Survey 2011
Note: Question: What are the most important issues facing your business in the next 12 months?

Figure 65: Impact of market conditions on mortgage intermediaries



Source: NMG IFA Census, Mortgage Barometer, December 2011
Note: Question: How have current market conditions impacted on the following? Numbers in parentheses are the respondents.

Despite the challenging economic landscape, average profit margins of financial advisers increased over the last year, driven mostly by increased retail investment revenue.[35]
The majority of financial advisers hold permissions to conduct business in financial advice, and mortgage and general insurance mediation, but an increasing proportion of their income is currently generated from general insurance. It is recognised that although some financial advisers have had to move into other business areas to maintain income, this may also reflect a shift in business models at some firms.

Product innovation in the investment market has also introduced new sources of revenue for financial advisers. Some financial advisers may have benefited from the wider range of investment products but many of these products pose risks for consumers. Some of these risks are highlighted in section 3.2 in Chapter B.

Developing an adviser charging proposition that will add value and strength to their brand remains an ongoing challenge for financial advisers. Some uncertainty prevails in the market and the sustainability of business models remains an inherent risk for the sector. Due to their scale and size relative to other firms in the sector, and their current business models, many of the challenges for the sector are particularly significant for networks. Still, evidence suggests that a significant portion of financial adviser firms have now at least considered a coherent, compliant and sustainable strategic response to the RDR including plans to meet qualification requirements and implement a remuneration model based on adviser charging (see section 4.5.3).

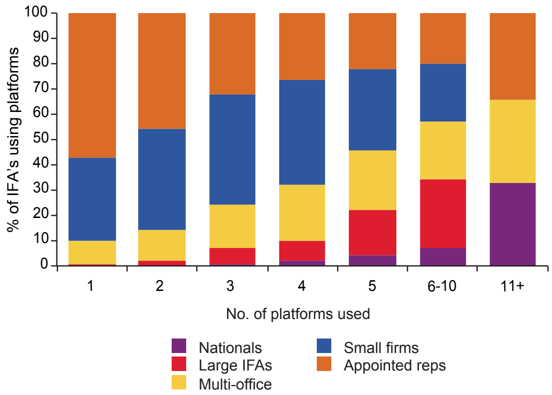
4.5.2 Competition trends

General Insurance (GI)

GI intermediaries remain under competitive pressure from insurers' direct sales propositions and the increasing role of price comparison websites (also known as 'aggregators') as distribution vehicles within the sector. This role is particularly significant in the home, motor and travel insurance business lines, with 60% of consumers looking to buy their motor and travel insurance online with price comparison sites.[36] GI intermediaries have adopted several strategies to respond to these conditions, e.g. product bundling and loss-leader strategies with the latter occurring where some firms secure sales by quoting low premium rates and then relying on the sales of secondary products to recover their margins.

35 Retail Mediation Activities Return (RMAR) 2010/11 data.
36 Data monitor's UK Insurance Broker Survey 2011.

Figure 66: IFAs' use of platforms



Source: Datamonitor, UK IFAs 2011 Report, Matrix Solutions

We issued guidance[37] on regulatory compliance to aggregator firms in October 2011, clarifying firms' regulatory responsibilities. Given that aggregators are diversifying into selling protection products and more complex insurance, the guidance is significant in helping to ensure the fair treatment of consumers.

Mortgage intermediaries

At an aggregate level, mortgage intermediaries are challenged by competition from lenders' direct sales. The additional funding pressures in the mortgage market have the potential to trigger a return of the aggressive dual pricing strategies seen in 2008 where lenders offered more competitive products in their branches.

These challenges are more acute for smaller firms. In particular, the top 1% of mortgage intermediaries accounted for 53% of mortgage sales undertaken by mortgage intermediaries in 2011[38], and with some instances of consolidation at larger intermediaries in the past year, there is increased pressure on smaller intermediaries to sustain profitability.

Financial advisers

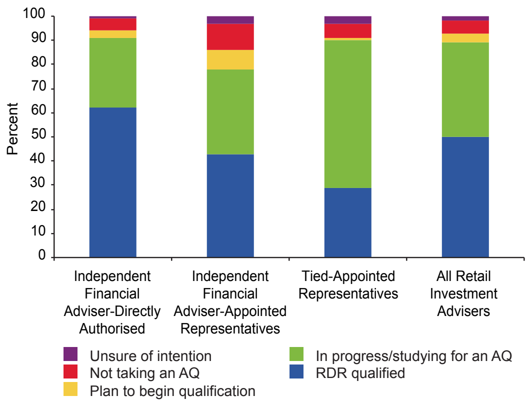
The market for the distribution of retail investment products remains unconcentrated, with a relatively large number of advisers, as well as a number of different types of distribution channels.

Past research indicates there is little evidence that advisers compete directly with each other for clients. Instead, firms seem to rely on being recommended by other professional services firms such as lawyers and accountants.[39] Financial advisers appear to compete on the basis of factors such as quality of service and access to products, more than price.

Platforms have played an increasingly important role in this environment given their ability to provide customers and their advisers with an easier way to access and administer a wide range of assets and investment products (see figure 66). They may also provide advisers with a competitive advantage in their service offering, as well as facilitating their transition to a

37 Guidance on the selling of general insurance policies through price comparison websites, October 2011, FSA. http://www.fsa.gov.uk/static/pubs/guidance/fg11_17.pdf
38 Product Sales Data.
39 RDR proposals: Impact on market structure and competition, June 2009, Oxera.

Figure 67: Retail Investment Advisers' RDR Qualification Status



Source: RS Consulting, Professionalism Report December 2011

RDR-compliant business model. Platforms are now widely adopted in the sector, with survey evidence suggesting that approximately 85% of financial advisers now use platforms.[40] In section 3.8.1 in Chapter B we discuss some of the risks associated with these tools.

4.5.3 Responses to regulation

The main legislative and regulatory initiatives affecting intermediaries include the RDR, the introduction of auto-enrolment into pension schemes, MiFID2, the MMR and the IMD review. While many of these initiatives will improve the long-term sustainability of the sector, we recognise the importance for firms to adequately prepare for the challenges posed by each.

Financial advisers

The transition to an RDR-compliant business proposition continued to have an impact on financial advisers. For example, with the RDR deadline now less than a year away, 79% of IFAs have undertaken some activity to demonstrate they are considering their business sustainability in relation to the RDR.[41]

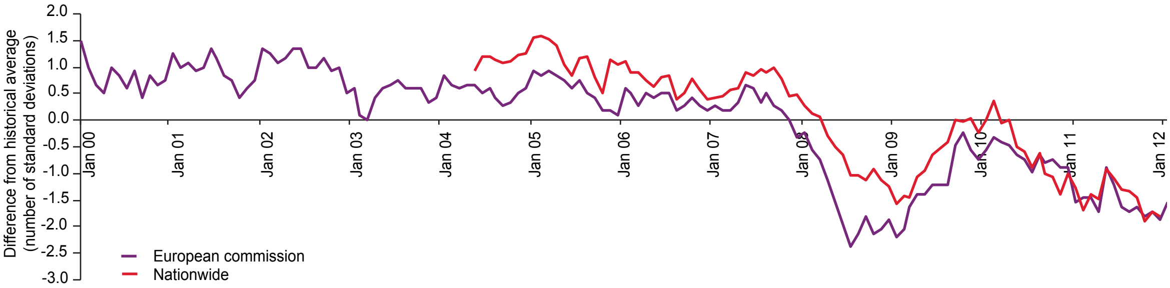
Similarly, market research[42] among all Retail Investment Advisers (RIAs) showed that only a relatively small proportion of advisers (8%) intend either to retire earlier than planned, stop advising and take another role in the industry, or leave the industry altogether. The majority of these advisers cited RDR requirements as being influential on their decision. Notably, 50% of all RIAs already hold at least one Appropriate Qualification (AQ), a further 39% have started studying for an AQ, 4% have firm plans to start and 7% are either not taking an AQ or are unsure of doing so. While this analysis shows that 89% of all RIAs hold or have started studying for an AQ, some groups are behind average with only 78% of RIAs in IFA-AR firms making similar progress (see figure 67).

Mortgage intermediaries

The MMR is a key regulatory initiative for the mortgage market (see section 3.1.2 of this chapter). In addition to our proposals on responsible lending and reforms to the mortgage sales process, many lenders are already voluntarily applying a more robust approach to lending

40 Datamonitor, IFA Insight: Platform Usage and Market Issues, September 2011.
41 NMG Consulting, Q4 2011 IFA Census.
42 RS Consulting, Progress towards the Professionalism requirements of the Retail Distribution Review, December 2011 (survey conducted in July to August 2011).

Figure 68: Indicators of UK consumer confidence



Source: Research carried out by GfK NOP on behalf of European Commission, Nationwide
Note: Chart shows number of standard deviations from average index over the period.

now compared to the lead-up to the crisis, and this has impacted on the availability of products for intermediaries to sell.

GI intermediaries

The European Commission's ongoing review of the IMD and the awaited proposal for changes to the IMD are important legislative changes that GI intermediaries will be expected to consider in 2012.

5. Consumers and demand for financial products

In section 2 of this chapter we have discussed some key trends in the macro-economy and their implications on the household sector in aggregate. In this section, we focus on the diversity of experience of consumers in the current environment and explore the different impact that the environment has on different consumers.

There is a close link between consumers' financial decisions and the confidence they have in both their financial position and the wider financial outlook. Consumer confidence remains low compared to historical levels, possibly as a result of fiscal consolidation, the sovereign debt crisis and increasing levels of unemployment. Confidence improved in the first half of 2011 (see figure 68), however, this was short-lived and it started falling again from June onward, albeit not to the levels seen in 2009.

The impact of consumer confidence and financial position on consumers' demand for financial services is, however, complex. To better understand recent trends and drivers in the demand for financial products and how they vary for different consumers, we commissioned GfK NOP to undertake primary research and analysis based on their Financial Research Survey[43] (FRS) to identify:

- what consumers' product holdings were in 2011 and how this had changed since 2010;
- the financial position of consumers and how this had changed over the same time period, i.e. 2011 compared to 2010; and
- how both product holdings and their values are influenced by customer characteristics (including demographics such as age, income and socio-economic background) and their financial position.

43 See Annex 1 for further information on the FRS and the research methodology.

The research highlights that consumers' interaction with financial services is affected by a complex mix of factors including demographic characteristics, like age, and their changing financial position. Consumers are a heterogeneous group, which makes broad generalisations on trends in their behaviour difficult. However, in relation to the period between 2010 and 2011, the key findings from this study are:

- Despite quite dramatic changes in some segments' financial position and low levels of confidence, FRS respondents' product holdings appear to have been stable.
- However, for some products, such as general insurance, respondents appear more price-sensitive and more inclined to use price comparison websites to achieve savings. We discuss some of the risks this focus on price in general insurance may pose in section 3.4.1 of Chapter B.
- More respondents seem to be exercising caution on debt accumulation, with some respondents also reporting to have made overpayments on their mortgage debt when they have been able to do so. Average annual credit card and loan balances fell in both penetration[44] and value among respondents.[45]
- On the assets side, particularly savings, consumers in the sample showed a preference for more tax incentivised savings vehicles.

Beneath these headline trends, we observed a number of consumer sub-segments effects.

Young respondents have been particularly affected by unemployment, but those young unemployed respondents who are able to do so, appear to be trying to better control their debts, with a decline observed in both their credit card and loan debt values.[46] On the other hand, young respondents in work or education appear to be saving more, with possible reasons being the need to accumulate higher mortgage deposits to buy a property (given tightening mortgage market conditions discussed in section 4.1.1 of this chapter), or as a buffer against the increasing risk of unemployment.

Looking at retired respondents, retirees with the highest income have seen the biggest percentage fall in their assets, possibly reflecting a relatively larger fall in property values and holding products with a higher investment risk. The retired group, overall, is the only group in the survey not to show signs of a more cautious approach to debt, with the value of total loan debt among this group increasing by approximately 21% between 2010 and 2011.

These findings have a bearing on risks we discuss in Chapter B, as some of these risks (e.g. risks associated with mortgage innovation, consumers' focus on price in the general insurance market and poor pension and retirement planning advice) may have a different impact on different consumer segments, due to their different financial positions and financial product holdings.

5.1 General trends in product holding and demand of financial products

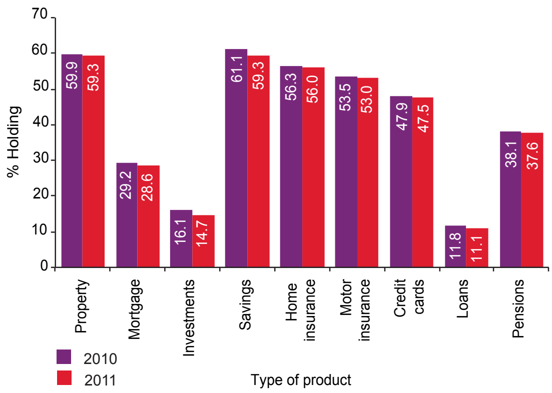
In this sub-section we consider how demand for financial products changed between 2010 and 2011 among FRS respondents.

44 In this study, 'product penetration' refers to the percentage of FRS respondents who hold products.

45 Based on the whole sample of FRS respondents, not just those who hold products. The values are therefore averages for all respondents, including zero values.

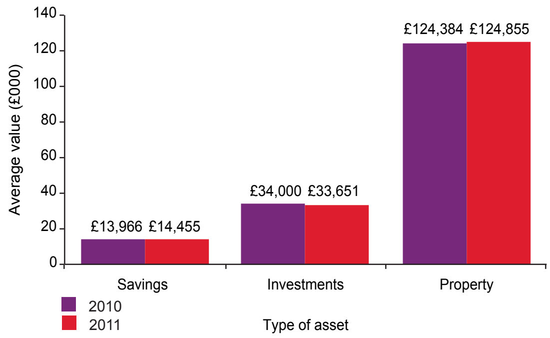
46 A significant gap in our research, however, was the fact that the FRS does not provide information on some type of liabilities including student loans and point of sale loans under £1,000. Since these products are likely to be a significant component of young respondents' debt, this group may be running significantly higher debt than reported here.

Figure 69: Change in product penetration (2010-2011)



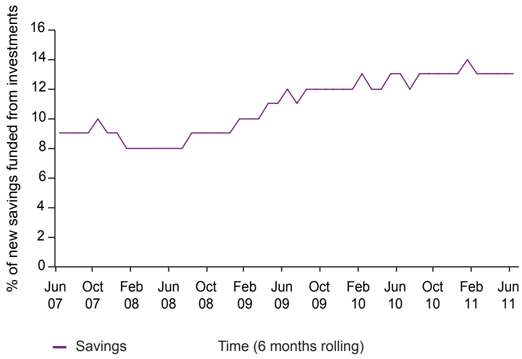
Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010 (61,570), July 2010 – June 2011 (61,357). Pension definition: all contributing to any pension. Base: All those aged 18+ and not retired.

Figure 70: Change in value of assets (among holders)



Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010: Savings (37,631), Investments (9,904), Property (24,662), July 2010 – June 2011: Savings (36,380), Investments (9,027), Property (24,977).

Figure 71: The flow of funds from investments to cash savings

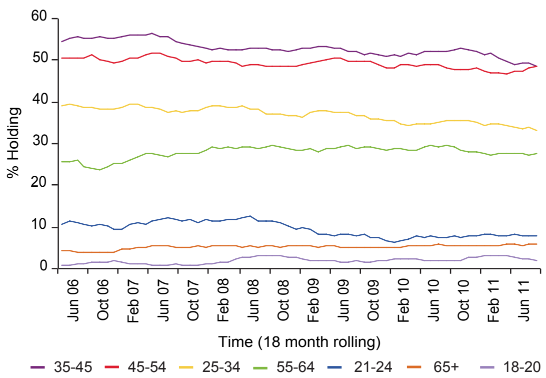


Source: GfK FRS
Note: Base: All savings opened in the previous 12 months.

FRS data suggests that the changing environment did not result in significant changes in product penetration at an aggregate level between 2010 and 2011 (see figure 69). With regard to investments, the number of FRS respondents holding investment products fell from 16.1% to 14.7%. Average total investment value among holders fell by 1% between 2010 and 2011 from £34,000 to £33,651, whereas the average value of total savings among holders rose by 3.5% from £13,966 to £14,455 (see figure 70). Some respondents reported moving money out of investments and into cash-based deposits (see figure 71). This may be partly due to lower confidence in investments and partly due to some consumers needing more immediate access to funds.

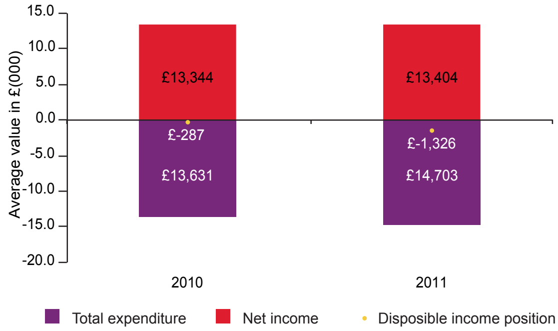
Savings showed more significant changes. Instant access accounts experienced the biggest fall in penetration, while cash ISAs were the only savings product to maintain the same levels of ownership year on year. In terms of value, cash ISAs increased by 5% and now account for 30% of all value held in savings and investments by FRS respondents. This may partly reflect the rise in the yearly cash ISA allowance and partly a desire of some respondents to save using the most tax efficient means. The value of NS&I savings certificates increased marginally and now account for 9% of value held in savings and investments, again possibly indicating some consumers' desire to find the most tax-efficient means of saving.

Figure 72: Mortgage penetration by age over time



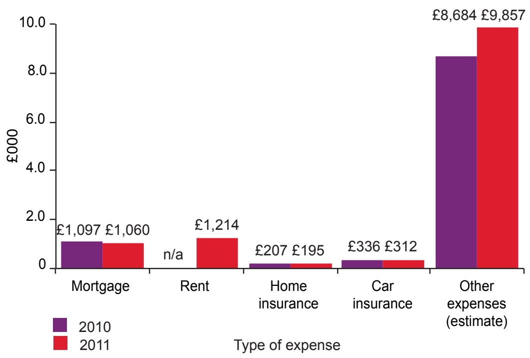
Source: GfK FRS
Note: Base: All 18+.

Figure 73: Change in overall income and expenditure



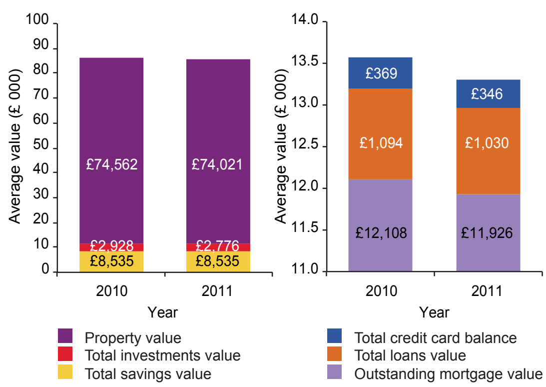
Source: GfK Recall Survey
Note: Base: 1933.

Figure 74: Change in expenditure by broad category



Source: GfK Recall Survey
Note: Base: 1933.

Figure 75: Overall assets and liabilities by category



Source: GfK FRS
Note: Base: full imputed sample: July 2009 – June 2010 (61,570), July 2010 – June 2011 (61,357).

Property ownership among FRS respondents decreased by 0.6%, possibly reflecting fewer first-time buyers in the sample, but the value of property remained largely the same. The number of first-time buyers fell over the last few years, possibly due to the increased size of the deposit required. Since 2008, mortgage penetration has, on the whole, been falling among those aged under 35, who are most likely to be first-time buyers (see figure 72). In section 3.11.4 of Chapter B we discuss mortgage product innovation, with some lenders looking at new ways of helping first-time buyers, and the risks this may pose for consumers.

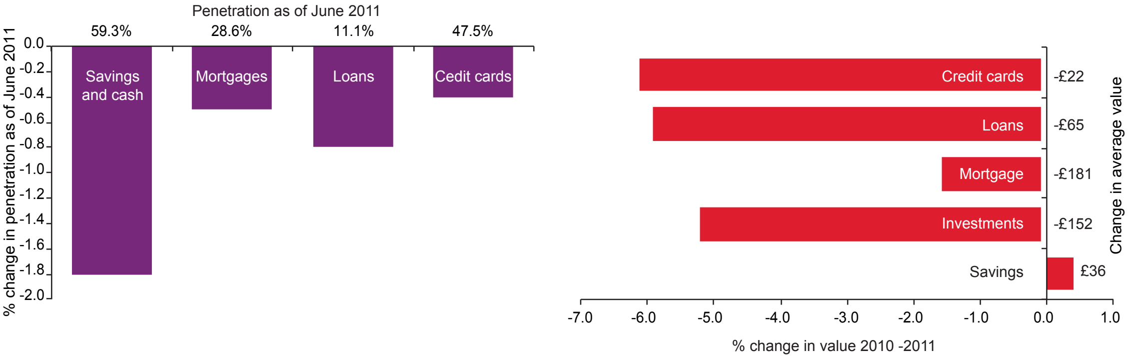
5.2 Consumers' financial position and impact on product holding

Among FRS respondents, average reported income[47], after tax and National Insurance, increased marginally in nominal terms by 0.4% overall (see figure 73), with some groups experiencing no change in income and others experiencing only marginal increases or decreases. However, average total expenditure[48] increased by 8%, with FRS respondents reporting the biggest cost increases to have been in general living expenses, which they estimate increased by over 13% year on year (see figure 74). Taking into account higher living costs, most respondents therefore saw erosions in their real disposable income.

47 Income has been calculated from stated gross personal income net of income tax and NI paid for FRS respondents. No account has been made of inflation.

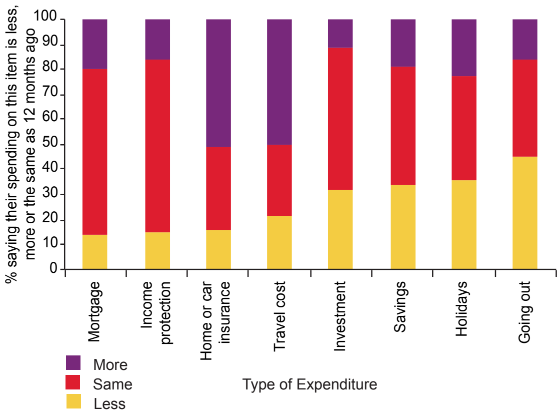
48 Expenditure is total stated expenditure of FRS respondents of regular savings, regular investments, life insurance premiums, pension contributions, mortgage, rent, home insurance and car insurance.

Figure 76: % change in assets/liabilities penetration and value



Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010 (61,570), July 2010 – June 2011 (61, 357).

Figure 77: Changes in expenditure (2010-2011)



Source: GfK Recall Survey
Note: Base: All saying that they spend in this category: Mortgage (648), Income protection (472), Home or car insurance (1,481), Travel cost (1,730), Investment (409), Savings (1,064), Holidays (1,424), Going out (1,652).

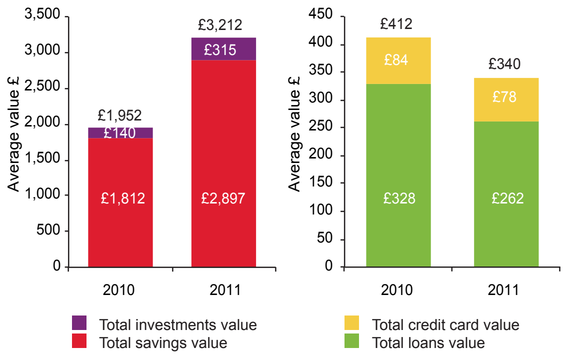
Within the same period, the average value of assets net of liabilities for FRS respondents deteriorated slightly by 0.5% (see figure 75).[49] While the average value of savings increased marginally, the average value of investments declined more, by 5.2% across the whole FRS sample. Penetration levels for savings (including cash ISAs) fell by 1.8% in total. In terms of liabilities, average annual mortgage, credit card and loan balances fell in both penetration and value among FRS respondents (see figure 76).

Even with higher living costs, 7% of recall respondents[50] reported spending more on mortgage-related expenses this year compared to last, with a substantial 23% of all mortgage payers in the recall survey stating they had made mortgage overpayments in the last year. This may suggest that some consumers were focusing on deleveraging in the low interest rate environment, while others were avoiding accumulating new debt even when subject to increased financial pressures.

On spending patterns, with the exception of home or car insurance and travel costs, a substantial proportion of respondents from the recall survey spent less on discretionary items like holidays or going out (see figure 77). Where consumers reduced spending, in some instances, this was achieved by shopping around for less expensive financial products, rather than via a reduction in product holdings. Insurance is a primary example, with 80% of those achieving

49 Data is based on the whole sample of FRS respondents, not just those who hold products. The values are, therefore, averages for all respondents, including zero values. Where assets or liabilities are shares, e.g. a joint mortgage, half the value is ascribed to an individual.
50 See Annex 1 for more information on the recall sample and the research methodology.

Figure 78: Change in non-property assets and liabilities for all 16-24 by category



Source: GfK FRS
Note: Base: Full imputed sample: July 2009 –June 2010 (8,989), July 2010 – June 2011 (8,958).

savings doing so through cheaper cover, compared to only 8% who had cancelled their policies. Of those obtaining cheaper cover, 14% switched to another provider.[51] With regard to motor insurance, the main consumer reaction to increased financial pressure was to find the most competitive quotes. Nearly two-thirds of all motor insurance holders seeking quotes at renewal now use price comparison websites at some point in their purchase journey, making comparison websites the most widely used channel in the market.[52]

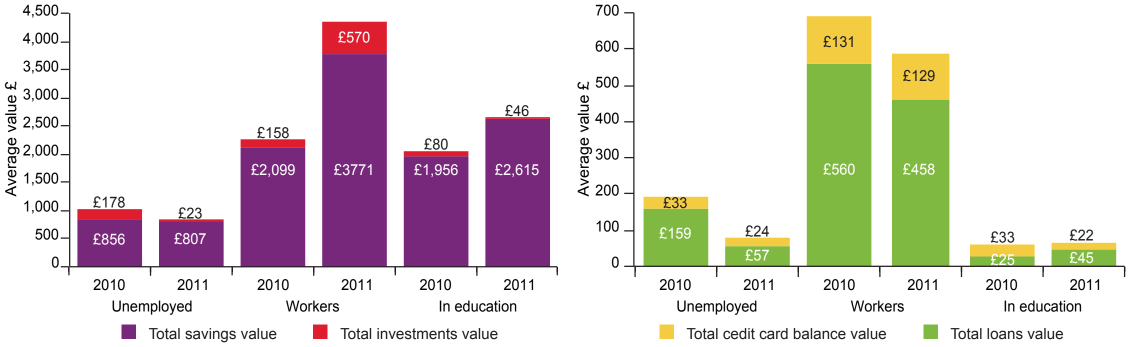
5.3 Differences across consumer segments[53]

Looking at differences in financial position by age, the youngest of the FRS respondents (16-24 year olds) generally saw a modest improvement in the value of their financial asset holdings, mainly driven by a growth in savings (see figure 78). This increase may be linked to the decline in mortgage holding among younger consumers (as discussed in section 5.1), some of whom may have been saving more to raise higher deposits to get onto the property ladder. This group's nominal income rose, on average, by 5% (the only group other than the 65+ to have experienced a growth in nominal income, although from a much lower base), but their average expenditure value rose by 7%.

There are some differences in the financial position of young consumers based on work status (see figure 79). Approximately 50% of FRS respondents in the 16-24 year old age group were in work, 20% were unemployed or not working and 30% were in education. The unemployed group, unsurprisingly, suffered more than the other two groups, who saw modest improvements in their overall financial position. The value of assets held by the young unemployed segment declined by 20% year on year, already from a very low position. Some consumers in this group may have had to use any savings available in light of lower disposable income. However, liabilities in the form of credit cards and loans also declined by over 50% in the same period. This may indicate that those within this segment who were able to were more focused on avoiding accumulating new debt (for example through parental assistance), but could also reflect a switch to other types of liabilities (e.g. payday loans).

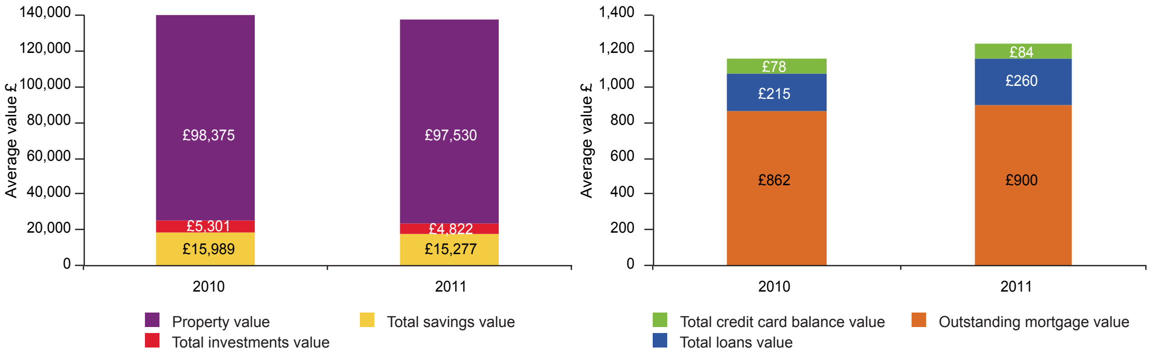
51 According to the FRS recall survey (based on product holders).
52 GfK NOP 'On the Horizon', December 2011.
53 This research highlights some interesting findings between FRS respondents with different characteristics. They are not intended to represent general trends among different groups in the general population. Therefore, given the low base sizes of certain consumer segments that have been considered, figures should be treated with a degree of caution.

Figure 79: Change in non property assets and liabilities for all 16-24, by category and working status



Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010: Unemployed (1,771), Workers (4,647), In education (2,562), July 2010 – June 2011: Unemployed (1,577), Workers (4,658), In education (2,723).

Figure 80: Change in overall assets and liabilities for all 65+ by category



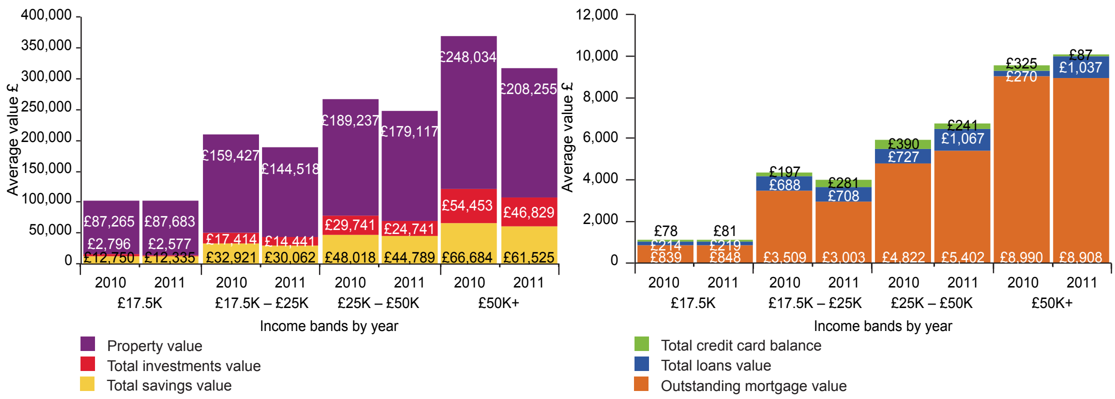
Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010 (12,252), July 2010 – June 2011 (12,394).

Unlike the unemployed segments, young workers, who made up the majority of the FRS respondents in this age group, saw increases in their nominal income of 5%. This sub-segment appears to be exercising a high degree of caution. The average value of their assets increased by over £1,000 (an 80% increase), possibly due to more respondents in this category saving for higher mortgage deposits, or in fear of unemployment. Those FRS respondents aged 16-24 years old who were in education managed to increase the value of their savings between 2010 and 2011. Income for this sub-segment increased by 4%, possibly suggesting that more may have worked alongside studying. Taking into account recent increases in tuition fees, it is possible that the financial position of this sub-segment may have in fact been worse than highlighted by the research, given higher costs of education and, as such, higher student debt levels (which are not captured in the FRS).

At the other end of the age spectrum, those respondents aged 65+, experienced overall decline in the value of their financial assets and were the only group not to have seen a reduction in the value of their liabilities. In fact, total average loan value for this group increased by 21% year on year and total average value for credit card balances increased by 7%[54] (see figure 80). Nominal income only increased marginally, by 1% on average. However, average total expenditure for retired consumers (the majority of which were

54 Figures based on a sample of 10,345 individuals aged 65+.

Figure 81: Change in overall assets and liabilities of retired by income



Source: GfK FRS
Note: Base: Full imputed sample: July 2009 – June 2010: <£17,500 (12,868), £17,500 to £25,000 (924), £25,000 to 50,000 (554), £50,000+ (123), July 2010 – June 2011: <£17,500 (12,946), £17,500 to 25,000 (1,043), £25,000 to 50,000 (614), £50,000+ (61).

aged 65+) increased by 7% year on year, meaning that this group of respondents was one of the worst affected groups, suffering a decline in net income and asset values and an increase in borrowing and debt. Given the current pressures on this group's financial position, there is a concern that an increasing number of elderly consumers may not be able to repay their mortgage debt at retirement. In addition, some retirees may be considering releasing equity from their homes as a potential source of funds. While equity release declined from 2007 – as the global financial crisis hit the sector and some providers left the market – recent data suggests a return to growth for this sector in 2011.[55]

While the financial position of FRS respondents aged 65+ deteriorated between 2010 and 2011, there were differences between retirees, depending on income levels.[56] With the exception of the lowest income group, whose assets and liabilities remained broadly flat, retirees in other income brackets suffered from a decline in the value of their assets net of liabilities of between 7 and 15% (see figure 81). Outstanding mortgage balances across this group were low, as would be expected, but interestingly, those with income between £17,500 and £25,000 experienced an increase in the value of both their credit card and loan balances.

The average income across remaining age groups (age bands 25-34, 35-44 and 45-54) remained relatively static, while average expenditure increased significantly in all three groups. The value of assets reduced, on average, among all of these age groups, with the decrease more significant for those aged 25-34. Some of these respondents may have been forced to use their savings and/or investments to cope with increased expenses. Those aged 25-34 and 45-54 saw a decrease in the value of their liabilities, while liabilities for those aged 35-44 increased marginally, mainly through a small increase in their outstanding mortgage value. Therefore, irrespective of age, consumers seem to have focused on avoiding additional debt despite increasing financial pressures.

Respondents earning in excess of £50,000 and with families saw marginal improvements in their financial position, primarily through a reduction in their mortgage liability of almost 5%. Families generally focused on managing their liabilities (with the exception of the lowest income group), with their credit card and loan balances having either decreased between 2010 and 2011 or remained broadly flat. Expenditure among all families increased, with a rate of

55 Key Retirement Solution's "UK Equity Release Market Monitor, 2011 Review" and Safe Home Income Plans (SHIP).
56 The vast majority of retirees were aged 65+ (12,252 out of 14,469 retirees in July 2009-June 2010 and 12,394 out of 14,664 retirees in July 2010 to June 2011).

growth ranging from 5% in the highest income group to 14% in the lowest. Respondents on the lowest income with families suffered the most out of all family groups in the study.

These findings emphasise the heterogeneous nature of consumers and the varying demands they place on financial services. Consumers appear more engaged in their financial arrangements, partly as a consequence of current financial pressures. Given this heterogeneity and engagement, it was important for us to gather more qualitative information from consumers on the key concerns they have about their interaction with retail financial service providers. Box 1 gives a brief summary of the findings of this qualitative research, which supports many of the risks we highlight in Chapter B.

Box 1: Key areas of concern for consumers in their relationships with retail financial services providers

We commissioned The Development Team Limited, a strategic research consultancy, to conduct qualitative research among consumers to better understand their perspectives and experiences with retail financial service providers.[57] This study, commissioned concurrently with the quantitative research undertaken by GfK NOP, explored consumers' key concerns on, and their direct experiences and relationships with, FSA-regulated firms they interact with. Both consumers who had previous issues with these firms and those who had no prior issues were recruited, although almost every consumer who took part in the discussions ended up sharing first-hand negative experiences with firms they use or have used in the past. This research revealed the following key concerns from the consumer perspective:

- **Pressure–selling:** Consumers regard cultures, in particular in banks, as shifting from a more personalised service to a retail shop where the focus is on selling. Among the consumers who participated in the research, there was general consensus that financial services providers are too proactive in terms of sales, often employing 'pushy' sales tactics regardless of the consumer's situation or mindset. While some consumers would be interested in hearing of new products or services that may be suitable for their particular needs, generally, there are perceived to be other, higher priority drivers of selling, including commission and targets. Consumers are also conscious of 'up-selling' products that are not necessarily the most suitable for them, a prime example being premium bank accounts. Consumers regard these changes in business models to be unwelcome as financial services providers appear to be less attuned in terms of responsiveness, consumer focus and service standards when compared to the non-financial services retail industry. This seems to be exacerbated by the fact that some consumers regard staff as having inadequate levels of product knowledge and training.
- **Lack of ongoing service and focus on single transactions and new customers:** Consumers consider the priority to be on the immediate product or service being sold and not on a holistic, ongoing service to ensure that consumers' needs are being met or satisfied over time. Consumers feel they are able to speak to firms easily about sales queries but often find it difficult to speak to someone for help, information and advice about their existing product holdings and/or services. There is a sense that financial services providers are more interested in new business than their existing customers and there are frustrations at the apparent lack of recognition of loyalty where special offers are only available to new customers. Many regard this practice as highly unfair.
- **Poor complaints handling:** The majority of consumers in the study felt there was 'no point' in making a complaint regarding a financial services provider as it 'won't work'. Channels and methods of communication appear frequently unclear and too automated. Scripting in call centres

57 For further information on the research methodology see Annex 1.

is often viewed as being a barrier to effective problem resolution and/or complaints redress. Consumers are also frustrated by the apparent lack of continuity in the problem resolution and/or complaints procedure, often having to repeat their concerns at every stage of the process. Firms are also generally perceived as not acting at all or fast enough once a problem is raised or a complaint is made. They are often viewed as lacking accountability, with little or no acknowledgment of error, feedback or an apology where warranted. Consumers would like to have one point of contact who they can call to enquire about the status of their problem and/or complaint and who will take ownership of the issue and resolve matters.

- **Ineffective time management:** Many of the consumers in the study were concerned about the length of time taken in conducting day-to-day business, the main areas being resolving problems/complaints and money/payment transfers. There are thought to be few clear timelines that are stated upfront and/or adhered to, with consumers wanting clear, prompt and efficient service from their providers.

- **Cancellation blockages:** Consumers in the study were concerned that it can be problematic to switch accounts, cancel or alter an instruction. Some consumers were unaware of cancellation restrictions when attempting to cancel their services.

- **Lack of proper infrastructure:** Throughout the study, there were several examples of failures in systems and/or human error which led to consumer detriment, including instances of money going missing when transfers were being made between accounts, failure to cancel direct debit payments when instructed and the inability to use credit or debit cards abroad even when firms had been notified of travel. These problems seem to be exacerbated by lack of accountability in some cases and delays in redress in others.

- **Complexity and volume of communications:** The vast majority of consumers in the study viewed communications received from financial services providers as being too large in volume and full of jargon. The extent and size of the small print is a major concern for many and there is a general perception that firms tend to 'bury' important information in the small print, which a lot of consumers find intimidating and/or incomprehensible. Consumers taking part in the study believe there is a clear need for simplified marketing and for consumers to be effectively informed at the outset of all key facts/conditions/restrictions that they would want to know before committing to a product/service.

- **Excessive and/or unfair charges:** This is a general area of concern for most consumers, which seems to support and fuel negative perceptions of financial service providers. Examples include using premium rate telephone numbers in circumstances where consumers are placed on hold for significant periods of time, acting as a potential barrier to effective redress for consumers, and charging standard overdraft fees, regardless of whether a consumer is overdrawn by £1 or £100.

- **Changing terms and conditions:** There were instances where consumers had, to their detriment, experienced changes in their terms and conditions before their contract expired, without notice and for reasons not contained in their policy or contract documentation.

While there were some examples of good conduct in terms of delivery (e.g. some consumers thought some of the financial advisers they interacted with had been professional and helpful), on the whole, financial service providers were seen to generally fall short on their promises, to the extent that the majority of consumers in the study considered that there had been an erosion of trust between them and their financial providers. In particular, they cited an inability on the part of financial service providers to offer the most appropriate solutions for them.

We are concerned about the continued lack of confidence in the UK financial system. All of the consumers taking part in the study seemed to fully understand and accept the difference between their own poor financial decisions and firms not treating them fairly. This suggests that firms taking action on the above issues are likely to help build increased consumer trust in the financial services sector.

6. Conclusions to Chapter A

In Chapter A we have discussed a number of important environmental trends affecting both firms and consumers participating in retail financial services market. These trends provide important context for the conduct risks discussed in Chapter B, as they may influence firms' interactions with their retail customers and what consumers need from financial services providers.

For firms, environmental conditions vary by sector. A number of themes, however, stand out in each sector:

- Regulatory change continues to be an important driver of firms' strategies and business models across a number of sectors.
- In retail banking, margins remain compressed. Competition among banks for retail deposits is still strong, with economic uncertainty from the sovereign debt crisis further increasing banks' wholesale cost of funding. Lower than expected impairments have had a positive impact on bank profitability, although the real level of impairments may be masked by forbearance.
- In asset management, net retail sales of funds were just over £18bn in 2011 declining from 2010, with investment flows favouring bond and balanced funds. Assets under management in Absolute Returns Funds reached around £20bn at the end of 2011, with a significant year-on-year increase. Sales of index tracker funds were the highest on record on the back of increased desire for passive strategies.
- The unprecedented extent of concurrent changes affecting life insurers continues to put significant pressure on their business models, accelerating the contraction of the sector. The 'Test Achats' case is one of several factors, with low nominal interest rates, increasing longevity and Solvency II capital requirements, adding upward pressures on prices of life products, particularly annuities.
- General insurers' earnings remain under pressure from low investment returns and increasingly intense price competition in core markets (e.g. motor) compounded by the increasing importance of distribution through aggregators.
- Changes in the regulatory environment remain a key concern for financial advisers, with market conditions remaining particularly challenging for mortgage intermediaries, and changes to regulatory requirements affecting GI brokers.

For consumers, four themes dominate:

- Many of the trends discussed in RCRO 2011 continue, including the search for both yield and security in a low-interest-rate and high-market-volatility environment.
- Consumer confidence both on their financial position and the wider financial outlook generally remains low, possibly as a result of a declining real income, fiscal consolidation, ongoing market uncertainty and increasing levels of unemployment. However, consumer experience varies among different segments of the population.
- The changing environment does not appear to have resulted in significant changes in product holding between 2010 and 2011, but some product categories (e.g. savings) experienced different patterns for different product types (e.g. with penetration of instant access accounts falling while cash ISAs maintained similar levels of ownership).
- Financial pressures have been affecting some consumers' spending patterns, including on financial products. Where consumers reduced spend on financial products, particularly in insurance, this was in some instances achieved by shopping around for less expensive financial products, rather than reducing product holdings. Increased financial pressures have also been affecting some consumers' ability to save and invest, with declining penetration for savings and investment products and a fall in the average value of investments. However, even in the face of increased financial pressure, most consumer segments, where they can afford to, seem to be focusing on debt reduction and/or consolidation.

In Chapter B we discuss the key risks we see for consumers in their interaction with financial services providers and, where appropriate, explain how these risks link with the environmental trends highlighted in Chapter A.

Chapter B – The risks

1. Introduction

Chapter B sets out our highest priority retail conduct risks we see in the markets we regulate. In a development from the RCRO 2011, we have grouped risks into 15 broad risk categories to make even clearer the risks that we regard as the highest priority. For each risk category, we set out the specific risks that we regard as crucial.

As a result, this section describes the 15 key retail conduct risk categories that we believe require particularly careful firm and regulatory focus over the next 12-18 months.

Changes to the environment described in Chapter A provide important context to these risks, and some of them have become more pressing as a result of the current environment. Others, however, reflect structural features of the retail financial services markets that create the potential for consumer detriment whatever the environmental circumstances.[58] The 15 risk categories are set out in Table 3.

	Table 3 – Top 15 retail conduct risk categories
1	Aligning business models to fair treatment of consumers
2	Complexity in retail investment products and services
3	Firms' responses to regulatory and/or legislative change
4	General insurance
5	Governance of funds in life offices
6	Host authorised corporate directors
7	Inadequate complaints handling
8	Investment propositions
9	Investment risk profiling
10	Investor compensation protection
11	Mortgages
12	Pensions and retirement planning
13	Product bundling
14	Projections
15	Systems and controls weaknesses in the network model

58 These structural features were discussed in Box 1, p 51 of the RCRO 2011.

There are three points worth noting in relation to the top 15 risk categories:

- The risk categories are set out alphabetically. This is because all 15 categories provide an overview of the highest priority retail conduct risks in the markets we regulate. As many relate to and affect more than one sector, we have not structured the risks sector by sector. Annex 2 provides a 'navigation tool' to help identify the key risks for each sector. However, firms will need to determine for themselves which risk categories are most relevant to their business.
- If an issue is not discussed in a risk category, this does not imply that a firm should not be focusing and/or taking action where it is relevant to them. The scope of this document is to set out the highest priority conduct risks across the firms and sectors that we regulate.
- Most of the 15 risk categories include a number of specific issues. While we have allocated specific risks to the risk categories set out in Table 3, we recognise the inter-connectivity across risk categories and specific risks could have been allocated in a number of different ways. With all the risk categories we have looked to create a coherent grouping of risk issues to best articulate where we see actual, or potential, consumer detriment as being the most significant.

2. Approach to retail conduct risk identification

Our view of the key risks draws on both the analysis of the environment and behaviours discussed in Chapter A, as well as our wider regulatory intelligence and internal risk analysis and identification work. We have used this information to assess which risks we regard as the highest priority in the markets that we regulate.

2.1 Risk classification

As with the RCRO 2011, we have found it useful to consider the specific risks within a risk category under three classifications[59]:

- Current issues, i.e. risks that have already crystallised to an extent, with poor firm conduct already resulting in consumer detriment.
- 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.
- Potential concerns, i.e. risks that may emerge in the future, given the possible effect of environmental factors and firm behaviour.

Each specific risk issue has been classified as one of these three types of risk above. It is also worth noting that 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 consumer detriment.

2.2 Risk prioritisation

Many of the specific risks discussed in this chapter were included in the RCRO 2011. Where this is the case we provide an update on how we see that risk now – and we would encourage the reader to refer to the RCRO 2011 for further information. Annex 3 provides a table setting out how all the risks covered in 2011 are presented in this publication.

59 These classifications are the same as those we used in the RCRO 2011.

The RCRO is not designed to be a complete directory of conduct risks, rather it represents our views on what the key conduct risks are, or might be, in future. As such, we may find it necessary to reprioritise some specific risks/categories each year – and there will be some that we have previously mentioned that we no longer see as being the highest priority conduct risks – we explain these in section 4 of this chapter. If a risk is no longer included in the RCRO, it does not mean we are not undertaking mitigation work or that firms should not be mitigating the risk.

3. The risks

3.1 Aligning business models to the fair treatment of consumers

As we outlined in Chapter A, firms in different sectors are adapting their business models and strategies to the current operating environment to increase profitability, minimise costs and/or improve balance sheets. While change may produce consumer benefits, it may also carry risks for consumers where not exercised with consumers in mind. In this section we explore the issues surrounding technology innovations, divestments/acquisitions, cost cutting exercises, incentives and other business model changes.

3.1.1 Cost-cutting and efficiency improvement initiatives in deposit takers (potential concern)

As identified in the RCRO 2011, some banks and building societies continue to adopt and/or implement significant cost-cutting strategies. The market conditions described in section 4.1 of Chapter A mean that firms' incentives to significantly cut costs remain. Our consumer research outlined in section 5 of Chapter A also supports our concerns in this area.

While cost control and higher efficiencies can be of benefit to consumers, the combination of cost cutting in key control functions and more aggressive sales targets may increase the risk of poor consumer outcomes such as:

- product mis-selling; and
- under-investment in telephony services, including the use of outsourcing arrangements, which are not well managed and controlled.

We regard this risk as a potential concern, and continue to monitor the strategies and business model developments of firms. Our qualitative consumer research outlined in Box 1 in Chapter A also supports some of our concerns in this area.

3.1.2 Incentives

Linked to changes in business models and strategies, we believe that the way firms incentivise and the increased focus on cross-selling create the potential for conduct risks and therefore potential consumer detriment.

3.1.2.1 Firms' reward policies and practices (emerging risk)

We recognise the importance of the reward and remuneration of individuals within firms and that firms may need to incentivise staff to grow the business and increase profits. However, reward schemes can also be drivers of behaviour that can lead to consumer detriment. We expect firms to treat their customers fairly, which includes managing the risks associated with reward.

Since the RCRO 2011 we have carried out thematic work on financial incentives of in-house sales forces across a sample of firms and sectors. We assessed whether the financial incentives increased the risk of inappropriate selling and whether these risks were adequately controlled. At an individual firm level we found a number of incentive schemes that significantly increased the level of risk, which was not being adequately mitigated. We are now working on the next steps, including taking action against firms where appropriate. Other action includes reviewing the necessity or otherwise of providing guidance or making changes to our rules in respect of high risk reward arrangements where the risks may be difficult to control. In doing this we will take account of EU developments, which will potentially lead to guidelines on sales force remuneration in investment firms.

While the focus of our thematic work to date has been on the risks associated with financial incentives, we recognise that sales staff will also be influenced by the broader culture of the firm and how senior management define what is expected of them through, for example, targeting and performance management. For instance, we have recently taken enforcement action against several firms where their approach to performance management contributed towards consumer detriment.

3.1.2.2 Cross-selling (potential concern)

In the RCRO 2011, we noted that a consistent theme from our analysis of several banks' and building societies' retail strategies was a desire by those firms to raise their cross-selling rates, i.e. to sell more products to each individual consumer. Continued pressure on retail banking profitability means that this is still a key theme in the retail strategy of many banks and building societies.

While cross-selling may benefit consumers in some circumstances, it may also lead to a risk that products will not be appropriately targeted or will be mis-sold, which could lead to consumer detriment. We remain concerned that the drive to increase selling can expose consumers to additional risk of detriment. We will continue to monitor these issues through our firm supervision work.

3.1.3 Changing business models in the life insurance sector (potential concern)

As discussed in section 4.3 of Chapter A, we continue to see significant pressures on the life insurance sector from a variety of sources. Continued net outflow of assets from the sector suggests firms will be required to make significant changes to their business models over the medium to long term. The key potential concerns identified are:

- There is the risk that non-core parts of the business receive less investment – both financially and in terms of management attention – leading to an increased risk of consumer detriment related to the performance of funds, services and communications.
- Some life insurers are looking to adopt aggressive growth strategies to increase profits and earnings. There is increased potential for this to come at the expense of treating consumers fairly and creating consumer detriment (through mis-selling, poor product design, low service standards etc).
- Changes in the product mix of firms can lead to consumer detriment if consumers are not appropriately informed of potential changes to the product features or if the new emerging substitutable products are less suitable for their consumers.

Since the RCRO 2011, we have seen increased evidence of life insurance firms refocusing their businesses. While this is not a risk in itself, it is symptomatic of continued change within the sector that we need to monitor.

3.1.4 Use of technology in payments (potential concern)

New technology can affect the strategy and business models of firms. It also has the potential to change the way consumers make day-to-day payments and operate their bank accounts. For example, internet banking has been available in the UK for some time and online payments have grown substantially in recent years. The total value of internet retail sales in Great Britain increased from an average weekly amount of approximately £169m in November 2006 to £446m in July 2010.[60]

We could soon see significant growth in new and existing electronic payment technologies, such as contactless cards, payments using electronic money (e-money), payments made via mobile phones and more widespread use of mobile banking. The development of e-money offerings is also being facilitated by the second Electronic Money Directive. This aims to encourage the growth of the e-money market and was implemented in the UK on 30 April 2011 through the Electronic Money Regulations 2011.

Some new payment technologies are already widely available in the UK. Examples are pre-paid payment cards and contactless debit and credit cards. At the end of 2010 there were approximately 13m contactless debit and credit cards in issue in the UK. By September 2011, this had increased to almost 20m.[61] In June 2011 around 12% of UK consumers had a pre-paid card[62] The use of some technologies (e.g. payments via mobile phones) may expand rapidly over the next few years as new products and services are launched into the market.

There are several potential concerns linked to the introduction and growth in new payment technologies. These include:

- the risk of inadequate controls within firms, on the development of new payment products aimed at consumers;
- the risk of inadequate security controls within firms, on payments made via new technologies; and
- the risk that consumers may be inadequately informed about how to use new payment technologies or about their rights and responsibilities in relation to new payment technologies.

If these risks were to crystallise they could lead to consumers suffering detriment in the form of unauthorised transactions, delays in making and receiving payments or not being able to access their funds. Due to the potential concerns highlighted, we will continue to actively monitor developments in this area.

3.1.5 Divestments, acquisitions and new players in retail banking (potential concern)

The global financial crisis led some governments to provide state aid to a number of banks and other financial institutions. As a condition for this state aid, the European Commission required divestment within a number of European banking organisations within set deadlines.

60 e-Society , Social Trends 41 (Office for National Statistics, 2010, pages 19-20).
61 Source: UK Cards Association.
62 Datamonitor Insight Report UK Cards October 2011 (data from Financial Services Consumer Insight online survey of 2012 UK consumers, June 2011).

In particular, there are requirements currently in place for a large number of UK retail bank branches to be sold in the next few years, representing approximately 8 million retail consumers in 1,000 bank branches. This has the potential to change the landscape of the UK banking sector, with the possible introduction of new players in the market and/or a significant increase in the business of existing firms. This may generate benefits for many consumers but also create some potential concerns.

During and after the divestment process, a number of risks for consumers could arise, including:

- new/existing players do not understand the new products they are selling and, as a direct result, sell inappropriate products to consumers;
- delays in processing payments;
- consumers incurring unnecessary charges;
- unclear, incomplete or inaccurate information being given to consumers;
- mis-pricing due to lack of experience in new product areas; and
- generally poor standards of service.

We are aware of these potential concerns and are monitoring them through our regulatory activity.

3.2 Complexity in retail investment products and services

As discussed in Chapter A, the combination of low interest rates and highly volatile markets has encouraged an increased supply of more complex products designed to meet consumers' demand for higher return products. Such products may appear to consumers to be lower risk than traditional investment products, but they sometimes involve risks that are not transparent to consumers or their advisers. Complexity does not necessarily imply higher risk, but we are concerned that complex products are more likely to be mis-sold because they provide a greater opportunity to exploit consumers' comparatively limited knowledge or understanding of risk.

Appropriate systems and controls around the quality of the design, marketing and distribution of complex investments are critically important. In general:

- products should be targeted appropriately to meet individual needs, circumstances and objectives; and
- information provided to consumers and distributors should be clear, fair and not misleading.

3.2.1 Development and marketing of structured investment products (current issue)

As discussed in section 4.2 of Chapter A, low interest rates and high inflation continue to create a 'search for yield' among retail investors. This environment provides an incentive for firms to sell consumers products that appear to offer higher yields such as structured investment products – particularly those with features that appear to offer 100% capital protection. Although sales of structured products fell 8% to £13.5bn in 2010, this followed a 71% increase in 2009. Moreover, AuM grew 13% in 2010 to around £52bn at the year end[63], representing a net accumulation of wealth invested.

63 Source: Structured Retail Products Ltd.

Consumers sold structured products take on a number of risks, including counterparty risk, market risk and inflation risk. These products have varying features, such as different payoff profiles and reference indices, which can be difficult for some retail consumers to understand.

In the past, the mis-selling and non-compliant marketing of structured investment products has caused significant consumer detriment, examples being so-called 'precipice bonds' and more recently the Lehmans-backed products. This has led us to have continuing concerns regarding structured investment products. More recently, we have been concerned that a lack of robustness in firms' product development and marketing processes can increase the risk of poorly designed products and lead to mis-selling, or mis-buying by consumers.

Since the RCRO 2011, our thematic review of the development and governance of structured products in provider firms has found that the products themselves have tended to become more complex and exotic, in terms of design and features. We also identified a number of weaknesses in product design and governance at a number of firms. One of the key weaknesses was a lack of early consideration of consumer needs (e.g. little in the way of identifying the appropriate target market), which we consider fundamental.

Our proposed guidance[64] as well as firm specific work aims to mitigate the risks that we have identified in this area.

3.2.2 Traded Life Policy Investments (TLPIs) (current issue)

TLPIs are pooled investments that have US life insurance policies sold on the secondary market as their main underlying asset – otherwise known as life settlements. TLPIs are complex products that can take the form of unregulated collective investment schemes. They are frequently marketed on the basis that they have no correlation with other asset classes, particularly equities, and are therefore low risk. They are not. The key issues with regards to TLPIs were noted in the RCRO 2011. Consumers have suffered detriment from these products for a range of reasons set out in the guidance we published on TLPIs in November 2011.[65]

Despite high profile TLPI failures, investment in these products persists and we continue to see new applications from firms wanting to sell these products in the retail market. We estimate that approximately £1bn of UK retail monies are currently held in the TLPIs, of which the majority is in products that are in financial difficulty or have failed already. As such, consumers have already suffered detriment.[66]

In November 2011, we consulted on guidance regarding TLPIs, based around a strong warning that we do not regard these products as suitable investments for the mass retail market and are concerned that these investments may be reaching investors for whom they are not suitable.[67] In 2012, as part of a review of the rules relating to Unregulated Collective Investment Schemes (UCIS), we intend to consult on a ban of all marketing – including marketing delivered in the context of financial advice – of TLPIs to retail investors.

64 Guidance consultation, Retail Product Development and Governance – Structured Products Review, November 2011, FSA. http://www.fsa.gov.uk/pubs/guidance/gc11_27.pdf
65 Guidance consultation, Traded Life Policy Investments (TLPIs), November 2011, FSA. http://www.fsa.gov.uk/pubs/guidance/gc11_28.pdf
66 As such, we have now included it as a current issue, rather than an emerging risk.
67 Guidance consultation. Traded Life Policy Investments (TLPIs), November 2011, FSA. http://www.fsa.gov.uk/pubs/guidance/gc11_28.pdf

3.2.3 Unregulated Collective Investment Schemes (UCIS)[68] (current issue)

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 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 generally considered to be a high-risk investment (and these risks are not always easy for advisers and consumers to understand). In addition, consumers may not be covered by the Financial Ombudsman Service or the Financial Services Compensation Scheme if the product experiences problems.

The majority of UCIS are designed for institutional investors. However, we are finding that some schemes either deliberately or by default are being sold to categories of retail investors for whom this product is inappropriate. UK investors have made substantial investments into UCIS either directly or via distributors. The RCRO 2011 noted UCIS as an area of growing concern, however, there is now evidence that these products are increasingly being mis-sold to consumers.

In the RCRO 2011 we set out our key areas of concern that may result in UCIS being mis-sold. These included:

- intermediaries failing to understand the marketing restrictions on UCIS and promoting them to retail clients in breach of statutory restrictions; and
- intermediaries lacking an understanding of the individual UCIS they are selling and providing unsuitable advice as a result.

We have found evidence of these issues, including consumer losses, in a number of retail intermediary firms and have pursued several enforcement cases. As such, we remain concerned about these issues. Firms should not inappropriately promote, advise or arrange UCIS investment to retail investors. We have clearly stated what we expect from intermediaries when promoting, advising on or arranging UCIS.[69]

Later in 2012, we propose to conduct a review of the rules relating to UCIS to improve consumer protection.

We also have ongoing concerns about how firms' behaviour further up the UCIS product chain is contributing to the risk of UCIS being mis-sold to consumers. These concerns include:

- providers and promoters targeting UCIS at retail intermediaries in ways that encourage mis-sales later in the value chain;
- firms making UCIS available to the retail market without conducting sufficient due diligence or establishing appropriate systems and controls to guard against the funds reaching the wrong consumers; and
- insufficient product governance controls at firms that establish, operate and manage UCIS funds to ensure that consumers are treated fairly.

We have also taken forward enforcement cases against UCIS providers. Providers and distributors should consider the impact of their action (or inaction) on the customer in various stages of the product life-cycle, or the various stages of the service.

68 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.
69 UCIS Findings, Good and poor practices, July 2010, FSA. http://www.fsa.gov.uk/library/other_publications/ucis

3.2.4 Private banking and wealth management (emerging risk)

We are concerned that poor firm conduct in private banking and wealth management might lead to widespread detriment. The wealth management industry is comprised of firms from different sectors, including IFAs, stockbrokers, private banks and wealth management divisions of retail banks. Many banks sell wealth management products and services to retail consumers, both through retail banking and their private banking arms. Private banking clients expect to receive a bespoke service and access to a wider range of products, many of which are complex. This is exacerbated by the current low interest rate environment, which leads to strong incentives for firms to sell retail investors products that target higher levels of return without adequately understanding or disclosing the risks.

The retail banking distribution 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 (see section 3.2.1 in this chapter). Some wealth management products were initially designed to be sold to institutional clients and are, therefore, relatively complex when compared to products most retail/banking consumers are familiar with. It is particularly important, when banks decide to grow their wealth management business, that they have continued regard to their Treating Customers Fairly (TCF) obligations.

The risks we see in this area are:

- Banks may sell complex or illiquid products that encourage existing private banking clients to take inappropriate risks with their savings. 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 sell.
- Banks inappropriately sell wealth management products to Affluent and Mass Affluent consumers, either by up-selling them into private banking or by offering them via their retail banking arm. Poor risk profiling may have already resulted in the up-risking of some retail consumers.

We have carried out a thematic review in the wealth management sector, which revealed evidence of misconduct, giving rise to potential consumer detriment. In particular, the results indicate that many firms do not gather or maintain adequate client information to demonstrate suitability, and that even where the information is available, there is a significant risk that consumers have unsuitable portfolios.[70] These risks have been communicated through a Dear CEO letter[71] to the industry and we are currently engaging with regulated firms, consultancies and trade bodies to improve standards. We have also taken supervisory action against a number of firms in this area. While some firms appear to have taken steps to improve record keeping and suitability, further work is needed to ensure change throughout the industry.

70 As such, we have reclassified this as an emerging risk.
71 Dear CEO – Wealth management review, June 2011, FSA. http://www.fsa.gov.uk/pubs/ceo/dear_ceo_wealth_management.pdf

3.2.5 Exchange Traded Products (ETPs)(emerging risk)

An Exchange Traded Product (ETP) is an investment product, listed on a stock exchange, which owns or is exposed to either a basket of securities, such as the constituents of an index (like the FTSE 100), or some other investment, such as oil or gold. Most ETPs try to match the performance of an index (investments of this type are generally known as passive funds). ETPs can offer many benefits to investors. For example, they enable investors to buy investments in a wide range of different markets, potentially at relatively low cost. Some ETPs are also structured to provide greater protection for consumers under EU legislation (known as UCITS).

While ETPs may share similar characteristics, the 'ETP' label describes many products that have a wide range of structures, with some investing in riskier and more exotic markets. Investors are exposed to the changes in the market the ETP is trying to track, as well as a number of risks arising from the structure of the ETP itself. Consumers or their advisers may not fully understand ETPs and consumers may therefore suffer detriment if they are sold a product unsuitable to their risk appetite.

Over the last 18 months, we have conducted thematic visits to a number of firms who account for a significant portion of the EU ETP market. We found some evidence of poor practice in UK-authorised firms and have asked firms to address risks where we have found issues. We are also working closely and effectively with the Financial Policy Committee and other EU regulators, to mitigate risks where we are not the lead regulator. Some issues require a coordinated response from the EU. We have played an active role in contributing to the various pieces of work at a policy level across EU institutions to ensure a coordinated EU approach. This work is ongoing.

3.2.6 Absolute Return Funds (ARFs) (potential concern)

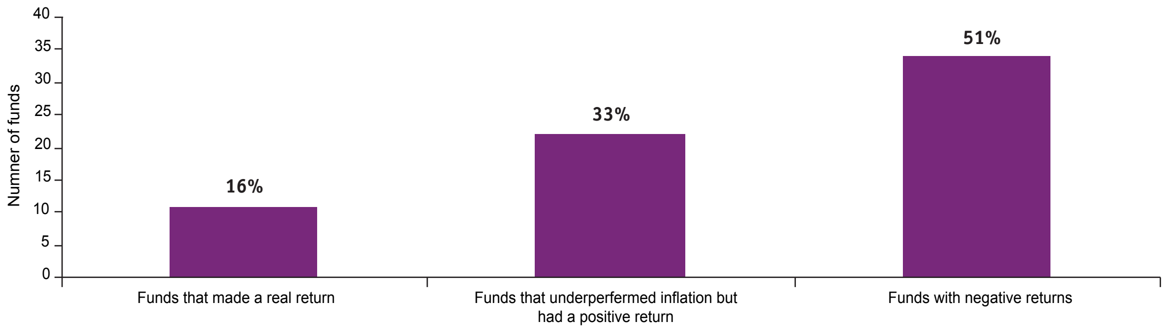
In the RCRO 2011, we highlighted ARFs in the context of asset managers developing more complex investment strategies and promoting them to retail investors. The issues discussed last year remain relevant. Recent data from the IMA shows that 9% of net retail flows in both 2009 and 2010 went into ARFs and approximately £21bn were being managed in these funds as at the end of October 2011. According to the IMA, the number of ARFs expanded from 17 in 2008 to 78 in 2011.

Despite the success of some funds in delivering positive returns for investors, ARFs may pose potential retail risk due to the following reasons:

- Consumers may not understand ARFs. For example, consumers may believe there is an element of capital protection, or guarantee of a positive return.

- Consumers could suffer significant unexpected financial loss if they are sold funds that fail to perform, and where the perception mentioned above continues to exist. Figure 85 shows that many ARFs made losses over the twelve months to January 2012.

Figure 82: Performance of Absolute Return Funds



Source: FE analytics, www.financialexpress.net
Note: 1. Based on 1 year returns to 31 January 2012,
2. Excluded funds that did not have 12-month performance data.

- The complex strategies and structures employed in ARFs could be more difficult to understand than those found in traditional long-only funds, and raise questions about their suitability for all types of retail investors.
- Financial advisers may not fully understand these products, which increases the possibility that poor communication of investment risks contribute to mis-selling to consumers.

Work is currently being undertaken to assess the extent of the risk posed by the funds. Providers will need to ensure they meet their regulatory obligations in relation to these products, for example in relation to the targeting of them and the explanation of their risks. Advisers must also ensure that they meet their obligations in relation to their understanding of the product and the risks involved, and the extent to which recommended products meet the needs of their consumers.

3.3 Firms' responses to regulatory and/or legislative change

As a result of UK and international regulatory initiatives, there are a number of key regulatory changes being implemented in the UK financial services market. We discussed in detail in section 3 of Chapter A some of the key regulatory changes underway. Here we explore how firms' response to these changes will affect the retail conduct risks in these markets.

3.3.1 Responses to the banking conduct regime (emerging risk)

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 comprises:

- the Banking Conduct of Business sourcebook;
- the full application of the Principles for Businesses; and
- the Payment Services Regulations 2009 (PSRs).

In RCRO 2011, we noted that our early reviews of compliance with the Banking Conduct Regime (BCR) suggested that many banks and building societies have widespread disengagement with the new standards.

We think that firms are still not fully engaged with the BCR and, in particular, with certain conduct of business requirements of the PSRs, and it therefore remains an emerging issue. This can mean that some consumers are not able to make informed decisions, receive a prompt, efficient and fair service, or get access to their own money quickly enough.

We think this is an indication that banks may not be giving the BCR due priority. Banks appear to be focusing on issues that are receiving enhanced regulatory attention, rather than proactively considering their own risks relative to the regime as a whole. Even where we have brought issues to the attention of industry, such as D+1[72], we have noted that some firms failed to engage early enough to ensure that they were compliant. Firms have been slow to change their consumer-facing literature to adequately reflect their responsibilities under the BCR, even though these requirements are now over two years old.

We have written to firms to highlight our concerns and remind them of their responsibilities and obligations to consumers. Specifically, we focused on identifying and preventing poor consumer outcomes resulting from non-compliance with the PSRs.

3.3.2 The Retail Distribution Review (RDR)

The RDR will lead to fundamental reform of the investment advice market. It will require both adviser and provider firms to change their business models in response to the new adviser charging regime and new qualification requirements. There are two key risks that we see in relation to the RDR (see section 3.1.1 of Chapter A).

3.3.2.1 Transition to the RDR (emerging risk)

In the RCRO 2011, we noted that firms may seek to maximise their recurring revenue streams ahead of the RDR. We noted our concern that, in some cases, firms may do this in ways that produce poor outcomes for consumers.

This risk remains an emerging issue and will remain valid in the run up to the introduction of the RDR. We will, therefore, continue to monitor firm behaviour and take appropriate regulatory action as necessary.

3.3.2.2 Business model change following RDR (potential concern)

In the RCRO 2011, we noted our concern that firms may make changes to their business that may lead to potential new areas of risk for consumers unless actively managed. Several examples of possible reactions to the RDR that may, if realised, increase the risk of poor outcomes for consumers that were identified in the RCRO 2011 and remain valid. These are:

- 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.
- 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 increase costs for consumers or the risk of unsuitable advice.

72 D+1 is the term used to indicate that banks and building societies are required to ensure payments reach the payee's bank or building society by the end of the following business day.

- Provider influence – Some providers may seek to avoid the ban on commission by offering other incentives to advisers, such as business or consultancy services, although inducement rules should mitigate this. There is a risk that this may continue to bias the sales process.
- Compliance – Business model change 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 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 FRO 2010) remain relevant.

Firms should ensure that their 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.

3.3.3 Solvency II (potential concern)

Solvency II will have a fundamental impact on the insurance industry and, as in the RCRO 2011, we regard this risk as a potential concern. 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 changes to their business proposition.

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, withdrawing from certain product lines or widening the range of assets consumers' benefits can be based on. There may be a risk of consumer detriment in this area if consumers are not appropriately informed of potential changes to the product features, or if the new products are less suitable to their needs. CP11/23, Solvency II and linked long-term business, published in November 2011[73], addresses some of these issues.

3.3.4 Mortgage Market Review (MMR) (potential concern)

While the proposed MMR reforms[74] are intended and expected to reduce risks to consumers from poor lending and selling practices, there is an emerging risk that the introduction of more stringent standards for responsible lending and evidence/record keeping around affordability, may mean that some firms turn instead to the inappropriate use of other products. For example, buy-to-let loans may be sold in place of residential mortgage contracts with the risk that the protections built into our regime would not apply (see section 3.11.3 of this chapter). There may also be inappropriate sales of bridging finance.

We are already aware of this type of issue in the current market, and we are concerned that it could grow, especially as these contracts are usually more expensive and can appear more profitable to lenders and brokers (although there are of course financial risks for firms in writing this type of business). Firms on the fringes of the industry may be incentivised to develop and market products that fall outside the scope of our regulation. We have issued consumer warnings where we have had concerns about innovative products in the past (see section 3.11.4 of this chapter), and will be willing to take similar and other actions in response to any consumer risks in the future.

73 CP11/23, Solvency II and linked long-term insurance business, November 2011, FSA. http://www.fsa.gov.uk/pubs/cp/cp11_23.pdf
74 CP11/31, Mortgage Market Review: Proposed package of reforms, December 2011, FSA. http://www.fsa.gov.uk/pubs/cp/cp11_31.pdf

There is also the risk of firms trying to increase business written before the MMR requirements come into force, with a resulting spike of poorer quality mortgage applications and approvals. However, lending/underwriting criteria have tightened very significantly since the financial crisis began and, therefore, unless the market starts to overheat again, we believe this risk is relatively unlikely to occur.

3.3.5 Pensions reform (potential concern)

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 and the first members may be enrolled from July 2012.

However, we have a number of potential concerns in this area. Firstly, there is the possibility that advisers could incorrectly recommend an employee to opt 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 to which they are entitled. There is also the issue that increased volumes of new business, transfer requests and paid-up plan requests may lead to pressure on administration systems. This pressure on operational systems could, in some cases, lead to consumer detriment.

We published PS11/8[75] in May 2011, which is designed to mitigate this risk (as well as other risks associated with automatic enrolment). However, we will continue to monitor developments when auto-enrolment starts later this year.

3.3.6 Gender pricing in insurance (potential concern)

As a result of a European Court of Justice (ECJ) ruling, from 21 December 2012 insurers will no longer be able to use gender as a factor in pricing. Instead they will need to implement unisex premium pricing. As a result, this creates a number of potential concerns.

Our primary concern on the transition to unisex premium pricing is that firms may fail to make appropriate or timely changes to their systems and controls to ensure that the pricing of insurance products is in line with the new requirements. It will be important for there to be clear communication to consumers, particularly when issuing illustrations around the time that the change is implemented in December 2012.

There is also a risk that consumers do not receive sufficient information either about changes to existing products or quotations obtained immediately before 21 December 2012, leading to policies that are not suitable or less suitable for their needs. A further potential issue is that firms may withdraw from the market entirely or from certain product lines, reducing choice and competition.

Firms should ensure they have appropriate systems and controls in place in sufficient time to meet the statutory deadline. They should also ensure that their pricing of insurance products fully reflects the requirements that will be set out in new legislation issued by the government in 2012 to amend the Equality Act 2010 to implement the ECJ ruling.

75 PS11/8, Pension reform – Conduct of business changes, May 2011, FSA. http://www.fsa.gov.uk/pubs/policy/ps11_08.pdf

3.4 General insurance

Our experience is that consumers tend to shop around on price[76] for their general insurance requirements and findings from our consumer research (discussed in section 5 of Chapter A) confirm this and suggest this trend is increasing. This is generally a good practice for consumers, provided they are comparing like for like and have the information they need to make an informed decision about the product being offered.

With this in mind, we have identified three issues that create an emerging risk of consumer detriment:

- Consumers making purchasing decisions based on the cheapest initial premium without adequately considering the differences in the quality of insurance policies being offered and other post-sale charges.
- Firms selling add-on general insurance products, where the consumer is focused on the primary sale and may not understand the overall cost and value of the add-on to them.
- Firms manufacturing general insurance products of limited utility to consumers, which may therefore represent poor value and result in consumer detriment.

We discuss each of these emerging risks below, and then go on to look at the potential concerns we see specifically in relation to new payment protection products.

3.4.1 Consumers' focus on initial premium (emerging risk)

We have noticed that the benefits and cover in some general insurance policies are being eroded relative to the standard that consumers have come to expect, while additional administration and cancellation charges are also being introduced.

The varying quality of general insurance policies makes it more complex for consumers to find the right deal and means that they cannot rely on shopping around based only on the headline price. This is because: (a) this is not a true reflection of total cost to the consumer; and (b) the scope of cover may vary. A distribution shift towards more affinity sales and white-labelling by intermediaries increases the potential for different variants of commonly bought insurance policies and adds complexity for consumers.

If consumers focus on buying the cheapest product, without understanding the scope of the cover, the product may not be value for money and consumers will suffer detriment if they later find they are unable to make a claim[77] or that they could have bought better value cover elsewhere.

3.4.2 Products of limited value (emerging risk)

We are concerned about firms often designing insurance products, bundled with other services, which are of limited use to the consumer and may be poor value, resulting in consumer detriment. The monthly or annual cost of these products might often be relatively low, but there is usually a significant profit margin for the firm distributing the cover. Pressure selling and misleading sales also often feature in this area of the market. Consumers will suffer detriment if they purchase insurance products they are unlikely to need or will be unable to claim on.

76 ICOB Review March 2007, FSA.
77 For example, because of limitations or exclusions to policy cover, including compulsory excesses.

While disclosure in the sales process can go some way to mitigate these risks, we know that consumers do not always act on the information given. Also, as many sales are now transacted online, without a robust sales process, it may be easy for the consumer to ‘click through’ without reading the important information. When designing and distributing insurance products, firms should ensure that their products are designed and marketed appropriately, and must provide the information the consumer needs in a manner that is clear, fair and not misleading. Otherwise, consumers may suffer detriment.

3.4.3 Add-ons (emerging risk)

It is sometimes the case that there is little profit margin in the primary general insurance product, so firms supplement their income through add-on sales with a high profit margin, some of which will historically have been included in a standard policy. Firms might therefore incentivise staff to pressure sell or to automatically include the add-on without explaining the cover properly or that it is optional. When products are bundled in this way it is not easy for consumers to understand the overall cost and value of the product to them.

3.4.4 Payment protection products (potential concern)

In the RCRO 2011, we noted that regulatory intervention on PPI may lead to firms developing alternative protection products to run alongside credit facilities or as stand-alone products. We noted that there had been growth in sales of protection products such as Critical Illness Cover (CIC) and Income Protection (IP).

Since the RCRO 2011, we have seen a number of large firms develop and launch new payment protection products, specifically insurance forms of protection, such as short-term IP products (though these are not new to the market generally).

In time, other new non-insurance forms of protection may also emerge, such as debt freeze or debt waivers. These are contractual features within a loan or credit product where, in return for some form of payment, the lender agrees to freeze or waive the requirement on a consumer to make periodic repayments, or to freeze or waive interest or other charges, should a specified adverse ‘event’ happen to the borrower, such as sickness or unemployment. These product features would fall under either FSA or OFT jurisdiction, depending on the linked loan or credit product (and would also fall outside the Competition Commission’s point-of-sale prohibition) but could pose similar risks to consumers as PPI and other insurance forms of protection.

The failings identified with PPI must not be repeated. Reflecting our increased focus on identifying potential consumer detriment at an earlier stage of a product’s life-cycle, we have published guidance[78] for consultation (jointly with the OFT). This draft guidance sets out a number of risks to consumers, which may arise from the design of payment protection products and how firms may manage those risks, including:

- identifying the target market for the protection;
- ensuring that the cover offered meets the needs of that target market; and
- ensuring that the product does not create barriers to comparing, exiting or switching cover.

78 GC11/26, Payment protection products, November 2011, FSA. http://www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/2011/11_26.shtml

As we said in the RCRO 2011, we expect firms to be able to clearly demonstrate that consumers' needs are at the heart of product design and distribution for any protection solutions they plan to develop or sell. We will continue to monitor developments in the market, and will consider taking action where we identify that firms' products and/or practices risk causing detriment to consumers.

3.5 Governance of funds in life offices

There are two emerging risks we see in relation to the governance of consumers' funds, which may give rise to retail conduct risk. We explore each of these issues below.

3.5.1 Communication and management of the risk profile of Life Assurance funds (emerging risk)

We have concerns that some insurance firms have poor governance and control practices around their unit-linked funds. Poor governance and control structures could lead to inadequate disclosure and may increase the risk that the product provider fails to maintain the fund within the stated risk profile. This can lead to risks to consumers because:

- inadequate disclosure may mean that the consumer is less likely to understand the risk profile of the fund and is therefore more likely to make investment decisions that do not fit with their investment objectives or risk appetite; or
- if the firm does not manage the investment mandate in line with the stated objectives of the fund, consumers may be exposed to investments/levels of risk that are not within their risk appetite or do not fit with their investment objectives.

The significant regulatory and legislative changes that are being implemented over the next few years may lead to insurance firms entering new product areas, redesigning products or, in an attempt to strip out expenses to sustain margins, making greater use of third-party managers. This could increase challenges for managing investment risks, and without effective governance and oversight there is an increased risk that actual product risk profiles may become out of line with consumer expectations.

3.5.2 With-profits funds operation (emerging risk)

In the RCRO 2011, we noted the significant challenges to firms offering defined or partially defined liability products, such as with-profits policies, and that 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 2010, they represented around £340bn of AuM (due to recovery of asset prices from 2009 levels) and around 24m to 25m policies remain.[79]

The inherent complexity of the product, lack of transparency and potential conflict of interests inherent in the operation of with-profits products can increase the risk that firms may not manage the funds appropriately and result in them not meeting the policyholder's needs and expectations. It can also make it difficult for consumers to fully understand these products and their features.

79 FSA Annual Returns.

In 2010, we carried out a review[80] of how senior management in firms have implemented the current regulatory regime for with-profits – in particular whether firms are appropriately managing their commitments to their with-profits policyholders and treating them fairly. Our two main areas of concern were:

- Ineffective governance of with-profit 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.
- Significant weaknesses in the quality of consumer communications – we were not satisfied that all firms were doing enough to ensure that policyholders receive sufficiently comprehensive, timely and clear information to help them understand their policies.

Firms within the review sample have now completed the risk mitigation programmes put in place after the review and other firms continue to be closely scrutinised in terms of the general operation of the with-profits funds. We also published a Consultation Paper[81] to further strengthen protection for policyholders in areas identified in the review and through other work. We published in March 2012 a Policy Statement setting out the changes. We will consider a further Consultation Paper to include proposals on with-profits communications.

3.6 Host authorised corporate directors (current issue)

Many collective investment schemes in the UK are structured as Open Ended Investment Companies (OEICs). Typically, investment management firms (investment managers) are the sponsors of new OEICs but more recently, some IFAs have also begun to sponsor OEICs which they can promote to their client networks. Every OEIC has an Authorised Corporate Director (ACD) that operates the fund and is legally responsible for protecting investors' interests including overseeing the investment manager.

When a firm sponsors a new OEIC, it must appoint a company to act as ACD. Until recently, sponsoring firms tended to appoint another group company to perform the role of ACD, keeping responsibility for regulatory oversight within the same business group. Recently, an alternative model emerged under which the firm sponsoring the OEIC appoints an independent third party to act as ACD. This independent third party is known as the 'Host ACD'.

In theory the Host ACD appoints and supervises the investment manager, but the commercial reality is that the Host ACD is a service provider to the investment manager (or to the IFA sponsor). The resulting conflict of interests may inhibit the Host ACD from providing appropriate challenge. Consumers who buy OEICS could suffer detriment if the Host ACD is unable to challenge the investment manager. Certain circumstances may increase the risk of poor oversight by Host ACDs.

Many companies acting as Host ACDs are parts of groups which provide other services to investment managers. There is a risk that a Host ACD will wrongly perceive that the ACD service amounts to another form of outsourced activity undertaken on behalf of the investment manager. They may not price the service appropriately to reflect the legal risk they face, may not invest sufficiently in systems and controls to guard against those risks

80 With-profits regime review report, June 2010, FSA. http://www.fsa.gov.uk/pubs/other/withprofits_report.pdf
81 CP11/5 Protecting with-profits policyholders, February 2011, FSA. http://www.fsa.gov.uk/pubs/cp/cp11_05.pdf

occurring and may not be adequately capitalised to absorb any losses if poor oversight produces significant financial losses to consumers.

Many of the investment managers used under the Host ACDs model are small, newly established firms which lack the systems and controls found in larger and more established investment managers. The OEICs managed by these firms often offer strategies with higher risks than offered by more traditional OEICs. We are particularly concerned that Host ACDs might lack the specialist skills and systems needed to safeguard investors in these complex funds.

As a result, we have increased our supervisory focus on Host ACD firms to ensure they understand their responsibilities and are able to meet their obligations.

3.7 Inadequate complaints handling

Consumers can suffer detriment if their complaints are not resolved in a timely manner, or if complaints are unfairly rejected. It is therefore essential for firms' senior management to instil the right culture for complaints handling and put in place appropriate processes and controls to secure fair treatment of consumers.

Many of the major banks have a poor record of complaints handling including failing to ensure they handle complaints fairly (particularly PPI complaints), pay appropriate redress to consumers where this is due, and carry out effective root cause analysis of complaints to identify and correct any systemic problems in their interactions with consumers. Poor complaints handling has resulted in consumer detriment, as discussed below.

3.7.1 Complaints handling in major banks (current issue)

In April 2010, we published our review of complaints handling in banking groups, which 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.

Following this review we required some banks to undertake significant change programmes to address our concerns. Although we have identified evidence of progress within some banks, we still believe the poor quality of complaints handling within the banking sector is an ongoing risk.

We will continue our activity in this area, engaging with the banks where we have concerns and monitoring the effectiveness of the changes being made. We will also monitor how all firms implement the changes to the complaints handling rules set out in CP11/10 through our supervisory activity. In particular, we will consider the effectiveness of senior management[82] in establishing the right culture for complaints handling, overseeing how the firm is preparing for the removal of the two-stage process for complaints handling and assessing the impact of the firm's root cause analysis.

82 CP11/10 - As of September 2011 firms are required to nominate a senior person responsible for complaints handling. http://www.fsa.gov.uk/pubs/cp/cp11_10.pdf

3.7.2 Payment Protection Insurance (PPI)[83] (current issue)

PPI mis-selling has been a significant issue since 2005. In August 2010, we published a Policy Statement, PS10/12, The assessment and redress of PPI complaints.[84] A judicial review of decisions of the FSA and the Financial Ombudsman Service (FOS) relating to regulatory standards applicable to PPI was launched by the British Bankers' Association on 8 October 2010 (subsequently joined by Nemo Personal Finance). This challenge was considered by the High Court (Administrative Court) in late January 2011 and the Court found in favour of the FSA and the FOS. This means that firms are required to comply with the regulatory requirements set out in the FSA Handbook relating to complaints handling, taking into account the guidance set out in PS10/12.

We are continuing to take action to mitigate the risk of poor consumer outcomes arising from firms failing to handle complaints in line with PS10/12, such as firms unfairly rejecting complaints, and offering inappropriate redress. As we have set out in PS10/12, since our Handbook provisions apply to complaints about the mis-sale of all types of PPI, firms in all sectors can expect to be reviewed to ensure that consumers receive fair redress. Firms will need to be able to provide us with ongoing evidence about the robustness of their PPI complaint handling processes, and their success in generating fair and compliant assessments of (and where appropriate, redress for) PPI complaints.

3.8 Investment propositions

There have been a number of innovations in the way that investment intermediaries are looking to advise and/or manage their consumers' funds. We see two emerging risks in this market.

3.8.1 Use of platforms (emerging risk)

Platforms are an online services tool used by investment intermediaries and investors to view and administer portfolios. They differ according to their charging models and whether they are used on an advised or an execution-only basis. The charging model influences the range of investment funds offered and the clarity of what an investor is paying for.

In the RCRO 2011, we said that platforms have the potential to bring benefits to both consumers and to firms. However, there are also associated risks. We continue to monitor the issues that we identified in 2011, including:

- Advisers may not adequately consider the suitability of the overall investment 'solution' (product, funds, platform and advisory services) for individual consumers, 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 market when advising individual clients.
- Disclosure standards adopted by platform services operators, particularly for charges, may not always provide a clear or complete description of the total costs involved.

83 We discuss replacement PPI products in section 3.4.4 of this chapter.
84 S10/12, The assessment and redress of Payment Protection Insurance complaints, August 2010, FSA. http://www.fsa.gov.uk/pubs/policy/ps10_12.pdf

In addition we are seeing an increase in the use of 'corporate wraps', i.e. platforms for the workplace. These are primarily aimed at the non-advised employee market, which could be considered a captive one. This may result in consumers being less engaged with the investment options and they may pay for services they do not need. Providers of corporate wraps need to consider the particular information needs of their target market.

The platform market continues to grow; from £156bn[85] in IFA assets (Q1 2011) to £168bn (end Q3 2011).[86] The RDR is likely to increase the use of platforms by intermediaries.

In August 2011 (PS11/9[87]) we reported that the FSA Board considered it desirable, in principle, to ban payments by product providers to platforms and to ban cash rebates to all consumers. However, the Board asked for more research to establish a timescale for such bans and to identify any unintended consequences. A ban on cash rebates to consumers for advised business has already been consulted on in CP10/29.[88]

Platform models that rely on rebates from providers could allow product bias and conflicts of interest to remain in the market. Such models can also prevent access to funds that do not pay rebates and can hinder transparency of charges.

When we have considered the findings from the research we plan to publish a Consultation Paper by the end of March 2012 setting out our proposals.

3.8.2 Centralised investment propositions (portfolio advice services, discretionary portfolio management and Distributor Influenced Funds) (emerging risk)

In the RCRO 2011 we noted how investment advisory firms are in the process of transitioning their business models 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), in-sourcing or out-sourcing to discretionary portfolio managers, or using Distributor Influenced Funds (DIFs). These changes may 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 ongoing investment advice services, which typically involve recommending a range of investments to meet an asset allocation and reviewing this periodically, but do not amount to discretionary portfolio management. The RCRO 2011 noted various risks associated with portfolio advice services. These risks remain valid.

We believe there can be many benefits to adopting centralised investment proposition, both for clients and firms. In many cases clients can benefit from more structured and better researched investments and for firms there can be benefits through efficiencies and the management of risk.

85 The Platforum Adviser Guide, issue 6, May 2011.
86 The Platforum Adviser Guide, issue 8, November 2011.
87 Platforms – Delivering the RDR and other issues for platforms and nominee-related services, August 2011, FSA. http://www.fsa.gov.uk/pubs/policy/ps11_09.pdf
88 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

We have two main concerns:

- Are advisers adequately considering the suitability of the centralised investment proposition for each individual client, or are clients being 'shoe-horned' into a 'one-size-fits-all' solution?
- Where firms have adopted adviser-charging style remuneration, are these being disclosed clearly and fairly to clients?

DIFs are funds typically structured as Open Ended Investment Companies (OEICs), where the distributor (usually an adviser firm or network) offers guidance or influence for the fund design and management.

In the RCRO 2011 we noted that 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 consumers to know if the fund is in their best interests.

Firms with DIFs should understand that we have concerns with this market and we expect them to pay particularly close attention to sales processes and the quality of their advice, including their obligations under the client's best interests rule.

In February 2012, we published an update to the DIF factsheets[89] to explain our expectations as a result of rule changes in the Retail Distribution Review.

We continue to be concerned about firm behaviour in these areas. Firms should ensure they effectively manage conflicts of interest and have adequate controls in place.

3.9 Investment risk profiling (current issue)

The risks around investment advice remain acute in an environment where firms exploit consumers searching for potentially incompatible combinations of high return and low risk. Consumers may not understand the risks they need to take to achieve potentially higher yields. The potential for unsuitable sales therefore remains high.

Our recent thematic and supervisory work has concluded that consumer risk profiling is ineffective across a range of different firms giving investment advice. We have evidence that some consumers have suffered detriment as a result of firms incorrectly evaluating the level of risk that a consumer is willing to take. As a result we are concerned that advisers are selling consumers products and/or services that are not compatible with their risk appetite.

To help firms to mitigate this risk we published guidance in March 2011.[90] Initial indications are that the guidance (and supervisory action) has had a significant impact on the industry. Firms and risk-profiling tool providers tell us that they have taken note of our concerns and have acted to review and amend processes where necessary. It inevitably takes time to develop, amend, introduce and embed such changes. As such, it is not yet clear that changes are either widespread or effective in reducing the poor consumer outcomes we have observed.

89 FG 12/04, Distributor-influenced funds factsheets, February 2012, FSA. http://www.fsa.gov.uk/library/policy/final_guides/2012/distributorinfluenced-funds
90 FG 11/05 - Assessing suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection, March 2011, FSA. http://www.fsa.gov.uk/pubs/guidance/fg11_05.pdf

We will continue to monitor practice in this area given that it is a current issue causing consumer detriment.

3.10 Investor compensation protection (potential concern)

When a UK investor buys investment products from an investment firm in another EEA member state (or a branch of such a firm passporting into the UK), if the firm fails, the level and scope of compensation available may be lower than if the investor had purchased the product from a UK firm that is FSA authorised.

The Investor Compensation Scheme Directive (ICSD) sets the minimum level of compensation protection for investors who use investment services in the EEA. Under the terms of the current ICSD, the minimum compensation protection that UK investors can expect for investments purchased from firms in other EEA member states (or their UK branches) is the return of at least 90% of their claim for money and instruments held on their behalf by the firm that has failed, up to €20,000.

At present, member states may choose for their compensation scheme to provide greater or more comprehensive levels of coverage than the minimum required under the directive. The Financial Services Compensation Scheme (FSCS) is an example of this. The FSCS may pay compensation to an investor where an FSA-authorised firm that has failed owes a civil liability to that investor – essentially the same test as would be applied by a court – up to a maximum of £50,000 per person, per firm. This means that the FSCS can provide compensation for negligent investment advice or a loss caused by, for example, misrepresentation.

As a compensation scheme of last resort, however, the FSCS cannot protect investors against every loss. For example, under the 'civil liability test' investors may be unable to claim compensation if the loss is caused by the actions of a third party (whether in the UK or in another jurisdiction), rather than those of the failed firm. This approach is consistent with the FSCS's role as a safety net, which requires the industry to bear the costs of protection when an authorised firm fails.

Consumers may suffer detriment if their investment firm fails and the compensation is not what they expected at the time they purchased the investment. Firms are currently required to make their clients (who use or intend to use the firm's services) aware of the coverage and amount of the relevant compensation arrangements.

The ICSD is currently being reviewed and we are working with the Treasury to ensure that the UK can continue to provide investors with at least the existing amount of protection the FSCS currently provides.

3.11 Mortgages

Faced with ongoing challenges in the mortgage market, some firms have employed inappropriate strategies to maintain revenues and/or secure new business. We have taken regulatory action against a number of firms for unfair treatment of consumers in arrears and unfair terms in contracts, and continue to monitor activity in these areas of the market. We are also concerned about issues around the maturity of interest-only mortgages, inappropriate use of innovation and fraudulent practices in buy-to-let (where regulated contracts should have been entered into). Our focus on this area recognises that mortgages typically represent one of the most significant financial decisions to be undertaken by the average consumer throughout their lifetimes and so poor firm behaviour can result in significant detriment.

3.11.1 Unfair terms in mortgage contracts (current issue)

We have continued to see some mortgage lenders proposing or taking action in their standard mortgage contracts that have resulted in detriment for consumers. For example:

- Some firms are seeking to increase their revenues by relying on unfair terms to vary interest rates in particular circumstances. We have mitigated this on a firm-by-firm basis.
- Some firms have included terms in their contracts to reserve to the firm the right to demand immediate repayment of the mortgage for breaches by the consumer that are not commensurately serious.

We also have concerns that terms that give the firm the right to switch consumers from interest-only mortgages to repayment mortgages in certain circumstances have the potential to cause detriment to consumers. We have published guidance[91] on this issue indicating that we consider that terms giving the firm too much discretion to determine when to switch consumers from interest-only mortgages to repayment mortgages are likely to be unfair. We take the view that these terms are unlikely to be expressed in plain, intelligible language if the terms: (i) fail to be clear about when a firm's right to switch a consumer onto a repayment mortgage arises; and/or (ii) fail to define key phrases in the contract that specify when the right to switch exists.

Firms need to ensure that their contracts are drafted fairly in accordance with our rules and principles (including TCF) and relevant legislation. Unfair and unclear terms indicate poor systems and controls in relation to consumer contracts.

3.11.2 Unfair treatment of mortgage customers in arrears (current issue)

As discussed in section 2.2.3 of Chapter A, the combination of very low interest rates and lower unemployment relative to the 1990s recession has so far limited the impact of the financial crisis on arrears and repossessions levels, although there are some signals that repayment difficulties may start to materialise again in 2012 and the level of arrears is higher in some parts of the UK.

However, poor treatment of consumers in arrears has caused detriment. Regulatory action to date to address poor practice has resulted in us taking action against five lenders, resulting in fines and estimated consumer redress totalling over £19m. Firms have been required to review how their practices comply with the required regulatory standards and to take the necessary corrective action. One outcome has been a greater focus on forbearance options to help consumers in financial difficulties.

The appropriate use of forbearance by mortgage lenders can benefit consumers by supporting them through periods of financial difficulty and enabling them to remain in their property. Forbearance should aim to return the mortgage to a sustainable long-term position and minimise the risk of consumers ultimately losing their homes.

91 Statement on using Switching Terms in mortgage contracts under the Unfair Terms in Consumer Contracts Regulations 1999, January 2012, FSA. http://www.fsa.gov.uk/pubs/guidance/fg12_01.pdf

However, the inappropriate use of forbearance measures, without consideration of the consumer's individual circumstances, can create detriment through an increase in the total costs borne by the consumer and increased risk of loss of the home in circumstances where the mortgage debt increases to an unsustainable level.

Forbearance measures have provided a lifeline to many borrowers, but as a result of the length of time forbearance has been granted, some lenders may now find themselves having to develop forbearance exit strategies. This is likely to increase the number of repossessions. The fair treatment of consumers in arrears and subject to forbearance will therefore continue to warrant close regulatory scrutiny.

Work undertaken by us (for the Financial Policy Committee) indicates that between 6% and 8% of mortgages are currently subject to forbearance of different types. Our data shows that the level of forbearance provided by lenders has remained relatively stable in 2011, although there have been some changes in the type of arrangements reached with consumers. Permanent transfers to interest-only arrangements and term extensions have decreased significantly, while the use of payment reductions has increased.

We have issued guidance on forbearance and impairment provisions, including examples of poor forbearance practices we have observed.[92] Firms should regularly review their policy, associated controls and practices in the provision of forbearance to consumers. Any temporary or permanent forbearance facility provided by firms should be made with full awareness of the consumer's personal circumstances and intent, and should be affordable and sustainable for that consumer.

3.11.2.1 Arrears charges

We are also proposing to further strengthen our rules in relation to arrears charges. In CP11/31 – Mortgage Market Review[93] – Proposed package of reforms we proposed the following changes to:

- Prevent lenders from attempting to collect more than two direct debits in a month.
- Replace the rule that permits firms to remove borrowers from concessionary interest rates if they go into payment shortfall. In its place we propose to create a new rule allowing firms to remove concessionary interest rates for borrowers where there is a material breach of the mortgage contract unrelated to a payment shortfall.
- Provide further guidance to firms on what costs can and cannot be recovered through arrears charges.

3.11.3 Misuse of buy-to-let mortgages[94] (emerging risk)

We are seeing anecdotal evidence of unregulated buy-to-let (BTL) mortgages being used fraudulently as a replacement for regulated residential mortgage contracts, as borrowers and intermediaries seek to circumvent more stringent income and affordability checks. These instances of misconduct could increase. This is especially likely as controls around self-certified mortgages have become tighter in recent years. The pressure to achieve greater margins on overall lending, given the current low returns available, and increasing competition in the buy-to-let market, might encourage firms to engage in this type of behaviour.

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92 Finalised Guidance – Forbearance and Impairment Provisions – Mortgages, October 2011, FSA. http://www.fsa.gov.uk/pages/Library/Policy/final_guides/2011/fg11_15.shtml

93 CP11/31, Mortgage Market Review: Proposed package of reforms, December 2011, FSA. http://www.fsa.gov.uk/pubs/cp/cp11_31.pdf

94 Buy-to-let was covered under the section on MMR in the RCRO 2011. We feel that it is appropriate to include buy-to-let as a standalone risk in the RCRO 2012. There is a separate section on MMR related risks in section 3.3.4 of this chapter.

This inappropriate use of products may, in certain circumstances, result in the consumer's loan being unregulated altogether. This means that consumers would be denied access to the protections that apply to regulated mortgages, such as our arrears handling rules, and access to the Financial Ombudsman Service. It also creates financial risks for the lenders involved.

3.11.4 Mortgage product innovation (potential concern)

Innovation can deliver benefits for consumers, but it can also result in increased levels of complexity, thereby creating potential detriment to consumers. Without appropriate controls in relation to the targeting and marketing of these products to consumers, there is a risk that innovative niche products will be sold to consumers for whom they are not suitable.

With the level of mortgage lending remaining subdued on account of ongoing funding constraints and concerns regarding credit quality, the majority of lenders have tightened their lending criteria and few are prepared to lend at higher loan-to-values, e.g. 95%. Simultaneously, the market remains concentrated, with six lenders accounting for an estimated 81.5% of the total volume of lending in 2010.[95] As a result, some smaller lenders with higher funding costs are looking at other ways of competing for business. One area where we have seen a number of innovative new products is in the higher loan-to-value sector of the market, with lenders looking at new ways of helping first-time buyers who do not have a 10% deposit or more. Some of the products include:

- New generation guarantor mortgages – unlike existing products, where parents' income was used to guarantee the mortgage, new schemes can involve parents' savings being used to offset the child's mortgage, or a legal charge being taken over a percentage of the parents' property, which is then used as the deposit.
- Mortgages where, to help borrowers to obtain a higher loan-to-value mortgage, part of the loan is a non-FSA regulated shared equity loan.

We have also seen some firms, operating in niche areas of the mortgage market, which have tried to launch unregulated 'look alike' products as alternatives to regulated sale and rent back and equity release products. We have published consumer alerts[96] to warn consumers of the potential concerns and lack of regulatory protections associated with these products.

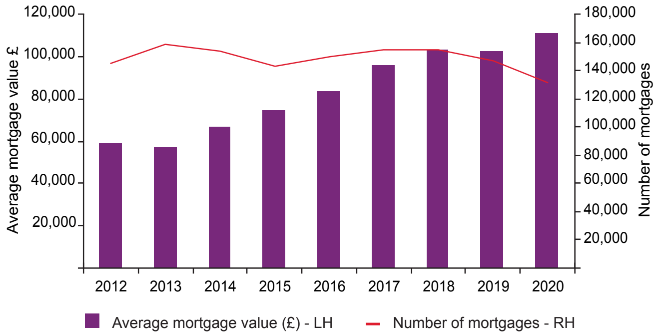
While market conditions remain flat we expect to see more innovation in the mortgage market and we will continue monitoring developments to ensure that, where new products are more complex than a traditional mortgage, the products are clearly targeted and sold to consumers who understand the risks involved.

3.11.5 Capital repayment of interest-only mortgages at maturity (potential concern)

Many UK lenders have a sizeable book of interest-only mortgages, a substantial portion of which are due to mature in the next five to 15 years.

95 CML News and views, August 2011.
96 Exchange with delayed completion and lease options contracts.
http://www.fsa.gov.uk/pages/consumerinformation/product_news/mortgages/lease-options/index.shtml

Figure 83: Projected volumes and average balances of interest-only mortgage maturities



Source: CML

For a variety of reasons, borrowers who took out interest-only mortgages may be unable to repay the full amount of the capital balance at maturity. Borrowers may have entered into interest-only mortgages relying on repayment strategies that have not materialised due to changes in personal circumstances or wider social and economic trends.

At present, interest-only mortgages are starting to reach maturity in relatively low volumes and in the lower loan-to-value ranges. In the medium to long term, the outstanding balances, as well as the loans-to-value of these maturing mortgages, are expected to increase significantly (see figure 83). Consequently, both lenders and borrowers need to pro-actively plan for the maturity of these mortgages.

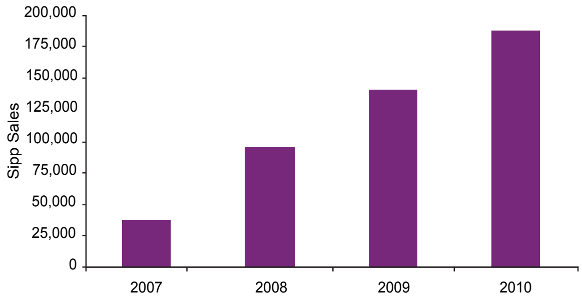
This issue, including the fair treatment of borrowers in this situation, is something that we will be monitoring closely. In particular, we are planning to undertake thematic work to inform our view on the conduct issues that arise when interest-only borrowers reach mortgage maturity without the means of capital repayment. This will examine the policies, procedures and strategies in place across a range of firms, and consider their compatibility with the fair treatment of consumers.

3.12 Pension and retirement planning

Securing financial wellbeing during retirement is paramount to most pension investors, which means quality of advice and product suitability for pension and retirement planning are of significant regulatory concern.

Risky, exotic, and complex products are likely to be unsuitable investments for funds earmarked for retirement. Retirement planning involves complex decisions, which creates the risk that poor advice results in lower retirement income and/or purchase of products with excessive risks. This impact of detriment is compounded by limited means to recover from financial loss, especially among vulnerable groups (e.g. the elderly) that have lower earning opportunity or financial flexibility.

Figure 84: SIPPs sales



Source: FSA Retail Investments Product Sales Data (PSD)

3.12.1 Self-invested personal pensions (SIPPs) (emerging risk)

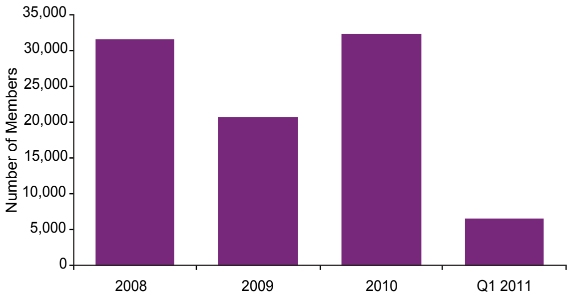
SIPPs were originally a niche product, but they are now available through mainstream pension and investment providers. The market for SIPPs continues to grow, with sales increasing almost five-folds between 2007 and 2010 (see figure 84).

Investors in most SIPPs have extensive choice when deciding what funds or assets to invest in, with some SIPPs allowing individuals to invest in any asset permitted by SIPP legislation and others offering a more restricted choice. Advisers should understand the risks involved in the investments they recommend and any limitations around their promotion.

The RCRO 2011 noted our concerns about poor firm conduct and the potential for widespread detriment. We still have three main concerns: poor controls creating the potential for consumer detriment generally; capital adequacy; and UCIS being held within SIPPs (see section 3.2.3 of this chapter).

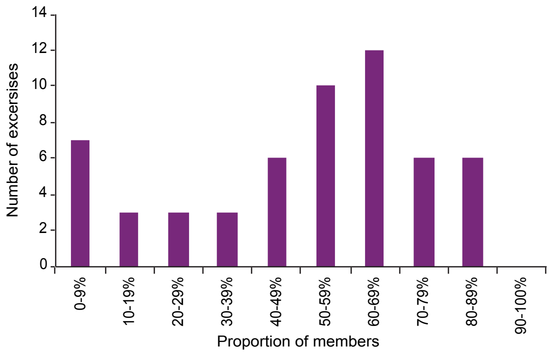
With regard to capital adequacy, there has been evidence of schemes having contained illiquid assets or assets that are difficult to market and we have seen this risk crystallise in one scheme. Despite this, SIPPs continue to be used by some advisers as wrappers for exotic, risky and potentially poor value products, such as UCIS. When this is coupled with inadequate controls over the investments held within the SIPP, it is clear that the combination could potentially lead to significant consumer detriment.

Figure 85: Number of members included in ETV exercises



Source: KPMG Enhanced Transfer Values Survey, August 2011

Figure 86: Proportion of members recommended to transfer



Source: KPMG Enhanced Transfer Values Survey, August 2011

3.12.2 Enhanced transfer value – pension transfer (emerging risk)

Enhanced Transfer Values (ETVs) are incentives paid to deferred members of a defined benefit (DB) pension to transfer to a personal or stakeholder pension. An ETV is achieved by an enhanced payment from the employer that is typically above the value of the underlying cash equivalent transfer value, yet below the full cost of funding the member's pension on a buyout basis. The 'enhancements' may be a cash sum, an increase to the member's cash equivalent transfer value, or both. These strategies are designed to reduce the size and funding risks associated with the sponsoring employer's pension liabilities. We consider advising on ETVs to be a high risk activity, which is why we have extra rules in COBS.

Pension transfer is a complex decision, which creates the risk that poor financial advice results in deferred members accepting ETV offers that are sub-optimal when compared to remaining in the DB plan. The ETV-related risks we are concerned about focus on the advice process and include the following:

- The risk that poor advice to transfer out of DB plans results in significantly lower retirement income for members.
- The risk that consumers are advised to transfer to a product (annuity or personal pension plan) that they have little knowledge or understanding of, and there is no ongoing support to help them make investment decisions in the future.
- The risk that advisers do not provide information to members to enable them to make a fully informed decision.
- The risk that advisory firms do not adequately manage conflicts of interest where firms advise both the firm and the employee. For example, conflicts of interest may arise where advisers are remunerated by the sponsoring employer.

A significant number of DB plans are closing and employers are increasingly focused on de-risking their liability structure by using ETVs. Sales of Individual Pension Transfers (IPT) have expanded 56% between Q1 2007 and Q1 2011 and KPMG reported[97] that approximately 91,200 individuals have been involved in ETV exercises between 2008 and Q1 2011, with a significant proportion of transfers done on an advised basis (see figure 85). Of those members engaged with an IFA, an average 50% received a positive recommendation to transfer out of DB plans (see figure 86).

Expectations are for continued growth in the ETV market as DB pension schemes continue to de-risk. An estimated 50% of employers or schemes are considering an ETV exercise, which implies that approximately 2.5 million deferred members could be offered ETVs across 3,500 DB schemes in the medium term.[98]

Through our work in this area, we have already uncovered poor advice by some of the larger firms in this market. Consequently, in 2010 we issued a joint statement[99] with the Pensions Regulator, highlighting our concerns about the quality of advice being given to members and whether firms are identifying and managing conflicts of interest that occur with this type of business. The statement also reminded firms of their obligation under the client's best interests and pension transfer rules.

When advising a scheme member to transfer their pension benefits to another scheme, firms must take reasonable steps to ensure that the recommendation is suitable for that member in light of their personal and financial circumstances. This means the firm must obtain the necessary information from the member so the firm can understand the essential facts about them.

The rules in COBS require a pension transfer specialist to compare the benefits likely (on reasonable assumptions) to be paid under an occupational pension scheme with the benefits of a personal or stakeholder pension scheme, before it advises a retail client to transfer out of the occupational scheme. The starting point is always that a transfer will not be in the client's best interests. As a result of external regulatory changes and feedback, we consulted in February 2012 on changes to the underlying assumptions that advisers must use when undertaking transfer value analysis, to clarify and update them and reduce the risks to consumers of receiving unsuitable advice. We intend to publish the updated rules in early 2012.

3.12.3 Decumulation (potential concern)

The decumulation market in the UK is growing rapidly as more people with defined contribution type pension arrangements reach retirement age. Traditionally, consumers in the UK have purchased annuities at the point that they reach retirement. However, the government has now removed the requirement to annuitise pension savings by the age of 75. Furthermore, low current gilt yields mean lower annuity rates and Solvency II may further increase the cost of annuities and reduce their attractiveness.

97 KPMG Pensions Survey, August 2011.
98 KPMG Pensions Survey, August 2011.
99 Joint statement by The Pensions Regulator and the Financial Service Authority: Enhanced transfer value exercises, July 2010, FSA and the Pensions Regulator. http://www.fsa.gov.uk/pubs/other/tprfsa.pdf

As such, there is increasing likelihood that alternative forms of decumulation products will become more popular. Indeed, the use of income drawdown has grown over the last five years, although there has been some moderation since 2009 (see figure 87). These products may pose additional and different risks for consumers (as opposed to traditional annuities). For instance, income withdrawal risk factors include:

- the capital value of the fund may be eroded;
- the investment returns may be less than those shown in the illustrations;
- annuity or scheme pension rates may be worse in the future; and
- high levels of income may not be sustainable when maximum withdrawals are taken, or a short-term annuity is purchased.

These factors increase the potential for mis-selling income drawdown products, as advisers are likely to need to consider other variables (capacity for loss, risk, higher costs, etc) that are not typically considered when an annuity is purchased.

Consumers have the potential to suffer detriment if they are sold an income drawdown type product when an annuity would have been more appropriate to their circumstances. This risk has the potential to affect all those people entering retirement in the near future.

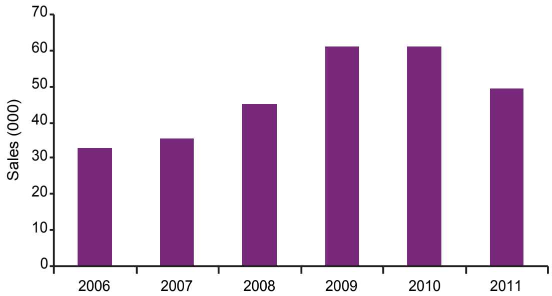
3.13 Product bundling

We remain concerned about the potential risks related to the use of product bundling in retail markets. Bundling can provide benefits to consumers in the form of convenience, but there is growing evidence that this practice is also resulting in reduced transparency and/or increased complexity. Consumers are likely to suffer detriment if they would be able to secure a better outcome by purchasing stand-alone products. Also, product bundling may be poor value for money where they include features that are not useful relative to individual consumer needs.

3.13.1 Packaged accounts (potential concern)

In the RCRO 2011, we raised the potential risk of banks needing to find ways to replace lost income (e.g. from lost PPI sales) and doing so by selling increasing numbers of packaged bank accounts that charge consumers a fee for additional features. There is a potential for consumers to suffer detriment if the product is then either designed or sold inappropriately. This could be increased by ‘firm reward’ that increase the risk of inappropiate selling (see section 3.1.2.1 of this chapter).

Figure 87: Annual income drawdown sales



Source: FSA Retail Investments Product Sales Data (PSD)

We have carried out more detailed analysis of the packaged bank account market since the RCRO 2011 and identified some specific issues. These include:

- Consumers might rely on insurance cover sold as part of a packaged bank account and only later find that they are ineligible to claim.
- The lack of price transparency resulting from bundling many different features with a bank account creates complexity for consumers and may limit their ability to compare/shop around and switch products and providers.

Mintel[100] and FSA data suggests that the rate of growth in this market has slowed down. This may be a reflection of our more intrusive supervision and/or that the number of consumers taking a packaged bank account has reached peak levels at the current time. However, we are aware of the possibility that firms may try to promote further growth in this market. As such, we remain concerned about the potential for consumers to suffer detriment if they are not in a position to make an informed decision about the choices available to them when considering a packaged bank account.

With this in mind, we published CP11/20[101] in October 2011, proposing new rules for the sale of insurance policies provided as part of a packaged bank account, along with opening discussion around price transparency. We have also begun collecting a range of information from firms in this market (from early 2012) to enable us to monitor the market and decide whether further policy intervention might be required.

3.13.2 Bundling of investment and deposit products (potential concern)

Some banks and building societies continue to offer ‘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 (sold on a stand alone basis) and have a shorter term than the associated investment products.

While bundling of this nature can lead to higher returns or increased convenience for consumers, it also involves potential risks, including:

100 Packaged and Current Accounts, UK report June 2011, Mintel.
101 CP11/20, Packaged bank accounts: New ICOBS rules for the sale of non-investment insurance contracts, October 2011, FSA. http://www.fsa.gov.uk/pubs/cp/cp11_20.pdf

- 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, depending on the terms and conditions of the bundle.

Poor consumer outcomes can be exacerbated by bundling deposit and investment products that have different target markets that are not well aligned. In the case of a bundle of a savings account and an investment product, for example, risks may be heightened by the enhanced deposit rate, which could be used to attract consumers for whom the bundled investment product may be unsuitable.

Given the continuing prevalence of these products in the market, we remain concerned about risks associated with bundling and have consulted.

3.14 Projections (current issue)

Projections are the means by which firms give consumers illustrative information about potential future returns from investment products and, in particular, help to show the effect of charges. They should not be seen as a guarantee of future returns.

Projections are part of the key point of sale disclosures we mandate for an important range of products, including pensions, and it is essential that firms and advisers use appropriate projection rates, particularly where consumers are investing with a specific target return in mind.

Consumers of these products often seek some idea of what they might get back before they invest and failure to use appropriate projection rates will mis-communicate the likely future returns and distort the process of comparing and analysing product choices. This increases the risk that consumers will purchase unsuitable products and the risk that they will not receive the returns they were expecting.

Our COBS[102] rules require firms who use projections to do the following:

- Project on three different rates of return:
  - 5, 7, 9% for tax-advantaged products (e.g. ISAs and pensions); and
  - 4, 6, 8% for all other packaged products.[103]
- Revise these rates downwards where a product or fund is unlikely to achieve returns in line with these rates.

We are committed to periodically reviewing the appropriateness of our projection rates. The last review was conducted by PwC in 2007 and their research concluded that our rates remained appropriate.[104] We are in the process of completing a further review and will report our findings in due course.

102 http://fsahandbook.info/FSA/html/handbook/COBS/13/4
103 http://fsahandbook.info/FSA/html/handbook/COBS/13/Annex2
104 http://www.fsa.gov.uk/pubs/other/projection_rates07.pdf

These rules benefit investors by:

- preventing firms from competing for business on the basis of unrealistic projections of future returns;
- indicating the uncertainty of future returns by providing more than one growth assumption; and
- avoiding unfair comparisons.

The importance of projections in any decision to invest means there is a strong commercial incentive for firms to compete for business on the basis of unrealistic projection rates and neglect to revise rates downwards in light of relevant changes in economic conditions, or based on the underlying assets within the product. This risk has become more pronounced in the current economic environment, where investors are attracted to products that are projected to produce higher returns amidst the low interest and relatively high inflation rates that characterise the UK investment climate.

Our thematic work in 2008 and 2009 indicated significant non-compliance with our COBS projection rules.[105] We found evidence of firms:

- not adjusting projected rates of returns downwards where the asset mix made our COBS standard rates unrealistic (e.g. for cash funds); and
- not reflecting lower rates in the charges table or the reduction in yield statistic.

Similarly, firms providing pension switching advice also failed to comply with our projection rules.

In 2003, we reminded life firms of the requirement to revise our maximum rates downwards where a product is unlikely to achieve returns in line with these rates, with specific reference to mortgage endowment re-projections. In 2009, we also issued a 'Dear CO Letter' to remind firms of the requirement to revise rates downwards and to indicate that we would take appropriate measures where we found non-compliance.[106]

We are committed to ensuring firms adhere to our rules on projections. Firms have been challenged to make requisite upgrades to their systems to enable them to deliver appropriate projection rates. We will continue to review firms' compliance during 2012 and take appropriate measures where we find non-compliance.

3.15 Systems and controls weaknesses in the network model (emerging risk)

Our ongoing supervisory activity continues to identify emerging risks arising from control and oversight issues in network firms. These issues relate to the oversight of appointed representative activity, monitoring procedures and levels of compliance resource within networks. As the RDR implementation deadline moves closer, pressure is likely to increase on firms to complete the implementation of adviser charging and to have progressed sufficient advisers qualified to Level 4 standard to deliver their business plans. This may place further strain on compliance and systems resource in the short term and may have a financial impact beyond 2012.

As such, this risk remains valid and we will continue with supervisory activity in this area.

105 These rules apply to non-MiFID packaged products, e.g. life policies with an investment element; personal pensions, including stakeholder pension schemes.
106 http://www.fsa.gov.uk/pubs/other/co_letter_projections.pdf

4. Issues from the RCRO 2011 we no longer see as highest priority

The RCRO is designed to set out our highest priority conduct risks and these risks may change from year to year. This section includes those risks that were discussed in the RCRO 2011, but that we no longer consider as high priority conduct risks. This does not mean we are not concerned about these areas or that firms should not be concerned about the related risks.

4.1 Developing and marketing structured deposits

Sales of structured deposits have grown significantly in recent times as consumers seek returns combined with capital protection. In the RCRO 2011 we identified some issues around developing and marketing structured deposits. We have since proposed guidance[107] relevant to structured deposits, which aims to mitigate the risk of poor consumer outcomes arising from weaknesses in firms' product development and marketing processes.

In particular, the guidance directs firms to:

- identify their target audience and design products that meet that audience's needs;
- stress-test new products to ensure they are capable of delivering fair outcomes for the target audience;
- ensure a robust product approval process for new products; and
- monitor the progress of the product through to the end of its life-cycle.

We note that underlying features of structured deposits typically give rise to lower levels of risk relative to the typical structured capital-at-risk products (SCARPS). For example, in a structured deposit, the deposit itself is not affected by market movements, and the depositor's capital is protected up to the current FSCS limit in the event of insolvency of the deposit-taker. With structured investment products on the other hand, investors may lose capital because of the insolvency of their counterparty or adverse market movements (see section 3.2.1 of this chapter). We believe that as the guidance is embedded it will significantly reduce consumer detriment for structured deposits. While no specific additional mitigation work is currently planned, we will continue to monitor these products by considering developing and marketing structured deposit products in general.

4.2 UCITS IV

In the RCRO 2011, we noted that one of the innovations in the latest version of the EU's Undertakings for Collective Investment in Transferable Securities Directive (UCITS IV) is the replacement of the Simplified Prospectus with the Key Investor Information Document. We raised issues around the implications of this on the ongoing quality of advice. However, we do not see this as a key source of conduct risk. In addition, this issue would be included in any ongoing work we might undertake on the quality of advice.

4.3 Tax changes and their implications for financial products

There will almost always be potential for tax changes to have an impact on the suitability of different financial products. We will continue to monitor the potential for tax changes to lead to conduct risk. However, there has not been any major change in this area in the past year that has caused significant concern.

107 http://www.fsa.gov.uk/library/policy/guidance_consultations/2011/11_27.shtml

Annexes

Annex 1

Consumer research - methodological notes

GfK-NOP quantitative research

GfK NOP research and analysis is based on their Financial Research Survey (FRS™).

GfK NOP's FRS interviews approximately 60,000 Great Britain consumers in the home or online every year. The questionnaire covers product holding, acquisition, usage behaviour and value of holdings in relation to a wide range of financial products, including savings and investments, mortgages, loans, personal credit, general insurance, life insurance and pensions. Consumers are selected from a repeated cross-section of the population on a yearly basis and not from a panel of consumers. As such, any interpretation of changes in consumer product holdings and/or consumer behavior should be treated with a degree of caution as changes could be driven to some extent by sampling error.

The research is based on a sample of 61,570 adults for the period covering July 2009 to June 2010 and 61,357 adults for the period covering July 2010 to June 2011. In particular, the study looked at six different age bands (varying from 16-24 to 65+) and the different life-stages of individuals from different wealth statuses (considering pre-family, family, no family, empty-nest and retired who have wealth of <£17,000, £17,500 to £25,000, £25,000 to £50,000 and £50,000+). In this research, wherever assets or liabilities are shared between the respondent and someone else, e.g. in the case of a joint mortgage with a partner, half the value is ascribed to the respondent. In relation to joint mortgage liabilities, the same approach is adopted for mortgage expenditure, i.e. only half of the mortgage payment is attributed to the respondent.

A sample of 1,933 of the original FRS respondents who had taken part in the FRS survey over the previous 12 months were re-contacted and asked about their current expenditure and income and, where the comparison was made, with the amounts for last year. The sample was drawn with the aim of achieving at least 75 interviews in each of the 20 life-stage and income groups used for analysis of the FRS survey to enable sub-group analysis of segments. These segments would have otherwise been too small for analysis on a nationally representative sample. The data applies to September/October 2010 (Year 1) and September/October 2011 (Year 2). Where further references are made to 'recall respondents' within section 5 of Chapter A, these refer to the sample of 1,933 of the original FRS respondents outlined in this paragraph.

The Development Team Limited qualitative research

The study collected views of 103 consumers through face-to-face group discussions (each lasting a minimum of 2.5 hours), and in-depth interviews (each lasting a minimum of 1.5 hours). These were carried out between October and November 2011 in six locations: Northern Ireland, Wales, Scotland and three locations in England covering the North, South and Midlands. The consumers were from a spread of life stages (pre-family, family with children under 16, empty nesters and 50+ with children) and socio-demographic groups and ranged from those who were confident with their finances to those not so confident. The consumers all had experience of at least two of nine financial services sectors, defined by the FSA as being relevant, and all sectors were covered within the study.

Annex 2

Sector Maps

Summary

In this section we provide 'sector maps' for the retail banking, asset management (including private client investment management), insurance and retail intermediary sectors. The maps summarise our views of the key environmental trends and retail conduct risks for each sector as set out in Chapter A and B of this document. The primary purpose of each map is to help firms operating in different sectors to navigate the RCRO 2012 and the risks that might be most relevant to their businesses.

However, as highlighted in Chapter B of this document, firms will need to determine for themselves which risks are most relevant to their businesses. The maps should not be viewed as a comprehensive list of the risks relevant to each sector or individual firms.

Retail Banking Sector map

1. Key environmental trends in the RCRO of particular relevance to the Retail Banking Sector (section 4.1 in Chapter A)

- Retail margins of UK banks remain compressed. Competition among banks for retail deposits is still strong, with economic uncertainty from the sovereign debt crisis further increasing banks' wholesale cost of funding.

- The fall in retail and wholesale impairment charges was an important driver of bank profitability in 2010. Impairment charges may continue decreasing in 2011, in part due to more stable house prices and also low interest rates, but this trend may reverse if adverse shocks to the UK economy (e.g. lower house prices or higher unemployment) arise in the future.

- In a context of tight bank profitability, banks' strategies continue to include a focus on cost-cutting plans in both front and back office functions.

- Since 2009, the volume of new lending has remained significantly lower compared with the volume at the peak of the market. Mortgage spreads remain elevated, and are particularly large on more risky products (e.g. higher LTVs and part of the buy-to-let (BTL) mortgage market), as banks maintain high new lending rates on riskier products.

- The level of mortgage repossessions has remained stable in the last two years after peaking in early 2009. This was partly a result of governmental and regulatory initiatives taken in mid-2008. Following these interventions, both capitalisation of arrears and temporary concessions increased for customers with higher levels of arrears. It has since slightly decreased.

- Some traditional sources of fee income for banks have been reduced as a result of regulatory action (e.g. from PPI), but banks' market share on pure protection products (e.g. Income Protection and Critical Illness sold as a rider benefit) has increased.

- Concentration levels in most retail products (e.g. lending and deposits) have increased and remain at historically high levels. The ICB recommendations on structural reforms may have potentially significant long-term impact on profitability and change the future competition dynamic in the sector.

- Regulatory changes such as the MMR and the RDR are likely to modify the retail banking landscape as banks rethink their business models.

2. Key risks in the RCRO particularly relevant to the Retail Banking Sector

- **Aligning business models to the fair treatment of consumers**
  - Cost-cutting and efficiency improvement initiatives in deposit takers (3.1.1)
  - Firms' reward polices and practices (3.1.2.1)
  - Cross-selling (3.1.2.2)
  - Use of technology in payments (3.1.4)
  - Divestments, acquisitions and new players in retail banking (3.1.5)
- **Complexity in retail investment products and services**
  - Development and marketing of structured investment products (3.2.1)
  - Private banking and wealth management (3.2.4)
- **Firms' responses to regulatory and/or legislative change**
  - Responses to the banking conduct regime (3.3.1)
  - Transition to the RDR (3.3.2.1)
  - Business model change following RDR (3.3.2.2)
  - Mortgage Market Review (MMR) (3.3.4)
- **General insurance**
  - Payment protection products (3.4.4)
- **Inadequate complaints handling**
  - Complaints handling in major banks (3.7.1)
  - Payment Protection Insurance (PPI) (3.7.2)
- **Investment Propositions**
  - Use of platforms (3.8.1)
  - Centralised investment propositions (3.8.2)
- **Investment risk profiling (3.9)**
- **Investor compensation protection (3.10)**
- **Mortgages**
  - Unfair terms in mortgage contracts (3.11.1)
  - Unfair treatment of mortgage customers in arrears (3.11.2)

- Misuse of buy-to-let mortgages (3.11.3)
- Mortgage product innovation (3.11.4)
- Capital repayment of interest-only mortgages at maturity (3.11.5)

- **Product bundling**
  - Packaged accounts (3.13.1)
  - Bundling of investment and deposit products (3.13.2)

- **Projections (3.14)**

Asset Management Sector map

1. Key environmental trends in the RCRO of particular relevance to the Asset Management Sector (section 4.2 in Chapter A)

- Low interest rates, relatively high savings rates and high inflation continued the 'search for yield' theme among retail investors discussed in the RCRO 2011. These factors combined with increased asset price volatility to create a challenging operating environment for asset managers in 2011.

- Retail funds under management in authorised funds maintained a positive growth path in early 2011 before declining in the second half of the year. Net retail sales of asset management products were broadly similar to pre-credit crisis levels but below the average £30bn registered for periods 2009 and 2010. As equity market volatility continued, balanced funds and bond funds were the best selling assets in 2011, accounting for approximately 57% of the year's net retail sales.

- Funds under management in UK domiciled Absolute Return Funds registered a year-on-year increase of 27% coming on the back of the promotion of these products as hedges against weakening markets. Retail interest in tracker funds continued to grow as a result of increased appetite for low-cost diversification.

- Investors also have tended to access a wide range of passive investments by means of Exchange Traded Products (ETPs). The European market for ETFs and other ETPs reached approximately £193bn in AuM in December 2011, despite some slow-down in growth in the past year.

- A continuation of the weak retail investor demand seen in the second half of 2011 could be a challenge for the sector's revenue performance in 2012. In response to these income pressures, asset management firms are likely to continue their focus on core activities and areas of greatest strength while tightening control over operating expenditure.

- Platforms continued to influence distribution patterns in the funds industry and may contribute to a change in distribution dynamics as the boundary between wealth managers and some IFAs becomes increasingly blurred, particularly with IFAs using enabling platforms to provide portfolio advice, rather than purely transactional advice.

- The industry structure remains un-concentrated. The long-term trend has been a concurrent withdrawal of bank-owned asset managers and a rise in the independent/autonomous asset managers.

- The RDR, UCITS IV, MiFID II and CRD IV, as well as other European regulatory initiatives are likely to challenge current operating models and may affect firm profitability within the sector. Separately, the Alternative Investment Fund Managers Directive (AIFMD) has significant implications for alternative asset managers, including managers of hedge funds, private equity and listed funds.

2. Key risks in the RCRO particularly relevant to the Asset Management Sector

- **Complexity in retail investment products and services**
  - Unregulated collective investment schemes (3.2.3)
  - Exchange traded products (3.2.5)
  - Absolute return funds (3.2.6)

- **Firms' responses to regulatory and/or legislative change**
  - Business model change following RDR (3.3.2.2)

- **Host Authorised Corporate Directors (3.6)**

- **Investment propositions**
  - Use of platforms (3.8.1)
  - Centralised investment propositions (3.8.2)

- **Investor compensation protection (3.10)**

3. Key risks in the RCRO particularly relevant to the Private Client Investment Management Sector

- **Complexity in retail investment products and services**
  - Development and marketing of structured investment products (3.2.1)
  - Unregulated collective investment schemes (3.2.3)
  - Private banking and wealth management (3.2.4)
  - Exchange traded products (3.2.5)
  - Absolute return funds (3.2.6)

- **Firms' responses to regulatory and/or legislative change**
  - Transition to the RDR (3.3.2.1)
  - Business model change following RDR (3.3.2.2)

- **Host Authorised Corporate Directors (3.6)**

- **Investment propositions**

  - Use of platforms (3.8.1)
  - Centralised investment propositions (3.8.2)

- **Investment risk profiling (3.9)**

- **Investor compensation protection (3.10)**

- **Pension and retirement planning**
  - Self-invested personal pensions (3.12.1)

Insurance Sector map

1. Key environmental trends in the RCRO of particular relevance to the Insurance Sector (sections 4.3 and 4.4 in Chapter A)

Life Insurance Sector (section 4.3 in Chapter A)

- The unprecedented extent of concurrent changes affecting life insurers continues to put significant pressure on their business models, driving ongoing restructuring in the sector and possibly accelerating its contraction. For example, high asset price volatility and low economic growth continue to create short to medium-term balance sheet pressure. They also limit the demand for life investment products by consumers, with a negative impact on insurers' revenues.

- The trend of net business outflows from the sector highlighted in the RCRO 2011 continued, reflecting a mix of long-term factors (e.g. increased payouts as more people retire and live longer, reduction in sales of policies over the last decade and high and/or rising levels of lapses) coupled with increasing competitive pressures from alternative savings and investment providers.

- Annuity providers remain particularly vulnerable to renewed widening of credit spreads on bond portfolios and continuing increases in longevity.

- Regulatory initiatives will significantly influence the life insurance sector. The combination of RDR, Solvency II and the introduction of the National Employment Savings Trust (NEST) brings opportunities to some firms but also represents a significant challenge for the sector.

GI and Protection Sector (section 4.4 in Chapter A)

- General insurers' earnings remain under pressure from low investment returns and intensified price competition in core markets (e.g. motor), which has been compounded by the increasing role of aggregators.
- Critical illness, health and income protection lines may also be exposed to demand-side pressures. Demand may particularly reduce where cover is linked to debt products, such as personal loans that may fall in popularity as households attempt to deleverage.

- Intermediaries (including mortgage and insurance brokers) generate the largest share of home insurance and protection premiums. Banks play an increasingly important role in the distribution of certain types of life and protection products.

- Continuing competitive challenges may lead some general insurers to seek alternative sources of growth and profitability. For example, household, travel and pet insurance provide natural cross-selling opportunities for motor writers.

2. Key risks in the RCRO particularly relevant to the Life Insurance Sector

- **Aligning business models to the fair treatment of consumers**
  - Firms' reward polices and practices (3.1.2.1)
  - Changing business models in the life insurance sector (3.1.3)
- **Firms' responses to regulatory and/or legislative change**
  - Transition to the RDR (3.3.2.1)
  - Business model change following RDR (3.3.2.2)
  - Solvency II (3.3.3)
  - Pensions reform (3.3.5)
  - Gender pricing in insurance (3.3.6)
- **Governance of funds in life offices**
  - Communication and management of the risk profile of Life Assurance funds (3.5.1)
  - With-profits funds operation (3.5.2)
- **Investment Propositions**
  - Use of platforms (3.8.1)
- **Investment risk profiling (3.9)**
- **Pension and retirement planning**
  - Self-invested personal pensions (3.12.1)
  - Decumulation (3.12.3)
- **Projections (3.14)**

3. Key risks in the RCRO particularly relevant to the General Insurance Sector

- **Aligning business models to the fair treatment of consumers**
  - Firms' reward polices and practices (3.1.2.1)
- **Firms' responses to regulatory and/or legislative change**
  - Solvency II (3.3.3)
  - Gender pricing in insurance (3.3.6)
- **General insurance**
  - Consumers' focus on initial premium (3.4.1)

- Products of limited value (3.4.2)
- Add-ons (3.4.3)
- Payment protection products (3.4.4)

- **Product bundling**
  - Packaged accounts (3.13.1)

Retail Intermediaries sector map

1. Key environmental trends in the RCRO of particular relevance to the retail intermediary sector (section 4.5 in Chapter A)

- The downward trend in overall number of intermediaries continued from 2010, with a further reduction of 4% in 2011. Similar to 2010, the significant number of firm closures for mortgage intermediaries primarily accounted for the overall decline in the number of retail intermediaries.

- The retail intermediaries sector will need to consider the requirements of the RDR, the introduction of auto-enrolment into pension schemes, MiFID2, the Mortgage Market Review and the Insurance Mediation Directive review among other regulatory and legislative initiatives.

General Insurance (GI) intermediaries

- The largest group of intermediaries continued to operate in general insurance. Growth in the number of GI intermediaries in recent years has been driven by increasing numbers of appointed representatives. However, this trend slowed during the second half of 2011.

- Revenues for GI intermediaries remained largely resilient in 2011. The majority of retail insurance purchases continued to be compulsory products but GI intermediaries are also increasingly relying on sales of high-margin ‘add on’ insurance products.

- General insurance intermediaries remained under competitive pressure from insurers’ direct sales propositions and the increasing role of price comparison websites as distribution vehicles within the sector.

Mortgage Intermediaries

- The number of mortgage intermediaries declined a further 10% in 2011 on the back of weak domestic economic growth, falling house prices, reduced levels of mortgage funding, and low levels of consumer confidence.

- Mortgage intermediaries currently active in the market have diversified and no longer simply undertake mortgage sales but now look to widen income streams. Others have adopted strategies to sell niche products to the mass market. Separately, buy-to-let lending has maintained an upward trend as a result of increased demand for rental properties, which has provided mortgage intermediaries with an additional income stream.

- At an aggregate level, mortgage intermediaries are challenged by competition from lenders’ direct sales with further funding pressures in the mortgage market potentially triggering a return of the aggressive dual pricing strategies seen in 2008 where lenders offered more competitive products via their branches.

Financial Advisers

- Although the difficult market conditions have led to approximately 8% decline in the financial adviser market from its population peak in 2008, the overall sector remained relatively stable in 2011.

- Product innovation in the investment market has also introduced new sources of revenues for financial advisers. Some financial advisers may have benefited from the wider range of investment products but some of these products pose additional risks for consumers.

- The market for the distribution of retail investment products remains unconcentrated, with a relatively large number of advisers, as well as a number of different types of distribution channels. Research indicates there is little evidence that advisers compete directly with each other for clients. Instead, firms seem to rely on being recommended by other professional services. Financial advisers appear to compete on the basis of factors such as quality of service and access to products, more than price. In such an environment, platforms continue to have an important role by giving customers and advisers access to a wider range of assets.

- Developing an adviser charging proposition that will add value and strength to their brand remains an ongoing challenge for financial advisers. The sustainability of business models remains an inherent risk for the sector. Still, evidence suggests that a significant portion of financial adviser firms have now at least considered a coherent, compliant and sustainable strategic response to the RDR and other environmental challenges.

2. Key risks in the RCRO particularly relevant to the RI Sector

- **Aligning business models to the fair treatment of consumers**
  - Cross-selling (3.1.2.2)

- **Complexity in retail investment products and services**
  - Development and marketing of structured investment products (3.2.1)
  - Traded life policy investments (3.2.2)
  - Unregulated collective investment schemes (3.2.3)
  - Private banking and wealth management (3.2.4)
  - Exchange traded products (3.2.5)
  - Absolute return funds (3.2.6)

- **Firms' responses to regulatory and/or legislative change**
  - Transition to the RDR (3.3.2.1)
  - Business model change following RDR (3.3.2.2)
  - Mortgage Market Review (MMR) (3.3.4)
  - Pension Reform (3.3.5)

- **General insurance**
  - Consumers' focus on initial premium (3.4.1)
  - Products of limited value (3.4.2)
  - Add-ons (3.4.3)
  - Payment protection products (3.4.4)
- **Investment propositions**
  - Use of platforms (3.8.1)
  - Centralised investment propositions (3.8.2)
- **Investment risk profiling (3.9)**
- **Investor compensation protection (3.10)**
- **Mortgages**
  - Misuse of buy-to-let mortgages (3.11.3)
  - Mortgage product innovation (3.11.4)
- **Pension and retirement planning**
  - Self-invested personal pensions (3.12.1)
  - Enhanced transfer value – pension transfer (3.12.2)
  - Decumulation (3.12.3)
- **Projections (3.14)**
- **Systems and controls weaknesses in the network model (3.15)**

Annex 3

Top 15 Retail Conduct Risk Categories and Specific Risks

- The text in 'purple' highlights those risk categories/specific risks that are new in the RCRO 2012 i.e. were not in RCRO 2011.

- The text in 'orange' shows those risk categories/specific risks that were there in RCRO 2011 but have changed categorisation in RCRO 2012.
  - Risks 2.2 and 2.3 have changed from 'emerging risk' in RCRO 2011 to 'current issue' in RCRO 2012.
  - Risk 2.4 has changed from 'potential concern' in RCRO 2011 to 'emerging risk' in RCRO 2012.
  - Risk 9 has changed from 'emerging risk' in RCRO 2011 to 'current issue' in RCRO 2012.

- The text in 'blue' shows those risks that have been de-prioritised since RCRO 2011.

1	**Aligning business models to the fair treatment of consumers**	
	1.1	Cost-cutting and efficiency improvement initiatives in deposit takers *(potential concern)*
	1.2	Incentives
	1.2.1	Firms' reward polices and practices *(emerging risk)*
	1.2.2	Cross-selling *(potential concern)*
	1.3	Changing business models in the life insurance sector *(potential concern)*
	1.4	Use of technology in payments *(potential concern)*
	1.5	Divestments, acquisitions and new players in retail banking *(potential concern)*
2	**Complexity in retail investment products and services**	
	2.1	Development and marketing of structured investment products *(current issue)*
	2.2	Traded Life Policy Investments (TLPIs) *(current issue)*
	2.3	Unregulated Collective Investment Schemes (UCIS) *(current issue)*
	2.4	Private banking and wealth management *(emerging risk)*
	2.5	Exchange Traded Products (ETPs) *(emerging risk)*
	2.6	Absolute Return Funds (ARFs) *(potential concern)*
3	**Firms' responses to regulatory and/or legislative change**	
	3.1	Responses to the banking conduct regime *(emerging risk)*
	3.2	The Retail Distribution Review (RDR)
	3.2.1	Transition to the RDR *(emerging risk)*
	3.2.2	Business model change following RDR *(potential concern)*
	3.3	Solvency II *(potential concern)*
	3.4	Mortgage Market Review (MMR) *(potential concern)*
	3.5	Pensions reform *(potential concern)*
	3.6	Gender pricing in insurance *(potential concern)*

4	**General Insurance**	
	4.1	Consumers' focus on initial premium *(emerging risk)*
	4.2	Products of limited value *(emerging risk)*
	4.3	Add-ons *(emerging risk)*
	4.4	Payment protection products *(potential concern)*
5	**Governance of funds in life offices**	
	5.1	Communication and management of the risk profile of Life Assurance funds *(emerging risk)*
	5.2	With-profits funds operation *(emerging risk)*
6	**Host authorised corporate directors** *(current issue)*	
7	**Inadequate complaints handling**	
	7.1	Complaints handling in major banks *(current issue)*
	7.2	Payment Protection Insurance (PPI) *(current issue)*
8	**Investment propositions**	
	8.1	Use of platforms *(emerging risk)*
	8.2	Centralised investment propositions (portfolio advice services, discretionary portfolio management and Distributor Influenced Funds) *(emerging risk)*
9	**Investment risk profiling** *(current issue)*	
10	**Investor compensation protection** *(potential concern)*	
11	**Mortgages**	
	11.1	Unfair terms in mortgage contracts *(current issue)*
	11.2	Unfair treatment of mortgage customers in arrears *(current issue)*
	11.2.1	Arrears charges
	11.3	Misuse of buy-to-let mortgages *(emerging risk)*
	11.4	Mortgage product innovation *(potential concern)*
	11.5	Capital repayment of interest-only mortgages at maturity *(potential concern)*
12	**Pensions and retirement planning**	
	12.1	Self-invested personal pensions (SIPPs) *(emerging risk)*
	12.2	Enhanced transfer value – pension transfer *(emerging risk)*
	12.3	Decumulation *(potential concern)*
13	**Product bundling**	
	13.1	Packaged accounts *(potential concern)*
	13.2	Bundling of investment and deposit products *(potential concern)*
14	**Projections** *(current issue)*	
15	**Systems and controls weaknesses in the network model** *(emerging risk)*	

Risks De-prioritised since RCRO 2011

1	**Developing and marketing structured deposits**
2	**UCITS IV**
3	**Tax changes and their implications for financial products**

Annex 4

Index of figures, tables and boxes

Annex 5

Glossary

ABI	Association of British Insurers
ACD	Authorised Corporate Director
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive
AMC	Annual Management Charge
AQ	Appropriate Qualification
AR	Appointed Representative
ARF	Absolute Return Fund
AuM	Assets under Management
BCOBS	Banking Conduct of Business Sourcebook
BCR	Banking Conduct Regime
bn	billion
BoE	Bank of England
bp	basis point
BTL	Buy-to-Let
CIC	Critical Illness Cover
CIS	Collective Investment Schemes
CML	Council of Mortgage Lenders
COBS	Conduct of Business Sourcebook
CO	Compliance Officer
CP	Consultation Paper
CRD	Capital Requirements Directive
CSR	Comprehensive Spending Review
DB	Defined Benefit

DFM	Discretionary Fund Manager
DGSD	Deposit Guarantee Schemes Directive
DIF	Distributor Influenced Fund
ECJ	European Court of Justice
EIS	Enterprise Investment Scheme
ETC	Exchange Traded Commodity
ETF	Exchange Traded Fund
ETN	Exchange Traded Note
ETP	Exchange Traded Product
ETV	Enhanced Transfer Value
EU	European Union
FCA	Financial Conduct Authority
FG	Final Guidance
FOS	Financial Ombudsman Service
FPC	Financial Policy Committee
FRS	Financial Research Survey
FSA	Financial Services Authority
FSCS	Financial Services Compensation Scheme
FuM	Funds under Management
GC	Guidance Consultation
GDP	Gross Domestic Product
GI	General Insurance
HMT	Her Majesty's Treasury
ICB	Independent Commission on Banking ICB
ICOBS	Insurance Conduct of Business Sourcebook
ICSD	Investor Compensation Schemes Directive
IFA	Independent Financial Adviser

IFS	Institute of Fiscal Studies
IMA	Investment Management Association
IMD	Insurance Mediation Directive
IMF	International Monetary Fund
IP	Income Protection
ISA	Individual Savings Account
ITP	Individual Pension Transfers
KID	Key Investor Information Document
LSE	London Stock Exchange
LTI	Loan-to-income
LTV	Loan-to-value
MCOB	Mortgage Conduct of Business
MFI	Monetary Financial Institutions
MiFID	Markets in Financial Instruments Directive
MLAR	Mortgage Lenders and Administrators Return
MMR	Mortgage Market Review
m	million
NEST	National Employment Savings Trust
NS&I	National Savings and Investments
OBR	Office for Budget Responsibility
OEIC	Open Ended Investment Company
OECD	Organisation for Economic Co-operation and Development
OFT	Office of Fair Trading
ONS	Office for National Statistics
PPI	Payment Protection Insurance
PRA	Prudential Regulation Authority
PRIP	Packaged Retail Investment Product

PS	Policy Statement
PSD	Payment Services Directive
PSD	Product Sales Data
PSR	Payment Services Regulation
RCRO	Retail Conduct Risk Outlook
RDR	Retail Distribution Review
RIA	Retail Investment Adviser
RMAR	Retail Mediation Activities Return
SCARPS	Structured Capital-At-Risk Products
SIPP	Self-Invested Personal Pension
SLS	Special Liquidity Scheme
SVR	Standard Variable Rate
TCF	Treating Customers Fairly
TERs	Total Expense Ratios
TLPI	Traded Life Policy Investment
TPA	Third Party Administrator
trn	trillion
UCIS	Unregulated Collective Investment Schemes
UCITS	Undertakings for Collective Investments in Transferable Securities
VAT	Value Added Tax
VCT	Venture Capital Trus

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