Discussion Paper

DP11/1

Financial Services Authority

Product Intervention

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Financial Services Authority

Contents

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Foreword by the Chairman

This Discussion Paper is different in scope to many of the papers we publish. It proposes a quite new and more intrusive approach to the regulation of retail financial services, aiming to ensure that potential consumer detriment problems are identified and offset at an early stage. It is designed to stimulate a public debate about how the FSA and, in future, the new conduct authority, the Consumer Protection and Markets Authority, should pursue the objective of consumer protection.

In the past the FSA's regulatory approach was based on the assumption that effective consumer protection would be achieved provided sales processes were fair and product feature disclosure was transparent. But this approach has not been effective in preventing waves of severe customer detriment. We have therefore come to recognise that there are fundamental reasons why financial services markets do not always work well for consumers. In response, we are adopting a new regulatory approach, described in this DP, which involves earlier regulatory intervention, engaging with firms to ensure that new products truly do serve the needs of the customers to whom they are marketed.

The FSA has already made a significant shift towards a more interventionist approach and we describe in this DP some regulatory initiatives to which we are already committed. But we also propose for debate a range of future interventions which we could make. These cover both introducing more prescriptive requirements for the governance of product development and introducing specific product interventions, such as prohibiting the sale of specific products to specific customer segments.

The crucial issue is how far along this spectrum of earlier and more intense interventions we should progress. This debate comes at a critical time as the scope and powers of the CPMA are being discussed by the government, parliament and stakeholders. It is fundamental to shaping the regulatory philosophy of the new organisation.

Our analysis has led us to the conclusion that a significant shift in approach is required but there are important tradeoffs to be struck – between consumer protection and consumer choice, between effective regulation to prevent customer detriment and the costs that will inevitably impose.

I hope that this DP will provoke a wide ranging debate on how to strike these tradeoffs.

Adair, Lord Turner, FSA Chairman

Glossary

AMF	Autorité des Marchés Financiers
BMSA	Business model and strategy analysis
CIS	Collective investment scheme
Conduct risks	Risks arising from the way firms conduct themselves towards their customers.
Consumer detriment	Consumer loss due to breaches of our rules or the wider duty to act fairly and reasonably.
CFEB	Consumer Financial Education Body
Consumer Protection and Markets Authority (CPMA)	The government announced in its consultation on financial services regulatory reform that it will create a new body with a working title of the Consumer Protection and Markets Authority with a primary statutory responsibility to promote confidence in financial services and markets.
DP	Discussion Paper
Distribution strategy	A firm's decisions on how a product is to be sold and by whom: e.g. with or without advice; by independent financial advisers or by tied agents.
EC	European Commission
ESAs	European Supervisory Authorities
EU	European Union
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
MiFID	Markets in Financial Instruments Directive

Mortgage Market Review (MMR)	Our review that sets out the case for regulatory reform of the mortgage market, aiming to ensure a sustainable market for all participants that works better for consumers. It was launched in DP09/03 *Mortgage Market Review*.
the Ombudsman Service	Financial Ombudsman Service
OFT	Office of Fair Trading
PPI	Payment protection insurance
PRIPs	Packaged Retail Investment Products
Product	Financial contracts for retail customers – such as bank accounts, general insurance, mortgages, investments and pensions.
Product governance	Systems and controls in relation to product design, product management and distribution strategies.
Product intervention	Regulatory interventions focused on products, including greater supervisory focus earlier in the value chain and of ongoing product governance, rules targeting product features, rules limiting sales of products and setting down specific conditions of sale.
Product strategy	This covers such areas as the firm's plans to develop and distribute its existing and new products over the next few years, how the firm sees the market for its products developing and where it considers strategic opportunities will arise.
Product value chain/life cycle	The different stages in the life of the product, from design, its sale to customers and after-sale monitoring and services.
Prudential Regulation Authority (PRA)	The government announced in its consultation on financial services regulatory reform that it will transfer operational responsibility for prudential regulation from the FSA to a new subsidiary of the Bank of England. This new Prudential Regulation Authority will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks.
Responsibilities of providers and distributors for the fair treatment of customers (RPPD)	Handbook guidance on the regulatory responsibilities of providers and distributors for the fair treatment of customers.
Retail Distribution Review (RDR)	Our review, launched in 2006, of the distribution of retail investments. See our web pages for further information: http://www.fsa.gov.uk/pages/About/What/rdr/index.shtml

SCARPs	Structured capital at risk products
SIPP	Self-invested personal pension
SRB	Sale and rent back
Stress testing	Scenario modelling or other forms of analysis used to identify how the product might function under a range of market conditions and how the customer could be affected.
SYSC	The Systems and Controls module of the Handbook
Target market	The group of consumers for whom the product has been developed.
TC	The Training and Competence module of the Handbook
TCF	Treating Customers Fairly
UCIS	Unregulated collective investment schemes

1 Overview

Introduction

1.1 Since the events of the economic crisis unfolded, we have radically changed our regulatory approach. Alongside a comprehensive reform of our prudential regulatory approach, we have developed a new approach to consumer protection.

1.2 Our general philosophy has previously been to accept that most retail financial products are suitable for some consumers and so we should not intervene in their design. We saw it as our role to make rules and supervise the market at the point-of-sale to stop products reaching the wrong consumers, rather than questioning their design. So, while we have made clear that firms have responsibilities to design products appropriate to the needs of the intended target market, we have in practice focused on the point-of-sale – including financial promotions, product disclosure and selling practices – to try to prevent mis-sales.

1.3 This approach has not always achieved the right customer outcomes: in some high-profile cases, consumers have suffered significant detriment.[1] We believe a new regulatory approach is needed to avoid these large-scale episodes of consumer detriment.

1.4 Chapter 2 outlines the revised approach we have adopted and continue to develop. We will now intervene earlier in the product value chain, proactively, to anticipate consumer detriment where possible and stop it before it occurs. We are looking in more detail at how firms design products and their ongoing governance procedures to ensure that products function as intended and reach the right customers. We also want to open a debate on a range of additional interventions in areas where the potential for customer harm is greatest.

1 By 'detriment' we refer to consumer loss due to breaches of our Principles and other rules. This does not include other possible sources of loss, such as reductions in investment value where asset values fall as a result of market movements in a well-designed investment product purchased on the basis of suitable advice.

Regulatory reform

1.5 The government outlined its plan for a new regulatory framework in its consultation document, *A new approach to financial regulation: judgement, focus and stability*.[2] As part of this framework, a new conduct authority will take a tougher, more proactive and more focused approach to regulating conduct in financial services and markets, with particular focus on protecting consumers and ensuring market integrity.

1.6 The government has indicated that this new authority, which has a working title of the Consumer Protection and Markets Authority (CPMA), will build on our recent progress towards a more interventionist and pre-emptive approach to regulating conduct in financial services and markets.

1.7 To support this new approach, the government has also indicated that the CPMA will have a new suite of powers, which will enable it to be more proactive and more transparent in preventing consumer detriment. The government will describe these powers in its forthcoming consultation document and, alongside the responses to this Discussion Paper (DP), these new powers will clearly shape the authority's new regulatory philosophy.

1.8 This DP therefore comes at a critical point in the development of the regulatory philosophy of the new conduct regulator and responds to the government's call for 'a frank and open debate about achieving the appropriate balance between the regulation and supervision of firms, consumer responsibilities, consumer financial capability and the role of the state'.

Issues for discussion

1.9 As our Chairman, Adair Turner, noted at the British Bankers' Association Conference in July 2010, our new regulatory approach represents:[3]

'…a major shift in philosophy and I believe a necessary one. But also one which carries risks – the risk that we swing to the other extreme, restricting consumer choice where we do not need to, and imposing regulatory costs which are disproportionate to what we can realistically achieve. We need to strike a balance, and to get that balance right, we need to debate it openly and explicitly: with the industry, with the press, with the politicians, with society.'

1.10 This DP contributes to that debate. The key theme is how improved consumer protection should be balanced with a healthy level of choice and competition in the market. A more intrusive approach may lead to a reduction in the number of products available to consumers. But limiting consumer choice may be acceptable when the resulting benefits to

2 *A new approach to financial regulation: judgement, focus and stability*, HM Treasury, July 2010. Consultation closed on 18 October 2010 with feedback expected early in 2011.

3 Speech by Adair Turner, FSA Chairman, British Bankers' Association Conference, 13 July 2010.

the majority of consumers from not being mis-sold a product outweigh the costs to the minority who might benefit from being able to access it.

1.11 Competition and consumer choice are key aspects of an effective financial services sector. Generally, competition works in consumers' interests and leads to better products, services and outcomes for customers. Our focus in this DP, however, is on situations where undesirable practices and products have the scope to thrive because competition does not work and we consider the problems to be intractable using our conventional regulatory measures. In some circumstances, the appropriate response may be to refer the matter to the competition authorities to improve competitive forces, but in others it may be more appropriate for us to intervene in the market to influence the design and customer segment targeting of products.

1.12 We still want to see innovation, but only where it is in the interests of consumers. It is not our intention to create a 'zero failure' regime where consumer detriment is impossible – this is likely to be unattainable in practice and would require a huge increase in our resources – but we aim to reduce the frequency with which large-scale market problems occur and, if possible, to stop them from happening at all.

1.13 Possible new requirements outlined here are not proposals for new rules and guidance. This is a preliminary document setting out possible options to be considered later in more detail. This DP gives respondents the opportunity to express opinions about the direction we adopt in future. Feedback from this DP will inform our approach to developing the CPMA's regulatory philosophy.

1.14 We also anticipate that the debate stimulated by this DP will contribute to the wider debate about the overarching legislative framework that will determine the CPMA's powers. This DP is therefore the beginning of an extensive public discussion.

Scope

1.15 The discussion in this paper relates to a broad range of financial products used by retail consumers: deposits, insurance policies, investment products and mortgages. We also ask whether we should be considering similar forms of intervention in the governance of services (such as platforms and discretionary management services).

1.16 We recognise that there are significant differences among the sectors we regulate. This DP covers a broad range of issues, but the approach adopted in practice would vary to take account of market differences. For example, the Mortgage Market Review (MMR) is already considering the appropriate use of specific product interventions relevant to the mortgage market.[4]

4 See, for example, CP10/16, *Mortgage Market Review: Responsible Lending*, Consultation Paper, July 2010

1.17 We also recognise that consumers are not a homogenous group and there are varied levels of financial sophistication among them that may warrant different treatment. We draw this out in a number of places in the DP where it is particularly relevant.

1.18 We refer to 'distribution strategies' a number of times in this DP. These are the provider's decisions on how the product is to be sold and by whom. For example, providers might choose to sell products:

- with or without advice;
- by independent financial advisers, their own sales forces or other tied agents.

1.19 These decisions can have a significant impact on the consumer's experience of a product and can make the difference between good sales and mis-sales. In this DP, 'distribution strategies' generally do not refer to the distributor's actions at the point-of-sale.

Other relevant matters

1.20 The discussion in this paper has links to a number of other considerations including:

- regulatory requirements from the European Union (EU);
- equality and diversity considerations; and
- other initiatives, such as Treating Customers Fairly (TCF), our previous work on consumer responsibility and the Retail Distribution Review (RDR).

Regulatory requirements from the European Union

1.21 Retail financial services markets are subject to a number of EU directives, many of which allow products to be traded across member state borders and that may be 'maximum harmonising'.[5] These are important matters when considering our approach to product interventions. It may be, for example, that we cannot make rule changes in some markets without going beyond directive requirements or creating a possibility that products will be set up in other jurisdictions and marketed into the UK. We will, of course, take appropriate account of our EU obligations and potential implications these have for UK-based business.

1.22 It may be that some aspects of our work on product intervention are more appropriately addressed at EU level.

- We are aware that we are not the only regulator in the EU with concerns about product governance.
- The European Commission (EC) has signalled that it is considering further work in this area. The EC's consultation on the review of the Markets in Financial Instruments

5 'Maximum harmonising' directives are those under which we generally cannot impose requirements which are lesser or go beyond the directive provisions.

Directive (MiFID) has a section devoted to organisational requirements for the launch of products and services.[6] It also discusses the possibility of banning specific activities, products or practices.

- The new European Supervisory Authorities (ESAs) also have roles relating to retail product oversight that complement our current consumer protection objective and strategy. Indeed, the ESAs have specific powers to prohibit or restrict activities temporarily (including potentially in relation to particular products) that threaten the orderly functioning and integrity of financial markets or the stability of the financial system. These powers can be triggered in an emergency situation or more widely, if provided for under particular directives.

1.23 One of the outcomes from this DP may therefore be to inform our negotiating position in relevant discussions with EU bodies. We will work closely with our European colleagues as we progress with this new approach.

Equality and diversity

1.24 One of the themes of this DP is how to strike the right balance between consumer protection on the one hand and the risks of restricting consumer choice and product innovation on the other. We indicate above that we are prepared to take action to stop a product being sold where the resulting benefits to the majority of consumers from not being mis-sold a product outweigh the costs to the minority who might benefit from not being able to access it.

1.25 Where the minority is also a group with protected characteristics covered by the Equality Act 2010 (such as age, gender and disability), we will need to be mindful of this and factor it into our cost-benefit analysis.

1.26 As our supervisory approach develops, we are giving further consideration to what opportunities there are to promote equality.

> **Q1:** What issues should we consider in relation to how our product intervention approach affects equality and diversity?
>
> **Q2:** How could we use our focus on products to promote equality and diversity?

Other initiatives

1.27 Our work on TCF has already done a great deal to set out our expectations for product governance.[7] Much of the present discussion builds on that work. Firms that have fully embraced TCF will therefore find much familiar territory.

6 *Review of the Markets in Financial Instruments Directive (MiFID)*, 8 December 2010, European Commission

7 See, in particular, DP06/04, *The Responsibility of Providers and Distributors for the fair treatment of customers, Discussion Paper, September 2006, PS07/11, Responsibilities of Providers and Distributors for the fair treatment of customers: Feedback on DP06/04, Policy Statement, July 2007* and *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers, January 2008*

1.28 There is also a range of other workstreams that have a bearing on this DP. These include: the RDR; the government's work on simple products; our previous work on consumer responsibility; and the Financial Services Consumer Panel's research into 'safer' products.[8]

1.29 We have engaged with relevant groups to discuss the interactions of the projects and consider them, where pertinent, in this DP. We will continue to take them into account as our work develops.

The structure of this DP

1.30 The structure of the DP is as follows:

- Chapter 2 provides further background to the discussion, explains our new approach and our 'risk tolerance';
- Chapter 3 explains why we consider product intervention to be necessary and relevant factors in making decisions about when to intervene;
- Chapter 4 describes the intensive new supervisory approach to product governance we are now developing and undertaking;
- Chapter 5 summarises the current regulatory framework and considers how we could develop it for product governance;
- Chapter 6 describes the range of additional product interventions we may consider where risks to consumers are most significant;
- Annex 1 contains the list of DP questions;
- Annex 2 summarises the legal context: domestic law, including the Financial Services and Markets Act 2000 (FSMA) and EU law; and
- Annex 3 contains some detailed case studies of previous problems in the financial services markets.

Who should read this DP?

1.31 This paper will be of interest to the retail financial services industry, consumers, consumer organisations generally and all policy makers interested in the appropriate philosophical approach to financial services regulation. It debates issues that will have a wide impact on the market. The issues discussed are of broader interest, however, and it may also be of interest to regulators in other countries and the EC.

8 *'Safer' products, research for the Financial Services Consumer Panel* by David Severn, November 2010

Next steps

1.32 The consultation period for this DP will end on 21 April 2011. We ask a number of specific questions, but comments on any of the matters raised in the paper are welcomed. Please send your comments to dp11_01@fsa.gov.uk.

1.33 We intend to publish papers in the first half of 2011 explaining our expected approach to the transition to regulation by the CPMA. We will use responses to this DP to inform those papers.

1.34 If appropriate, we will publish Consultation Papers, which will include detailed cost-benefit analysis, over the next few years.

2

Our new approach

2.1 In this chapter we discuss our aim to 'intervene, earlier in the product chain if necessary, to anticipate consumer detriment and choke it off before it occurs'.[9] We are more willing than previously to target products when specific problems emerge, rather than focusing so much on selling practices as we have in the past. We aim to take rapid action to stop problems from growing and affecting large numbers of consumers, and to deter the creation of products likely to lead to consumer detriment.

2.2 We expect benefits to consumers, firms and the regulator:

- consumers should be more certain that they are able to purchase financial products designed in their interests and that will work in the way they expect them to;
- firms should benefit from growing confidence in the market and fewer product failures that result in reputational damage and large amounts of redress; and
- we should be able to meet our objectives of consumer protection and market confidence more efficiently.

Background

2.3 Previously, our regulatory approach focused on transactions at the point-of-sale; that is, the interaction between the consumer and the firm selling them a financial services product. We have, however, seen many episodes of significant consumer detriment in the financial services industry – for example:

- on pensions and investment products – pension mis-selling, large-scale mis-selling of endowments and, more recently, problems with split capital investment trusts and structured products;
- on general insurance – both the FSA and the competition authorities have had to take action over payment protection insurance (PPI) sales; and

9 Hector Sants, FSA Chief Executive, *FSA Business Plan 2010/11*, March 2010

- on mortgages – charging practices for customers in arrears have prompted regulatory intervention to protect consumers.

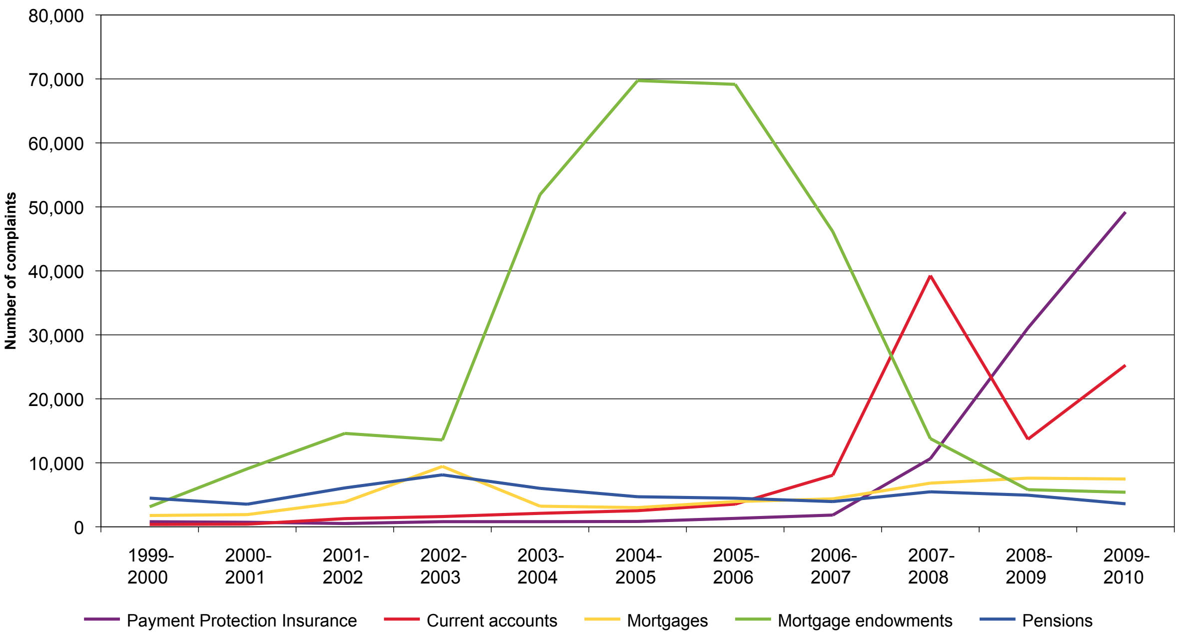
2.4 As our Chairman noted:[10]

‘looking back over the last 20 years, what we see is a series of waves of major customer detriment – products mis-sold, huge and rising numbers of complaints, and then Financial Ombudsman Service (the Ombudsman Service) and FSA intervention to require compensation against specific complaints, and then full reviews; with huge payments made in compensation – around £3bn for mortgage endowments – £11.8bn for pension mis-selling – £195m for split capital investment trusts.

And as the waves followed one after another it became increasingly obvious that there are problems in retail financial services which were not going to be solved simply by demanding fair disclosure in the sales processes – that there are deep reasons why retail financial services markets do not work smoothly and can produce adverse effects for consumers.’

2.5 Figure 1 shows how the Ombudsman Service has had to deal with these waves of customer detriment.[11] The chart shows the pattern of complaints for some products over the last ten years.

Figure 1: Sample of financial products leading to new complaints to the Ombudsman Service



10 Speech by Adair Turner, FSA Chairman, British Bankers’ Association Conference, 13 July 2010
11 Break-down of complaints received drawn from FOS annual reviews between 2000 and 2010.

2.6 A new regulatory approach was clearly needed to avoid these large-scale episodes of detriment, using a wider range of interventions than just those focused on the point-of-sale.

Our new strategy

2.7 To address this, in March 2010, we adopted a radically new approach to regulating firms' conduct with their customers – more intrusive and interventionist and acting earlier in the product life cycle to try to prevent detriment before it occurs.

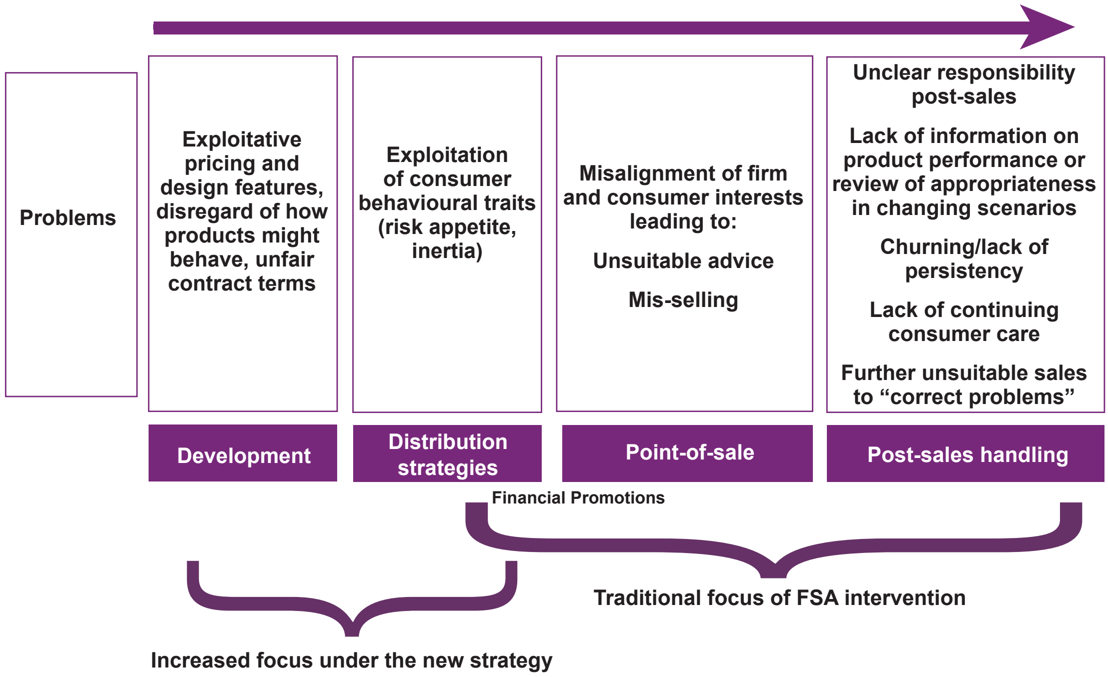
2.8 The strategy consists of the following elements:

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

2.9 This DP is focused mainly on the third of these: intervention earlier in the value chain – i.e. product intervention.

2.10 Figure 2 illustrates how our previous approach was to focus mainly on the later part of the product life cycle. Our new approach complements this by increasing consideration of the earlier parts of the life cycle.

Figure 2: Where problems can occur in the product life cycle



2.11 While high standards at the point-of-sale are essential to help consumers buy the right products for their needs (and we will continue to supervise this), firms' actions before the point-of-sale also have a significant influence. The decisions firms make about the following can have a major impact on outcomes for the customer:

- designing product features;
- making reasonable assumptions about how the product will function under various conditions and keeping this under review;
- determining how a product will be managed;
- determining a strategy for marketing and distribution; and
- ongoing product monitoring.

2.12 We have also found that in some circumstances there are problems with a regulatory strategy that relies heavily on disclosure. Our information disclosure rules are designed to equip consumers to make informed decisions about which products are suitable for their needs. This has not always worked as intended: in many cases consumers have reacted unexpectedly to information disclosures, ignored them or not valued them.[12] When buying products, patterns of consumer behaviour are open to exploitation by firms and may lead to detriment. Product features can exacerbate these problems. We explore this in further detail in Chapter 3.

12 We have done a lot of work with the industry to improve disclosure standards. We monitor financial promotions and have published guides to help firms producing product disclosure documents. See for example the *Good and poor practices in Key Features Documents, September 2007* and the *Supplementary annex to good and poor practices in Key Features Documents, April 2009*. While we have seen some improvement, we are concerned that these disclosure documents can remain an exercise in compliance rather than communication and are not always achieving our goals.

2.13 Furthermore, a supervisory focus on the point-of-sale tends to mean that problems are discovered after consumers have suffered detriment. Once problems have gained traction, they are more difficult to tackle, as more firms enter the market and increasing numbers of consumers are affected. It is also costly for firms and for the regulator to deal with problems and sort out redress after detriment has happened. Product interventions should be more efficient as, in many cases, fewer firms are involved in the earlier stages of the product life cycle than at the point-of-sale. Regulatory costs may also be lowered, as decisive action at an earlier stage should help avoid lengthy regulatory interventions.

2.14 So we now see product intervention as an essential part of effective regulation. Supported by our other initiatives at the point-of-sale (such as the RDR), our increased focus earlier in the product life cycle should lead to better consumer outcomes by ensuring the entire value chain works in the best interests of customers and reduces the amount of redress that has to be paid out.

2.15 Our new strategy signals a decisive shift in our tolerance for the amount of actual harm or detriment we are prepared to allow to happen – our 'risk tolerance'.

Risk tolerance

2.16 The issue of how much risk society (and the FSA acting on its behalf) is willing to tolerate is central to the debate in this DP about where the balance should lie between earlier intervention to protect consumers and allowing firms freedom to develop innovative products and services. There is also a practical angle: we cannot target all potential problems because we have limited resources.

2.17 The overall context within which we operate is set by FSMA. This prescribes that the FSA has a consumer protection objective, and establishes an ombudsman service and compensation scheme to provide consumers with redress where appropriate. In theory, this could be seen as implying zero tolerance of customer detriment, since all cases of perceived detriment, however small, can be subject to complaint and compensation procedures. Such a post-event complaint and compensation process will always, however, be incomplete in its effectiveness.

2.18 Within this context, therefore, the FSA judges the appropriate balance between:

- leaving customer detriment to post-event sanction and redress, involving the Ombudsman Service, the FSCS and in the event of large-scale, industry-wide detriment, FSA requirements for firms to conduct market-wide and past-business file reviews and make appropriate redress; and
- acting to ensure that potential detriment is prevented before it develops.

2.19 Our new strategy makes a shift towards the second objective – we are seeking to reduce the amount of detriment suffered. The new conduct authority will build on this. As our Chief Executive has said:[13]

13 Speech by Hector Sants, FSA Chief Executive, Reuters Newsmakers Event, 13 December 2010

'The CPMA should be judged on the degree to which it minimises the amount of consumer detriment. Society's reactions to the events of the last decade have demonstrated that the amount of consumer detriment has been at an unacceptable level. In future, the CPMA must therefore have a lower risk tolerance than that of the FSA.'

2.20 This could imply, as an extreme, that we adopt the most interventionist approach and act as a gatekeeper for all products entering the market, seeking to eradicate the risks of consumer detriment. At present we do not believe this extreme approach is justified and do not intend to propose an authorisation approach for all products. It risks stifling innovation, is resource intensive and creates the potential for misperception of a 'regulator endorsement' of products. We recognise that excessive regulation can inhibit innovation and competition, which might otherwise be to the benefit of consumers. This does, however, mean that giving firms a degree of freedom to innovate allows for the possibility that they will occasionally get things wrong and that we, the Ombudsman Service and/or the FSCS may need to intervene after consumer detriment has occurred to put things right.

2.21 Our new approach is therefore pitched between a strategy that relies on point-of-sale interventions and one that relies on product pre-approval. The minimum we expect of firms is that they have appropriate product governance processes that promote fair outcomes for consumers. Chapter 4 describes how we have increased our supervisory focus in this area.

2.22 Where we still see potential risks of significant detriment for consumers, we will take further action. There is a spectrum of additional options open to us (discussed in Chapters 5 and 6) which vary in how far they intrude into the way firms design and market products.

2.23 Selecting the right intervention will be a judgement about the most appropriate tool to tackle the problem, and selecting the proportionate approach, given the risks of over-intrusive regulation. Clearly, where we see the greatest risk to consumers, we must act.

2.24 We explore in the next chapter how we might identify situations that pose the greatest risks for consumers and how our risk tolerance applies to individual problems.

Implementing product intervention

2.25 The DP covers two broad areas that constitute 'product intervention'.

- **Existing product governance obligations** that require all firms to have appropriate systems and controls in relation to product design, product management and distribution strategies.
- **Additional product intervention** that we may consider where we identify products with features that have the potential to cause significant detriment to consumers, or where we identify products that have the potential to cause significant detriment because of firms' flawed governance and distribution strategies.

2.26 Firms will see increased supervisory and enforcement focus on their product governance processes. We expect to see general improvements in product governance across the market.

2.27 The more interventionist options include product banning or mandating certain product features. We would expect these actions to be used only in the most serious cases; we would not expect them to be used frequently. We invite views on the options discussed and when, if at all, we should use them.

2.28 If we do not intervene on a particular product, this should not be regarded as our endorsement or approval of that product. We will not be explicitly endorsing particular products and are mindful of the risks of being seen to do so implicitly.

3 The rationale for product intervention

3.1 In this chapter we discuss:

- our high-level market failure analysis, which sets out the types of problem that we should address with product intervention;
- how to judge which problems pose the most significant risks to consumers and our regulatory objectives; and
- indicators that these problems might emerge.

High-level market failure analysis

3.2 Market failure analysis is part of the process by which we determine if regulatory action is necessary. In this DP we have considered what types of problem, or market failure, would merit product intervention. In developing our approach, we have considered how product features can – deliberately or inadvertently – exploit demand-side weaknesses where there is a lack of effective competition.

3.3 While effective competition between firms and business models can benefit consumers by leading to better products, services and outcomes for them, ineffective competition can lead to consumer detriment.

3.4 Ineffective competition can arise through problems with supply. For example, where there are only a small number of providers and potential entrants are deterred from entering the market, incumbents may be able to raise prices, limit quality or restrict product availability. However, while having a number of providers in a market is a necessary condition for effective competition, on its own it will not always mean that the market provides good customer outcomes.

3.5 Indeed, we believe that ineffective competition in retail financial services markets more usually results from a number of 'demand-side weaknesses'. By this we mean that customers are not exerting pressure on firms to produce the desired quality of products or to influence prices.

3.6 We see one or more of these weaknesses in many of the retail financial services markets we regulate:

- consumers lack relevant information or do not use the information they do have to make appropriate purchases;
- consumers are obstructed from making accurate judgements about the price and quality of products;
- consumers do not realise there is a problem with a product they have bought until it is too late to do anything about it;
- where consumers make infrequent purchases they are less able to exert pressure on poor firms by taking their business elsewhere; and
- the problems above are exacerbated when distribution incentives are not aligned with those of consumers.

3.7 In brief, our experience suggests that it can be difficult for consumers to understand and compare products and their charges. In many markets – such as for long-term investment or insurance products – consumers often cannot learn from their mistakes in ways that allow them to put pressure on providers to offer good quality and good value products. In such circumstances, firms may seek to benefit from using opaque charging structures or lowering quality levels.

3.8 We have previously sought to address these problems through mandated information disclosures, requiring firms to provide standardised information to consumers to help them make informed choices about whether products are suitable for their needs. This approach includes the standardised disclosure of charges, which is designed to improve competition on price and quality by encouraging consumers to shop around.

3.9 Experience has shown that consumers do not necessarily use these mandated disclosures in the way we anticipated. The newly formed Consumer Financial Education Body (CFEB) may, over time, be able to improve the ability of consumers to make better use of information. The government has also recently published a consultation on the development of a new class of simple financial products, to help consumers compare products and understand product features more clearly. [14] However, some current product features and sales techniques are exacerbating the existing problems and can result in consumer detriment.

14 The simple financial products consultation and literature review on lessons learned from previous 'simple products' initiatives are available here.

3.10 This is not to say that consumers should bear no responsibility for their decisions. As our Chief Executive has said: 'the CPMA will not always assume that the consumer is right, or that consumers have no responsibility to look after their own interests when dealing with financial firms.'[15]

3.11 At the same time, our Chief Executive noted that the CPMA 'will pursue a more aggressive consumer protection agenda'. In the Feedback Statement to our 'Consumer responsibility' Discussion Paper, we said that consumer responsibility does not 'take away or modify the responsibility of firms to treat their customers fairly and conform to our conduct principles and rules.'[16]

3.12 Our view is that it is inherently more difficult for competition in retail financial services to be as effective as it is in other consumer sectors.[17] Certain product features and sales processes can interact with consumer behavioural traits in ways that make it difficult for consumers to protect their own interests. Therefore, the persistent nature of the issues identified above and the recurrence of problems in the market leads us to consider product interventions.

3.13 We explore each of the weaknesses identified earlier in more depth below. A product designed to exploit these and similar traits (for example, achieving profitability by loading fees onto elements that consumers ignore when making decisions) may require additional regulatory interventions to protect consumers.

Consumers lack some relevant information or do not use information they have

3.14 Effective competition in retail financial services markets relies on consumers understanding products and using information to make choices.[18] However, evidence on financial capability shows that many consumers do not understand basic financial concepts.[19] For example, only a minority of consumers understand how compound interest works, although this is central both to the performance of investment products and to the way in which debt accumulates.[20] US studies show that consumers who do not understand how the charges work on their debt products pay more in fees and charges.[21]

15 Speech by Hector Sants, FSA Chief Executive, Reuters Newsmakers Event, 13 December 2010

16 DP08/05, *Consumer responsibility*, Discussion Paper, December 2008 and FS08/05, *Consumer responsibility: Feedback on DP08/05*, Feedback Statement, September 2009.

17 The EC's Consumer Markets Scoreboard provides analysis of how well a market is working from a consumer point-of-view and identifies sectors where improvements are possible: *The Consumer Markets Scoreboard: Making markets work for consumers, 4th edition, October 2010, European Commission*. Using a number of indicators, it scores consumer opinions across 50 sectors. Lower scores indicate possible market malfunctioning in a given sector. Investments, pensions and securities have the lowest score of the sectors covered, both in the UK and the EU on average. Banking credit and banking current accounts also have low scores and transport and household insurance, while scoring better, are also in the bottom half of the survey.

18 Alternatively, consumers may choose to use an intermediary who does understand products and whose interests are aligned with theirs.

19 See, for example, *Financial Capability in the UK: Establishing a Baseline*, March 2006

20 Lusardi, Annamaria and Peter Tufano, Debt literacy, financial experiences and over-indebtedness, March 2009, the National Bureau of Economic Research, Working Paper no. 14808

21 Lusardi, Annamaria *Household saving behavior: The role of financial literacy, information and financial education programs*, February 2008, the National Bureau of Economic Research, Working Paper no. 13824

3.15 Consumers also behave in predictable ways that can work against their interests and can lead them to make poor decisions. For instance, consumers do not tend to focus on costs that will arise later in the life of a contract in the event of certain contingencies. Examples of such contingent costs are mortgage exit administration fees, mortgage arrears charges and unauthorised overdraft charges.

3.16 How the product is sold can also hamper a consumer's ability to recognise suitability. For instance, if it is sold as a secondary product or bundled with another product (for example, offset mortgages that bundle savings and mortgage products), this can lead to problems. Given consumer interests and behavioural traits, consumers may focus less on certain product features or add-on products and request less information about them than they would about standalone products. So, bundling or offering add-on products can give providers market power, which they may exercise at consumers' expense.

Consumers are obstructed from making accurate judgements about the price and quality of products

3.17 Competition may be focused on irrelevant or less relevant features, such as past performance. Where consumer attention is distracted from relevant factors, it is harder for them to gauge the quality of a product in comparison to others and so to identify more suitable products.

3.18 And, to some degree, financial products are all complex.[22] This can make it difficult for consumers to gather and understand enough information before making a purchase. Where consumers are subject to behavioural biases, complexity can also result in misleading views about a product.

3.19 So, when designing and marketing a product, providers may do so in ways that make gathering information or judging its quality more difficult. This could involve unnecessarily complex terms and conditions, or features that draw attention (like initial bonus rates) but that do not necessarily represent the overall quality of the product. Or, information on prices can be provided piece-by-piece with, for example, the cost of the product wrapper being given initially and information on the investment fund charges only provided later.[23] In such cases, decisions may be made on the basis of the initial partial information, and not revisited when add-ons are later shown.[24] Such complexity may make it more difficult for consumers to understand products before buying them, or even to know if the product is not functioning as intended after it has been bought.

22 It is important to distinguish inherent product complexity (i.e. complexity necessary to provide a particular set of benefits) and complexity that is introduced to exploit consumer behavioural biases. It is the latter that is of concern to us.

23 The Office of Fair Trading (OFT) has recently published a warning on misleading pricing practices, including drip pricing. They have urged businesses to review their use of common pricing practices to ensure they comply with fair trading laws, or risk enforcement action.

24 Huck et al *The impact of price frames on consumer decision making*, OFT, May 2010

Consumers do not know there is a problem with their product

3.20 For many financial services purchases, customers generally do not realise whether the initial offering was good or bad until some years later, by which time real damage may have been done. Indeed, they may never become aware of this damage. Though this may be unavoidable, a product could also be designed to make it more difficult for a consumer to understand its quality.

3.21 Typically, the unattractive features (such as an inability to meet investment objectives or limits to insurance cover) only become clear after a considerable time, when a claim is made or its performance is otherwise exposed.

3.22 In some cases, the consumer may never realise that the initial offering was bad in terms of price, quality or match to their particular needs. For example, the quality of an investment may never become clear, since the return typically depends on the performance of the market and it may be difficult to attribute a high or low return to the quality of the investment, even with hindsight.

Consumers are unable to discipline poor providers

3.23 If the product is purchased rarely or as a one-off, then even dissatisfied consumers are not often in a position to exert competitive pressure on providers to offer good quality and good value products by exercising choice.[25] In addition, products may be designed to hamper consumers' ability to switch (with, for example, high exit fees maintaining firms' market power after the sale).

Incentives of distributors are misaligned with those of consumers

3.24 In markets where consumers rely on the advice of intermediaries (for example, retail investment, mortgages or insurance), an adviser should act to reduce information asymmetry between the consumer and provider, enabling the consumer to purchase a more suitable product.

3.25 However, intermediaries can have incentives to withhold relevant information or use it to their own benefit and to the detriment of consumers. For example, if they are paid commission for sales and the amount varies among products, this may influence which products are sold, especially if the chance of an unsuitable sale being discovered is low.

3.26 Although it is not the focus of this DP, the incentives at the point-of-sale play a role in delivering the right products to consumers. This is why the RDR rules seek to align the incentives of investment advisers with the interests of their customers and change the way they are remunerated to reduce bias and improve consumer outcomes. Such measures are therefore an important complement to product intervention.

25 Since September 2010, we have published data on complaints received by firms. If consumers review this information before making a purchase, it may help them exert pressure on firms to do better.

Market failure and regulatory options

3.27 Even where there is clear evidence that one or more of these underlying problems is leading to persistently poor consumer outcomes in a particular market, this does not mean that some form of product intervention is the appropriate response.

3.28 In some markets, new firms entering the market and product innovation may act to eliminate problems identified within an acceptable timeframe so that no regulatory intervention is needed. In other markets, reducing underlying conflicts of interest may be necessary and sufficient to improve outcomes. Problems may also be sufficiently mitigated by well-targeted disclosure requirements relating to product features, product price or conflicts of interest, provided these requirements take careful account of how consumers behave.[26]

3.29 However, our experience shows that there will be markets where new firms coming into those markets and competitive pressure are not sufficient to deal with consumer harm, and where even well-planned disclosure will have only limited impact. These are likely to include markets where:

- firms' control of the sales process and understanding of consumer motivation allow them to work around or neutralise any disclosure prescribed to protect consumers;
- experience shows consumers will not focus on prescribed disclosure;
- consumers will typically not be able to recognise – even after purchase – that a product's design or charging structure made it the wrong product for their needs;
- consumers purchase infrequently, face material costs on switching or are otherwise unable to discipline poor providers; or
- the effect of multiple underlying problems is such that the workings of a market are firmly set in ways that cause unacceptable harm.

3.30 In any of these cases, the regulator needs to consider how far measures to influence the design and targeting of products need to be part of its response.

Targeting the most significant problems

3.31 Market failure analysis can help determine whether product intervention would be an appropriate tool to protect consumers. However, we still need to make a judgement about whether to act, given that we need to balance consumer protection with the risk of causing harm through overly-intrusive regulation. We also have a responsibility to use our resources efficiently and so we need to target the problems that matter most.

26 The potential value of such disclosure requirements, fully informed by up-to-date research into consumer behaviour, is reaffirmed in the European Commission's *First behavioural study on Consumer Decision-making in Retail Investment Services*, November 2010.

3.32 The complex and changing problems that emerge in financial services do not lend themselves to mechanistic models or fixed decision-making parameters for assessing their significance. For example, the impact of the same monetary loss is different for different consumers and market conditions may affect the scale of detriment suffered. Targeting the most significant problems requires both quantitative and qualitative analysis applied to constantly evolving problems.

3.33 The scale of the problem in terms of numbers affected and the amount of loss is clearly a central consideration. However, large levels of detriment can be caused in different ways. It can come from large numbers of customers each incurring a small loss (for example, where firms fail to refund customers immediately in the event of unauthorised payments from their bank accounts) or smaller numbers of customers, each incurring a larger loss.

3.34 A key variable is the sector in which problems occur. Detriment arising from asset management products tend to involve fewer customers but more loss per customer than, for example, retail banking products.

3.35 The judgement about the significance of a problem is also dependent on the nature of the problem itself, primarily:

- whether an individual's core financial interests are affected (such as their pension, savings, home ownership, protection of income or assets);
- whether the detriment is or could be focused on, or particularly damaging to, consumers facing financial hardship; and
- whether the impact is likely to be long-lasting or unable to be rectified.

3.36 Our intention is to intervene more often before detriment happens, so these judgements will need to be made on the basis of our assessment of how problems will evolve, if left unchecked. We consider below some practical indicators that may help us to identify problem products at an earlier stage.

Indicators of problems with products

3.37 From our market failure analysis and observations of past episodes of mass consumer detriment, we have identified some typical indicators of problematic product features (see Figure 3).

3.38 This is not a complete list that we will check against when considering whether to take action in relation to a product; rather it contains suggestions of indicators that may help us build a picture of whether a product could cause detriment and help inform whether we need to take action. We welcome views on these indicators and whether there are others that could be added.

3.39 Products may come to our attention that do not have any of the indicators set out below. This does not mean we will not take action if we still have concerns and our analysis shows regulatory intervention is necessary.

Figure 3: indicators of problematic product features

General
• Complex products, including bundled products or those with opaque structures. • The decision to buy is secondary or tertiary following another purchase. • The product cross-subsidises other products. • The product carries an inherent conflict of interest that is potentially damaging to consumers. • The product's inability to meet customer needs would not be apparent until a considerable time in the future. • Products with secondary charges (e.g. charges contingent on events throughout the life of the product). • Layers of charging due to multiple products or services included in the package. • Products where the customer is attracted by a teaser rate and then tied in. • Exit charges or other features which act as a material barrier to exiting. • Bundled products with a limited overlap of the target markets for each of the products. • Products aimed at consumers facing financial hardship. • Product features outside the core range (e.g. 'bells and whistles' or 'gimmicks' of little use to most customers or at significantly higher margin).
Insurance
• Factors affecting eligibility to claim risk undermining the utility of the product or exclude large groups of customers. • Circumstances in which the provider can withdraw cover risk undermining the utility of the product. • Limited risk transfer to the insurer. • Complex claims notification procedures that will deter claimants.
Investments
• Use of non-standard assets for investment purposes. • Use of product names that imply greater levels of safety/return than are actually possible. • Charges that do not appear to reflect the level of service provided e.g. a passive collective investment scheme with a high annual charge. • Performance risks that are difficult to assess or are not properly understood by the provider or distributor.
Mortgages
• Product structures that encourage irresponsible lending/borrowing. • Products designed to be repaid solely through property appreciation.

3.40 We see these indicators as warnings that a product might be detrimental (usually when several of them are combined and there is a cumulative effect) if firms have not taken sufficient steps to mitigate the problems. For example, where the decision to buy an insurance product is secondary, the consumer is less likely to make an informed decision about the value of the product and may not properly take into account the list of exclusions.

3.41 The indicators need to be viewed in the context of the particular product being scrutinised and do not necessarily mean that it is flawed – for example:

- Product complexity may be a necessary feature to obtain benefits for the customer (such as the range of illnesses covered by critical illness policies). Or the complexity may be an unnecessary complication, providing limited benefits that the consumer could have obtained elsewhere with a simpler, cheaper strategy.

- Secondary charges may be necessary and may be useful features of many products. However, there is scope for unfairness to arise from the manner in which charges are made.
- Similarly, if secondary sales or features are not targeted at meeting the genuine needs of the customers purchasing the main product, they may lead to detriment.
- While cross-subsidy is an integral part of business strategies in most markets, the design of a financial product as part of a strategy of extracting as much profit as possible from a particular group of consumers is clearly a matter for regulatory concern.

3.42 Judgements will need to be made about whether the indicators are a cause for concern on a case-by-case basis.

3.43 In some cases, products may be inherently bad for most retail consumers and we will take action. More commonly, however, we expect to see products with some of the indicators, but that might still be suitable for some consumers. Where this is the case, we expect firms to take additional steps in their product governance to mitigate the potential risks created by including these features.

3.44 Risks may be mitigated by appropriate distribution strategies, for example, which play an important role in determining whether products will cause detriment in practice. A complex investment product intended for sophisticated investors as part of a balanced portfolio may be useful for some consumers, but it has the capacity to become a toxic product if it is sold without discrimination to less sophisticated customers who are led to take on more risk than they expected. Where a product is not suitable for a broad range of customers, firms should demonstrate that they have a credible strategy for targeting the right market by selecting appropriate distribution channels and taking other mitigating actions. This is not about providers checking suitability for individual sales, but taking steps to ensure that their distribution strategies broadly target the right audience.

3.45 Where we see firms failing to mitigate risks through their product governance processes, they should expect us to consider additional product intervention. If necessary, we will take action to stop detriment from spreading by using the range of product interventions described in this paper.

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

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

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

4
The emerging supervisory approach

4.1 In this chapter we describe changes to our supervisory process and how firms can expect our scrutiny to be more intensive and intrusive.

4.2 Whilst previously our supervisory actions have tended to focus on the point-of-sale, we have a range of powers and interventions available to us in relation to firms' product governance. We are now beginning to use these through our new supervisory strategy for scrutinising products. Although this approach is still in development (and we will continue to strengthen and refine it), our interventions have already prevented customer detriment occurring in many instances.

4.3 We describe below some of the tools and methodologies that form part of our assessment approach. These include some 'macro' tools, which we use to assess risks to consumers from firms' conduct (conduct risks) generally, and which we are further enhancing to support our focus on product design. We also have specific tools developed for our new intensive and intrusive supervisory approach.

4.4 These in-depth risk assessments are being implemented for the very largest, high-impact firms. We are also using these methodologies with individual relationship-managed firms as appropriate.[27] We describe how we will approach the supervision of product governance for smaller firms later in this chapter.

Early identification of conduct risks

4.5 We use a wide range of intelligence to identify emerging risks in firms. For example:

- market-wide and sectoral data and analyses;

27 Firms that can have a significant impact on the market and so pose a risk to our objectives are supervised with regular assessments by a relationship manager. The precise volume and type of work we undertake will depend on the firm's size and the risks it poses. See 'How we supervise firms' on our website for more detail.

- retail conduct risk outlook analysis;
- independent product research providers;
- product marketing events;
- FSA data e.g. Product Sales Data, complaints statistics and information from our customer contact centre;
- whistleblower information and alerts from third parties such as other firms, the Ombudsman Service or consumer groups;
- financial promotions;
- press comment; and
- firm-specific intelligence (including our business model and strategy analysis and product governance assessments, which are described later).

Example 1: early identification of product risks
Our monitoring work identified the imminent launch of a new inflation-linked structured deposit by a building society. We reviewed the promotional literature for the product and determined that the predicted returns were based on an inappropriate measure and gave an unrealistic impression of the likely returns achievable. We also identified a number of other issues that rendered the financial promotions unfair, unclear and misleading. The firm was required to withdraw its promotional website and amend its product literature immediately. As a result of our intervention, all the promotional literature was compliant before the product was actually launched. We can, and will, take prompt action where products are misrepresented and, through our wider work, will challenge firms where we consider products are not fit for purpose and unable to deliver their intended outcomes.

Retail conduct risk outlook analysis

4.6 This is our assessment of the environmental drivers of conduct risks which we use to identify risks that may emerge across the whole financial services market. This analysis includes consideration of macroeconomic conditions relevant to conduct risks, sectoral trends, known and expected regulatory developments and consumer characteristics and behaviours. We aim to identify possible responses from firms to these drivers and areas where conduct risks, including those related to products, may emerge in the future.

4.7 We use a variety of sources of information to support this analysis, both internal (e.g. FSA analysis of key trends in different sectors, thematic reviews, macroeconomic trends) and external (e.g. industry research produced by independent analysts).

4.8 This in-depth analysis informed the conduct elements of our 2010 Financial Risk Outlook, which highlighted some of the potential conduct issues on the horizon.[28] We plan to follow this up with an even more focused publication – the Retail Conduct Risk Outlook – emphasising the importance that we place on conduct issues.

Business model and strategy analysis

4.9 Business model and strategy analysis (BMSA) is our detailed assessment of the conduct risks posed by an individual firm's business model. Using the wider market or sectoral context set by the retail conduct risk outlook analysis, the BMSA assesses if, or how, the identified risks manifest themselves in a particular firm, as well as seeking to highlight any risks specific to that firm.

4.10 This is a very detailed analysis of a firm's business model and strategy, considering the markets in which it operates and viewed in the context of its peer firms. We assess the vulnerabilities of, and the threats to, a firm's business model such that they could give rise to conduct risks. Should any new risks be identified, these are used to inform subsequent versions of the retail conduct risk outlook analysis.

4.11 Our BMSA analysis draws on a wide range of data, both internal and external. For example, we may consider:

- information obtained from the firm about current and planned product or strategic developments;
- accounts, financial analyses and other financial data;
- profitability of individual product lines;
- strategic and marketing plans or business plans for potential investments or acquisitions;
- market studies and external analysts' reports; and
- analysis from our sector teams, including peer group assessments, and reviews of Product Sales Data.

4.12 We use this data to judge the coherence, feasibility and reasonableness of the firm's strategy and consider the impact that relevant factors (e.g. competitor activity) will have on that strategy. We then assess how customers may suffer detriment as a result.

4.13 Our aim is to produce a critical analysis of both the firm's current and future strategies and how this will affect customers. We identify the key conduct risks and prioritise these using

28 *FSA Financial Risk Outlook 2010*

our ARROW supervisory model.[29] This intensive scrutiny will identify areas of risk where we can effectively focus further supervisory work.

4.14 Obviously, detailed analysis such as the BMSA is only appropriate for the very largest firms that pose the greatest risk to our consumer protection objective. However, similar forms of analysis can be used for other firms.

Example 2: Business model and strategy analysis identification of issues
BMSAs have already identified potential conduct risks specifically related to product governance (including distribution strategies). These include: • a provider firm that, in an attempt to reduce its costs, sought to limit the number of customers taking advantage of guaranteed benefits within their pension policies. Firms must not put in place barriers that prevent or inhibit customers' ability to claim benefits they are entitled to; • a lender, seeking an improved return on equity, setting higher than reasonable targets in impaired credit mortgage sectors. This could lead to customers who may have been eligible for mainstream 'prime' mortgages taking out more expensive products unnecessarily; • particularly high commissions paid by a provider to a connected distributor, which could lead to provider bias; and • a sharp rise in critical illness sales from a particular firm. This prompted us to look into the standard of sales at the firm, which confirmed poor outcomes were occurring. The firm was required to take remedial action. This issue also led us to investigate peer firms where we found similar problems occurring. All of these issues have been, or continue to be, the subject of supervisory scrutiny.

Our intensive supervisory approach

4.15 We are increasingly carrying out in-depth testing of firms' product governance processes. As part of the development of this intensive supervisory strategy, we have specifically recruited staff with experience and expertise in product design. As we move further into this area, we will continue to focus on recruitment and training to ensure we have the necessary skills to supervise firms effectively.

4.16 Under our new approach, the largest provider firms can expect a very intensive and intrusive assessment of their governance processes and the products that these deliver. We discuss later how we apply similar concepts to other types of firm.

4.17 When deciding which particular products to review we assess the inherent risk posed to customers. We consider a range of factors including:

- clarity of product structure;
- product complexity, including the bundling of different types of products;
- limitations to access or the ability to switch products, including tie-ins;
- layers of charges; and
- inherent conflicts of interest.

29 The Advanced Risk Response Operating Framework (ARROW) is the framework used by the FSA to allocate supervisory resources in a risk-based manner.

4.18 There is more information about indicators of problematic product features in Chapter 3.

4.19 Our assessment approach includes:

- reviews of the firm's policies and procedures relating to product development, and their effectiveness;
- consideration of whether they have properly adhered to these policies and procedures;
- interviews with staff at all levels, including board members and product-development staff;
- reviews of relevant audit and compliance reports;
- analysis of terms of reference, minutes and other documentation relating to boards and committees involved in product governance;
- reviews of senior management objectives and personal development plans;
- consideration of distribution agreements and remuneration arrangements; and
- a review of the adequacy of consumer research and testing.

4.20 The following provides more detail of the approach we adopt.

Product oversight

4.21 We assess whether firms ensure that the fair treatment of customers is built into their oversight arrangements. What we look for includes:

- a board engaged in ensuring products deliver the right outcomes for consumers;
- clearly allocated responsibilities for oversight of product governance; and
- the effective inclusion of control functions such as Compliance in oversight arrangements.

Example 3: our expectations for product oversight standards
We have seen instances where treating customers fairly is not embedded in product design and control functions such as Compliance do not provide sufficient, substantive challenge to ensure fair customer outcomes, i.e. their approvals are a 'rubber-stamping' exercise. In one example, we required the firm to include explicit consideration of TCF issues in key individuals' personal development plans and the terms of reference of committees which approve products.

Product strategy

4.22 We consider how firms set their product strategy[30] and whether they include adequate challenge of it, including:

- controls in place to ensure that customers' needs are reflected in setting and implementing the product strategy; and
- evidence that these controls have led to improvements from a customer perspective.

30 'Product strategy' covers such areas as the firm's plans to develop and distribute its existing and new products over the next few years, how the firm sees the market for its products developing and where it considers strategic opportunities will arise.

Example 4: the role of product strategy in securing good customer outcomes
Through BMSA we identified an instance where a firm's strategic decision to increase cross-selling of its investment products potentially put pressure on its independent advice division to recommend its own products. Subsequent assessment demonstrated that the firm had appropriate controls in place to manage this risk.

Target market

4.23 We will consider how the firm has defined its target market, how it tests that this is the right approach and the surrounding governance procedures.[31] What we look for includes:

- policies and procedures that support the design of products appropriate to a specified target market;
- a design process that leads to an appropriate matching of products to the needs of the target market;
- clear consideration of what customer usage or needs the product would not fulfil;
- a target market that is plausible in terms of size or shape; and
- products designed to meet customer needs, not simply to copy a competitor's product, for example.

Example 5: intervention in product governance – bundling of investments and deposits
There is an increasing trend for banks to 'bundle' deposits with investment products – offering a higher rate of interest on the deposit than would be obtainable if the deposit was standalone. There is a risk that some customers, who would not normally purchase investment products, are influenced into doing so – even though investments are not suitable for them – simply to obtain the higher deposit interest rate. There is potentially a disparity between the target markets for these types of products. When investigating a firm's product design processes, we found that they were not identifying or establishing appropriate controls to mitigate the aggregate risks posed by the combined bundled offering and the limited overlap of the different target markets. They were only considering the risks relating to each individual product in isolation. Firms selling these bundled arrangements need to ensure they have adequate controls in place to mitigate the additional risk of unsuitable investment advice which exists with these product combinations. We required the firm to reassess the customer risks of its current product range and, going forward, to improve the way that it assesses and manages the risks of all products, including bundled product offerings.

Distribution strategy

4.24 We ask firms to provide evidence that the fair treatment of customers is built into the development and oversight of the distribution strategy. In vertically-integrated groups and situations where multiple providers are involved, we will consider how the individual firms define and meet their differing regulatory obligations (see also the section below on 'chains of providers').

31 For more discussion on this see DP06/04, *The Responsibility of Providers and Distributors for the fair treatment of customers*, Discussion Paper, September 2006 and *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers*, January 2008

4.25 What we look for includes:

- controls in place that ensure the distribution channels and strategy are compatible with the needs of the target market;
- details of the target market, product features and risks being accurately conveyed to distributors;
- interactions and communications with distributors that are likely to lead to fair customer outcomes; and
- the firm taking action to address any mismatches between the actual distribution/sales and the intended target market.

Example 6: our expectations for distribution strategy standards
We recently censured a firm publicly for failing to ensure that distributors were given balanced information about the risks of geared traded endowment policies.[32]

Incentives

4.26 Our requirements under the remuneration code make clear that firms need to include measures to avoid conflicts of interest in their remuneration policies. An example of a conflict that might arise is where incentives are put in place to encourage the promotion of one product over another, against the best interests of the firm's clients.

4.27 We are also carrying out specific thematic work investigating remuneration and other incentive practices for in-house sales staff. These reviews include considering:

- how sales staff are incentivised;
- whether the incentives increase the risk of mis-selling; and
- whether those risks are adequately controlled.

Risks and stress testing

4.28 We consider the depth and breadth of risk assessment and stress testing undertaken, looking for, among other things:

- clear identification and management of the risks to the customer;
- robust stress and scenario testing to ensure the delivery of fair customer outcomes; and
- evidence that subsequent changes to product features actually mitigate the risks to the customer.

4.29 By 'stress testing' we are referring to scenario modelling or other forms of analysis used to identify how the product might function under a range of market conditions and how the

32 Press notice of public censure, 12 May 2010

customer could be affected. In the consumer protection context, we are considering the stress testing of a product from the consumer's point-of-view, rather than stress and scenario testing for prudential purposes, to manage risks to the firm. Stress testing is particularly important, for example, where a product has expected, but not guaranteed, pay-outs.

Price and value

4.30 We look for warning signals that indicate a product may not offer reasonable value for money for customers, including whether:

- product design is driven by features that benefit the customer and not by a business model that is dependent on poor customer outcomes;
- product costs are compatible with the objectives of the product; and
- conflicts of interest have been avoided or managed effectively.

Example 7: intervention over price and value
We have required a vertically-integrated firm to review past sales where it inappropriately recommended expensive investment funds managed by its parent organisation when cheaper suitable funds were available.

Execution and review

4.31 We also expect firms to ensure that their products continue to work well for their customers. We consider the quality of their regular reviews, the use they make of customer feedback and the ongoing active management of the product.

4.32 What we look for includes:

- no outstanding risks to customers resulting from flawed implementation;
- appropriate mechanisms in place to ensure that lessons learned (e.g. from complaints) are fed back into the product development process;
- evidence that post-sale analysis is used to make changes that have improved customer outcomes in existing or new products; and
- appropriate action is taking place if the product is no longer behaving as expected (for instance because of changes to wider market conditions or legislative changes). It may be, for example, that the firm should stop selling the product to new customers on the same basis, contact existing customers to explain the problem and suggest ways in which they could deal with it.

Example 8: intervention over a firm's review mechanisms
A firm, in which management information on complaints was insufficiently detailed to identify complaints about specific products, was required to improve the quality of this information.

Our supervisory approach for smaller firms

4.33 The assessment methodology developed for the largest firms can also be used for other firms but clearly needs to be adapted appropriately. We consider that our general approach is scalable and can be tailored to suit varying types and sizes of firm and business model.

4.34 For example, we used a thematic approach to assess the quality of small operators of a certain type of personal pension scheme, Self-Invested Personal Pensions (SIPP).[33] This review included a number of product governance-related elements including:

- managing conflicts of interest;
- the adequacy of systems and controls relating to customer administration;
- disclosure of fees, charges and levies; and
- accuracy of projections.

4.35 Our recent work on Unregulated Collective Investment Schemes (UCIS) included an assessment of whether small firms were complying with the statutory restrictions on the promotion of UCIS to the general public.[34] As a result of this work, 11 firms were required to appoint a skilled person under Section 166 of FSMA to review their UCIS promotions. These firms were also asked to cease the promotion of UCIS until this review and any associated remedial action had been carried out.

Example 9: assessing product governance – fund management, target market and stress testing in a medium-sized firm
Our analysis identified that the target market of a particular fund had not been adequately assessed. The fund was made available on retail platforms despite not being assessed as suitable for a retail customer base and only having been officially released to institutional investors. In addition, when stress testing the fund, the back testing was only modelled over a relatively short period of time. We required the firm to carry out a two-year review to determine whether the fund had met the requirements of those customers who may have been inappropriately targeted. We also required the firm to review its procedures regarding stress testing.

4.36 In addition to challenging authorised firms through our intensive supervisory approach, we will also scrutinise the product offerings of potential new entrants to the market.

Example 10: toxic products – refusing an applicant's permission to carry out regulated activity (Part IV permission)[35]
We recently refused to grant Part IV permission to a firm because we considered that their core product was fundamentally unsuitable for consumers, demonstrating a combination of 'toxic' product features that have led to poor customer outcomes in the past.

33 *Self-Invested Personal Pensions (SIPP) operators, A report on the findings of a thematic review*, September 2009
34 *Unregulated Collective Invested Schemes: Project findings*, July 2010
35 Firms are required to apply for permission to carry on regulated activities under Part IV of FSMA

Chains of providers

4.37 It is worth noting here how we see the situation where several providers are involved in providing a single financial solution. In these cases, it is likely that the customer will consider this to be a single product, but firms involved in different activities will have different responsibilities.

4.38 For example, it is possible for a customer to have a SIPP in which they hold shares in an open-ended investment company via a fund supermarket. We would expect the overall structure to work in a way that promotes fairness to the customer. But providers in different parts of the chain will not necessarily be aware of all other elements, so our approach needs to impose only reasonable duties on firms, given their role in creating the final product as experienced by the customer.

4.39 In particular, it may be that the firm at the highest level – the SIPP provider in the example – should take more responsibility for the overall structure than firms lower in the chain. This is not to say, however, that other firms involved in this structure do not have any responsibilities of their own.[36] This is consistent with the approach set out in our work on the *Responsibilities of Providers and Distributors for the Fair Treatment of Customers Guide* (RPPD).[37]

4.40 Where a customer is receiving advice, the distributor also has a very important role: they must assess the suitability of the overall recommendation. While providers must design products that work as expected and deliver good outcomes for customers, advisers have the responsibility to ensure that the recommendation – whether of an individual product or a combination of products – is suitable for the individual customer.

The impact on firms

4.41 Firms will feel the effect of our new intensive approach in that they:

- will be subject to better informed and more insightful, critical challenge regarding their product offerings;
- may be required to amend their product designs or even cease distribution of a particular product; and
- will be held to account for failures in this area.

4.42 We are determined to ensure that customers are at the heart of firms' product governance processes. Where they are found to be failing in this respect, we will use our full range of supervisory and enforcement tools to ensure that changes are made.

36 As outlined in *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*, manufacturers of wholesale components (like derivatives) which may be wrapped into retail products will not necessarily have to consider all of these impacts. We would expect the duty to retail customers to fall on the firm that creates the retail product.

37 See, for example, DP06/04, *The Responsibility of Providers and Distributors for the fair treatment of customers*, Discussion Paper, September 2006, the additional chapter to DP07/02, *The responsibilities of providers, distributors and platform providers for the fair treatment of customers where a platform is used in the supply of a product*, Discussion Paper, September 2007 and *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers*, January 2008

4.43 However, there should also be benefits to firms. Where consumers are more confident that the products being sold in the market will contain no unpleasant surprises and will meet their expectations, they are more likely to purchase those products. Firms benefit from consumers having confidence that they will not be sold products that do not behave as expected. There may also be benefits to firms in that the risks of being liable for redress payments will be reduced if there are fewer instances of product failures.

Supervisory and enforcement tools

4.44 In situations where we fear that continued pursuit of a course of action by a firm will lead to customer detriment, we may need to take stronger action. There are numerous ways that we may intervene, for example:

- We can ask firms to provide undertakings under the Unfair Terms in Consumer Contracts Regulations 1999 concerning the use of contract terms we consider to be unfair. This is a direct method by which we can intervene in product terms and conditions.
- We have the power under section 45 of FSMA to vary or cancel an authorised firm's permission to carry out regulated activity (Part IV permission) or to impose restrictions to meet any of our statutory objectives. This power can, among other things, be used to prevent a firm from selling a particular product or to impose conditions on how a firm sells or promotes a particular product.
- Where an authorised firm breaches our rules, we have the power to take disciplinary action and to impose a penalty. The imposition of penalties is an important part of our credible deterrence strategy, particularly where previous FSA regulatory action has failed to improve industry standards.
- Our new penalty regime, which applies to misconduct on or after 6 March 2010, allows us to increase a penalty where earlier action has failed to improve industry standards.[38] This will include instances where previous enforcement action may have related to a different product but the breaches are similar.

4.45 As part of our emerging supervisory strategy, we anticipate making increased use of tools such as these to develop our agenda and encourage market change. Although we go on to consider other options such as introducing new rules and guidance, these actions will remain open to us in future. We also note that the government has indicated that, where appropriate, it will enhance such supervisory and enforcement tools in the transition to the new regulatory regime to ensure that the new authority can deliver its role as a credible conduct regulator.

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

38 See PS10/04, *Enforcement financial penalties*, Policy Statement, March 2010 for more information.

5

Possible development of the regulatory framework

5.1 Much of the existing regulatory framework was implemented before our increased focus earlier in the product life cycle. We already have rules and guidance on product governance and we are now supervising and enforcing the rules more intensively, but they tend not to be prescriptive.

5.2 In this chapter, we describe the current regulatory framework for product governance and then go on to consider the possibility of adding greater prescription to our requirements.

The current regulatory framework

5.3 Our existing rules and guidance relating to product governance tend to be high level. Consistent with our earlier regulatory philosophy, the aim has been to set the standards we expect from firms without prescribing specific actions.

5.4 Our Principles for Businesses are the starting point. The most relevant Principles to product governance are:

- Principle 1: a firm must conduct its business with integrity;
- Principle 2: a firm must conduct its business with due skill, care and diligence;
- Principle 3: a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems;
- Principle 6: a firm must pay due regard to the interests of its customers and treat them fairly;
- Principle 7: a firm must pay due regard to the information needs of its customers, and communicate information to them in a way which is clear, fair and not misleading; and

- Principle 8: a firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

5.5 In addition, the Senior Management Arrangements, Systems and Controls module of the Handbook (SYSC) requires firms to establish, implement and maintain adequate systems and controls to comply with the regulatory system.[39] These systems and controls must be comprehensive and proportionate to the nature, scale and complexity of the firm's activities.

5.6 For all investment firms, including those involved in product governance, there is an additional, high-level conduct of business requirement that they must act honestly, fairly and professionally in accordance with the best interests of their clients.[40]

5.7 To help firms interpret these Principles and high-level rules, we have published some guidance, developed as part of our TCF initiative: *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers Guide* (RPPD).[41]

5.8 The RPPD discusses what is expected of firms to treat customers fairly. It sets out the actions that firms should consider in various stages of the product life cycle or provision of a service to comply with the relevant Principles and rules on systems and controls. It addresses, among other issues, product design, information provision from providers to distributors and customers, selecting distribution channels and the post-sale responsibility of providers.

5.9 In addition to the general framework, in response to particular problems in markets or to implement EU directives, there are more prescriptive rules that apply to the creation and sale of specific products. These include requirements that:

- To be sold to the general public, UK-based collective investment schemes need to be authorised by the FSA and comply with prescriptive product rules.[42]
- Customers entering into sale and rent back (SRB) schemes have security of tenure for a minimum of five years.[43] SRB is a facility where individuals, often those in financial difficulty, sell their homes, typically at a discount, in return for the right to remain as a tenant for a set period. Previously, SRB agreements typically provided only six to 12 months security of tenure.
- Charges on all types of mortgage and other types of home finance products (such as SRB) do not impose and cannot be used to impose excessive charges.[44]

39 SYSC 6.1.1R. An alternative but broadly similar test applies to certain types of firms under SYSC 3.
40 COBS 2.1.1R(1)
41 *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*
42 Under section 238 of FSMA, collective investment schemes cannot be promoted in the UK unless they meet certain conditions: they must be recognised schemes or authorised by the FSA. Our collective investment schemes sourcebook (COLL) sets requirements for UK-based schemes.
43 MCOB 2.6A.5B R(1)(b)
44 MCOB 12.5.1R

- Insurance policy charges in the event that a product is cancelled within the minimum required cancellation period must be proportionate to the service already provided and must not be a penalty.[45]
- Firms recommending non-stakeholder personal pensions must explain in writing why they consider the recommended policy to be at least as suitable as a stakeholder pension.[46]

5.10 Annex 2 contains further discussion of the wider legal framework.

Possible development of the regulatory framework

5.11 We are minded to introduce greater prescription in the current regulatory framework to help improve customer outcomes and strengthen our ability to hold firms to account for product governance failings.

5.12 The case studies included in Annex 3 help to demonstrate why we think that additional rules may be necessary.

5.13 With structured capital at risk products (SCARPs), for example, we followed the previous regulatory strategy of focusing on point-of-sale measures and sought to improve customer disclosures. These measures and the existing regulatory framework on product governance failed to prevent significant consumer detriment. We therefore question whether the current framework is, on its own, sufficient to deliver good customer outcomes and whether we need more prescriptive rules.

5.14 As we made clear when adopting a more principles-based approach to regulation, we are willing to create more detailed rules where they are the only practicable way to achieve a given regulatory outcome. The waves of consumer detriment seen in relation to specific products, even after we take action to improve selling practices, lead us to ask what more we can do to protect consumers and whether product governance is an area requiring more detailed rules.

5.15 While we have already achieved a great deal under our new supervisory approach, our early experience suggests that we could do more to protect consumers if the rules were more prescriptive.

45 ICOBS 7.2.2R
46 COBS 19.2.2R

5.16 We consider there may be scope for introducing this prescription by consulting on turning some of the current RPPD guidance into rules and adding to them if appropriate.[47] In addition, bringing together the existing rules and guidance into a single section of the Handbook would give firms a single reference point for our product governance requirements and guidance.

5.17 For example, greater prescription could be provided by rules applying to providers that include:

- further high-level rules requiring:
  - identification and appropriate mitigation of inherent risks to customers from the product; and
  - sound governance and management processes for the purpose of controlling product design and provider distribution strategies to promote fair outcomes for consumers;
- more detailed requirements covering a range of issues touching on each stage of the product life cycle, such as:
  - product stress testing to ensure that likely risks are fully understood and assessed from a customer's point-of-view, enabling the product to be better targeted at relevant market segments and better designed to mitigate risks to the customer;
  - analysis of the proposed charging structure to ensure that charges are reasonable;
  - design of distribution strategies to guard against likely mis-sales (so, for example, providers could consider whether more complicated products should only be sold with advice);
  - measures designed to increase the quality of disclosure documents and communications directed to distributors, e.g. to analyse distributors' information requirements and ensure the communications are sufficient and accurate;
  - ongoing requirements that provider firms must gather information to ensure that products are reaching the target market and consider what to do if they are being sold more widely than expected;
  - ongoing requirements to consider if the product's risk profile has changed, because of external factors such as market conditions or changes to legislation, for example, or because the firm has made changes to the product's features over time, and to consider what to do if this has happened; and

47 We note that the Association of British Insurers and the Association of Independent Financial Advisers prepared a joint document on the responsibilities for providers and distributors at each stage of the customer life cycle, including a section on developing products that includes some of the ideas discussed here: *Working Together to Deliver Good Customer Experiences, Responsibilities of Providers and Distributors*. Customer Impact – an industry group that aims to improve consumer outcomes – has also produced a guide for providers on *Product Design and Delivery*. We could consider whether there are any aspects of these that we could learn from in adding greater prescription and detail to our rules to raise standards across the market.

- requiring staff responsible for signing-off products to have appropriate qualifications.

5.18 Were we to introduce any such rules, we would expect them to apply in a risk-based manner, proportionate to the risks involved in the product.

> **Q7:** Should we give further consideration to new rules to prescribe conduct by firms when designing and managing products?
>
> **Q8:** If so, what should be covered?
>
> **Q9:** What would the impact be on the market?

Sectoral considerations

5.19 Although we consider that a set of product governance rules should have a broad, cross-sectoral applicability, we recognise that there are sectoral differences that may require a specific approach.

5.20 In particular, the collective investment scheme (CIS) sector has widespread use of distribution channels not controlled by the CIS manager. This sector is also one that is largely controlled by EU directives.

5.21 We will take appropriate account of our EU obligations and other relevant factors if we develop any proposals.

Services

5.22 Often financial solutions are presented to retail customers in the form of products (such as deposits, investments, pensions, general insurance contracts or mortgages). Our current rules often tend, therefore, to set requirements for the sale of different products.

5.23 Innovation in the market is, however, beginning to lead to changes. We see increased use of services (such as platforms and discretionary management services). So, while this paper discusses 'product intervention' we are also asking whether we should be considering a similar approach more widely and whether we should consider intervening in the governance of services too.

> **Q10:** What would the implications be if we consider similar interventions for services as those discussed in this paper for products?

6 Additional product intervention options

6.1 Chapters 4 and 5 have set out how our existing framework and, potentially, more prescriptive rules should raise standards across the board.

6.2 However, this may not provide a complete solution. As we described in Chapters 2 and 3, there are deep underlying reasons why retail financial services markets do not always work well for consumers and waves of consumer detriment have occurred. As a result, the measures described in Chapters 4 and 5 may not in themselves be sufficient to address the problems identified, and we may continue to see the launch of products which cause significant customer detriment.

6.3 The issue therefore arises whether still more interventionist policies might be justified. This chapter describes what such policies might be, and the circumstances in which they might be appropriate, while also highlighting some of the arguments against their use.

6.4 Starting with the most radical interventions and moving to less intrusive, we explore the following options in this chapter:

- product pre-approval;
- banning products;
- banning or mandating product features (including setting minimum standards for products);
- price interventions;
- increasing the prudential requirements on providers;
- consumer and industry warnings;
- preventing non-advised sales; and
- additional competence requirements for advisers.

6.5 We have not sought to make this a comprehensive list of all the options. We welcome views on what other interventions might be appropriate.

6.6 At this time we are not proposing to introduce new rules for any of the options discussed in this chapter. We discuss some of the options open to us in the future and seek views on what should be taken into account if such interventions are made. We note that some of the aspects of this chapter may be affected by the outcome of the regulatory reform process; for example, the final remit and powers of the CPMA and the coordination mechanisms between it and the Prudential Regulatory Authority (PRA) will have a bearing.

6.7 We recognise that regulatory failure is a real risk. In considering the solutions to underlying causes of persistent problems, the regulator must always be aware of the possibility of unintended consequences. In broad terms, regulatory failure refers to situations in which regulation has economic costs higher (or economic benefits lower) than were originally expected, so that the net effect is harmful or less beneficial than it might have been. We need to be mindful of this risk and welcome this debate on the degree to which we ought to pursue the options discussed.

6.8 While we aim to restrict the market for products likely to lead to detriment for customers, we may not always hold the necessary expertise to dictate the best solution to the market. There is a risk that consumer choice for acceptable products may be reduced. However, as part of a new financial services regulatory philosophy that tolerates fewer product failures, this might be inevitable. It is important for the industry and society to offer views and expectations on how the market should be regulated and where the correct balance lies between choice and consumer protection.

Product pre-approval

6.9 At this time, we do not propose to consider a general requirement for all firms to have their products pre-approved.

6.10 There would be a number of major implications if we considered this, including:

- given the number of products in the market and the frequency of product changes and variations, this would have massive resourcing implications for us, requiring additional staff and systems – these additional costs are likely to be passed back to firms and ultimately consumers;
- to mitigate the moral hazard of the regulator ‘signing off’ a product, we would be likely to take a conservative approach, limiting access to more innovative, complex or risky products; and
- a likely delay to the introduction of new products to the market, while awaiting approval.

6.11 So, while this option might help to control risks and detriment for customers, we question whether it is practical or desirable. A market-wide pre-approval approach may stifle innovation and restrict customer choice by too great a degree. In short, we consider that the responsibility for ensuring appropriate product design should remain with firms.

6.12 There may, however, be a case for pre-approving specific products where we have particular concerns. Where we find recurring problems with a product type or in a specific firm, the benefits of controlling the supply of that product to the market or the actions of that firm may outweigh the costs involved. FSMA does not give us power to require pre-approval of products other than for collective investment schemes, so a change in legislation would be needed if we wanted to take this forward.

6.13 Since there are significant difficulties with even limited pre-approval, an alternative option would be to require firms to notify us some time before they introduce a new product or make changes to an existing product.[48] Again, rather than requiring pre-notification for all products, this could be a viable option for certain product types or for specific firms that we have concerns about. This option would have similar difficulties to those of pre-approval of products, but they would be more limited in scope.

Example 11: the pre-notification approach adopted by the Malaysian Central Bank
The Bank Negara Malaysia (the Malaysian Central Bank) operates a system whereby firms launching products that have never before been introduced to the Malaysian market must notify the central bank 14 days before launch and supply product information. While this is not a pre-approval system, it does alert the central bank to market developments and allow them to investigate the product in more detail if they think it appropriate.

Banning products

6.14 Product banning is an option that we might be willing to consider where we see products that have the potential to cause significant detriment.

- It is rare for us to determine that a product is inherently flawed, but occasionally we see products that include so many of the negative indicators discussed earlier that it is clear consumer detriment is likely to arise if the product is sold. We could consider banning such products.
- In our experience, most products are suitable for some consumers but, where the industry demonstrates that it is incapable of selling to the right consumer, we could also consider product bans.

6.15 Banning harmful products would prevent potential detriment to consumers. Where the product has already reached the market and been sold to some customers, banning it would stop the problem from growing and reaching more customers.

48 SUP 15 already requires firms to notify the FSA of certain facts. We could consider adding new product launches or variations to existing products to these requirements.

6.16 This option has the advantage of being simple for firms to comply with and relatively less costly for us than other interventions that are more complex to monitor. Otherwise, if detriment materialises, there is a high cost to:

- customers who lose out;
- the industry, in payment of redress and reputational damage; and
- to the regulator in additional supervision and enforcement after the event.

6.17 On the other hand, there will be costs involved in taking such an approach:

- consumers for whom the product is suitable (even if there are only a few) would lose access to it;
- it might undermine the business models of some firms which were managing the product effectively;
- it may be difficult in practice to be certain that a product is properly categorised as 'bad'; and
- there may be an unintended consequence that firms become less willing to innovate generally.

6.18 From a regulatory perspective, adequately defining the product to enact a ban will be challenging: a product ban is open to arbitrage, as firms may seek to design products that replicate the features of the banned product but are technically outside the ban. Furthermore, there is a danger that products that are not banned will be perceived by consumers as having been approved for sale by the regulator.

6.19 However, because product bans will be extremely effective in rapidly stopping consumer detriment, we believe they are a tool that should be considered in future, in appropriate circumstances.

Mandating or banning product features or exclusions

6.20 Where our concerns relate to the sale of inferior products offering limited benefits, we could set criteria that products must meet if they are to be sold in retail markets. For example, there is scope for firms to exploit consumer behaviour in general insurance sales (such as focusing too narrowly on price when comparing products) by reducing the scope of the cover to below the typical market standard. The Treasury's simple financial products initiative aims in part to tackle similar concerns.

6.21 Alternatively, we could ban certain features, or combinations of features, if we consider them likely to lead to significant customer detriment.

6.22 We do not envisage routinely setting out a minimum set of product features for particular products but, where there is significant and widespread detriment arising directly from the lack of, or presence of, particular product features (such as an exclusion on an insurance policy), it may be appropriate in some circumstances to specify that products must contain/exclude the particular feature or combinations of features.

6.23 There are risks to this approach, in particular, that the product may become too expensive for some consumers. In addition, the possibility that this could lead to the complete withdrawal of the product from the market would be an important factor in deciding when to use this intervention.

Price interventions

6.24 Although we have not traditionally focused on regulating prices, we have rules relating to excessive charges in certain parts of the market.[49]

6.25 We have repeatedly found problems with the pricing of retail financial products where firms can exploit consumers' difficulty in taking account of fees and charges. While the specifics vary from market to market, we have concerns over all parts of the retail market. Some recent examples are discussed below.

- Our investment advice thematic reviews and testing of suitability take into account the cost of products. We have in the past rated cases as 'unsuitable' where the cost of the product is higher than similar products that would have met the client's needs and objectives, and there is no good reason for the additional cost. We have found great variability in the charges paid by customers and unsuitably high reduction in yield figures in a number of cases. In the pension-switching review, for example, the most common reason for us to regard advice as unsuitable was that the recommendation led to unnecessary additional costs.[50]
- The MMR has proposed new provisions to deal with problems with mortgage arrears charges. If implemented, these aim to address particular issues of poor practice and to clarify how arrears charges must be calculated and applied.

49 However, in the investment sector, when we updated the relevant Conduct of Business sourcebook in November 2007, we removed the rule on excessive charges for investments. We noted that action here might amount to setting a price ceiling, which carries a number of risks. CP06/19, *Reforming Conduct of Business Regulation*, Consultation Paper, October 2006 discussed the removal of this rule in more detail.

50 Quality of advice on pension switching: a report on the findings of a thematic review, December 2008

6.26 Outcomes testing and thematic reviews, which focus only on a sample from the market, cannot ensure that all consumers get a fair deal. More widely applicable rules on firms designing products could be considered, where competition does not provide the necessary market disciplines to protect consumers. This may include, for example, reinstating the rule on excessive charges for investments. We are considering a wide range of possible options, discussed below.[51]

Responsibility for firms designing products to ensure they have appropriate charging structures

6.27 This would involve an explicit requirement that firms test the product charging structure to make sure it is appropriate for the needs of target customers.[52] So, for example, a flat-rate monetary annual charge (e.g. £500 per annum administration charge) may not be appropriate for investment products with low minimum investment levels, as flat-rate charges are likely to erode the value of smaller sums within such a product.

6.28 Complicated combinations of investment charges (including allocation rates, performance fees, establishment charges or loyalty bonuses) may also be inconsistent with targeting a mass-market with low financial capability and modest amounts available for investment. Using less opaque, simpler charging structures would be more comprehensible and may be better suited to the needs of this market. For example, combinations of annual charges and performance-related fees on investments may incentivise excess risk taking to maximise profits for the firm, rather than focusing on consumer needs. Some charges are also referred to by confusing names that may be inappropriate for a mass-market target audience. A 98% allocation rate, for example, might be more clearly expressed as a 2% initial charge.

Provider duty to consider the appropriate overall charge for products

6.29 This is particularly relevant to investment products, where there is a risk that the total charge is at such a level that it undermines the possibility of achieving a reasonable return. The provider could be obliged to test their products at the design stage to determine if they are likely to become uneconomic if sold in particular ways (for example, if further layers of charges may be added if the investment allows a choice of funds and some of those carry high charges).

6.30 This idea is in some ways similar to a proposal that we considered, but did not pursue under the RDR, for providers to monitor the effect on their products of the levels of any adviser charges that they paid out on behalf of the end customer. However, we are no

51 We are not proposing anything like the Maximum Commission Agreement for investment sales. Between 1 July 1988 and 31 December 1989, the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO) operated a system known as the Maximum Commission Agreement, which capped the amount of remuneration that advisers could receive for recommending a product. The OFT objected to this on the basis that it distorted competition. We will need to work closely with the competition authorities where we are considering price interventions to ensure they do not have an adverse effect on competition.

52 We note that Customer Impact has a guide for life assurance providers on the *Description and presentation of charges* which includes a section on designing charging structures that are appropriate for the target market and the expected experience of the product. This makes some similar suggestions to those outlined here.

longer suggesting that providers monitor individual cases for value for money. Instead of checking each transaction, we could require providers to consider the point at which their product ceases to offer value for money and to take steps to guard against consumer detriment from excessive charges. For instance, they could communicate this to distributors and customers.[53]

6.31 Firms are already obliged to provide us with certain information on product sales. An alternative option might be for firms to provide us with information about actual charging levels. We would then have additional information available to us, to help focus our supervisory resource on high-charged products, if appropriate, and give us the opportunity to intervene to protect customers. However, the costs and complexity of gathering such information should not be under-estimated.

Point-of-sale responsibility to benchmark advice against a low-charged substitutable product

6.32 Since the introduction of stakeholder pensions, there has been an FSA rule, commonly known as RU64.[54] This rule requires advisers, when recommending a pension that is not a stakeholder pension, to explain in writing why the recommended policy is 'at least as suitable as a stakeholder pension'. Although not designed specifically for this purpose, this rule has had an impact on prices in the personal pension market.

6.33 We view the rule as an important consumer protection, although we note that there are many industry commentators who regard the rule as having had a negative market impact. They see the rule as having, in effect, put in place a price cap that has led to a decline in pension sales, which became uneconomic.[55]

6.34 We could consider extending a similar requirement to advised sales of other types of product. The rule appears to be most suited to investment products with explicit charging structures. But we would welcome thoughts on whether or how it could be applied in other retail markets.

6.35 This option would not provide a cap on prices. It would still be possible to sell more expensive products where there is a demonstrable need, but it would set a benchmark and encourage greater assessment of the value for money of propositions.

53 Where a customer is receiving advice, it remains the responsibility of the firm providing the advice to ensure that the recommendation is suitable.

54 RU64 refers to guidance in the Personal Investment Authority's (PIA) Regulatory Update 64 (RU64) published in March 1999 about personal pension suitability and selling practices in the period before stakeholder pensions became available. This was superseded once stakeholder pensions were launched in April 2001 by PIA and FSA rules - the latter are set out in COBS 19.2.2 R. The rules are still commonly referred to as RU64.

55 We discussed the possibility of removing this rule in CP05/08, *Suitability Standards for advice on personal pensions*, Consultation Paper, June 2005 and FS07/01, *Suitability Standards for advice on personal pensions: feedback on CP05/08*, Feedback Statement, February 2007. We concluded that we do not agree that the rule acts as a substantial barrier to consumers receiving pension advice, including consumers on low incomes. In addition, in light of the poor standards of advice identified in our thematic projects, we regard the rule as providing an important consumer protection. We have therefore retained this rule.

6.36 We are not saying that low charges are always best for all customers. For some customers it may be better to pay higher charges to benefit from product features that are genuinely important to them. However, we consider that a customer's interests are generally best served where they receive a product that meets all of their needs and objectives at the lowest price. We think that the starting point for most customers should be a low-charged product and higher-charged products should only be used where the benefits can be shown to outweigh the higher charges.

6.37 We would need to consider how this concept would work in conjunction with the RDR's proposals for adviser charging. It could, for example, apply to the product charges before adviser remuneration is added, incentivising providers to compete on product charges and for advisers to hold them to account.

6.38 At present there is no obvious default product in many areas of the market, so we would need to investigate options to find suitable benchmarks. We acknowledge that there are challenges in establishing criteria and getting them right. For example, we would need to confirm the correct benchmark price to be fair to customers and economic for firms. We would also need to assess that the net impact of such a rule would be beneficial.

6.39 We note that one of the aims of the Treasury's work on simple products is to help customers make comparisons across the market. Extending a benchmarking requirement would be consistent with this approach and shows how the two initiatives could work together. Indeed, the Treasury's consultation considers whether simple products could be used as a benchmark in relevant sectors.

Price capping

6.40 Price capping is the most radical price intervention and would involve us making difficult judgements about the appropriate price we regard as consistent with good consumer outcomes. However, we consider that it is an option that should remain open.

6.41 The numerous difficulties with setting appropriate price caps are well known. It is a challenging and complex task for regulators in markets that feature natural monopolies and homogeneous products, such as utility markets. In the diverse and ever-changing financial services markets, we consider that the challenges will be even more significant. It is also a blunt tool that may have unintended effects on the market, reducing desirable innovation or leading to all prices rising to the limit we set. Or, firms may simply recover lost revenue by increasing the price of other products.

6.42 Even so, price capping may be a means of tackling the most serious cases of mass consumer detriment, where firms are making excess profits by exploiting a lack of consumer sensitivity to, or awareness of, prices. In such cases, it may be appropriate and feasible to cap prices. For example, we could consider:

- setting caps for operational costs like management fees;
- capping charges for payment difficulties, such as mortgage arrears charges;
- capping risk-based charges, like the level of interest charged on impaired credit mortgages (although this is much more difficult to get right); and
- in some circumstances, it could be feasible to require the price of certain products or product features to be cost reflective and place the burden of proof on firms to show that the price level is appropriate.

6.43 If we do consider this option in the future, it may be as an interim measure in extreme circumstances, until a more finessed approach, using other regulatory tools, can be formulated. This may not necessarily require an extensive exercise to determine the most appropriate price, but a short-term measure to find a price that is sufficient to reduce incentives to help stop a particular problem growing while a permanent solution is put in place.

Increasing the prudential requirements on providers

6.44 We could investigate the extent to which we can vary prudential standards to reflect the risk to consumers posed by different products, to address possible future consumer redress issues. By this we mean that, where providers make undesirable products available, they are potentially exposing themselves to higher numbers of complaints and increased redress payments. To ensure they have the capital available to meet these payments we could require them to hold additional funds.

6.45 Many of the larger firms responsible for product manufacture will already be subject to requirements for substantial capital holdings. Firms in some market sectors may also be subject to prudential requirements set by EU directives, limiting our ability to act here. In addition, under the reformed regulatory framework, larger firms will be subject to the remit of the PRA for prudential regulation. This option is therefore likely to be more relevant for smaller, niche providers in some parts of the market.

6.46 By increasing costs for providers, we acknowledge that this may reduce returns to, or policy coverage for, customers. However, one of the primary intentions of increasing prudential requirements would be to encourage firms to avoid the higher capital requirements by not producing the product. To be most effective, it is likely that this would be part of a package of measures, along with other interventions to restrict access to potentially harmful products.

Consumer and industry warnings

6.47 We could adopt less interventionist means to steer the market away from product designs about which we have concerns. For example, in February 2010, Peter Smith, Head of Retail Investments Policy at the FSA, made a speech about the risks of traded life policy investments.[56] We could do more to provide early warnings about products we regard as posing the risk of significant detriment.

6.48 CFEB's Moneymadeclear pages already highlight high-risk and complex products that should not generally be sold in the retail market, including:[57]

- higher-risk shares (including unlisted shares); and
- contracts for differences.

6.49 We could look to follow this approach and publish a list of products that we regard as being generally unsuitable for the mainstream, retail market. This list might include, for example:

- traded life policy investments;
- some of the more complicated structured products; and
- leveraged Exchange Traded Funds.

6.50 Such a list would not ban the products, but would make it clear that the starting point is that these products are unsuitable for most retail customers. It would still be possible for a distributor to recommend the product, but this list would be a signal that the product is likely only to be suitable for certain segments of the retail market (for example, sophisticated customers capable of fully understanding the way in which the product works and the likelihood of it failing). We would not expect the product to reach the mass market, would not expect it to be marketed widely and would expect extensive research and justification when making it available.

6.51 We could also include products that are suitable for a wider range of consumers, but that exhibit so many of the indicators of potential consumer detriment, that consumers need to be warned to exercise additional caution before purchasing them.

56 Speech by Peter Smith, Head of Retail Investments Policy, FSA, at the European Life Settlement Association conference, 24 February 2010
57 http://www.moneymadeclear.org.uk/

Example 12: the Autorité des Marchés Financiers position no. 2010-05 on marketing complex financial instruments[58]
The Autorité des Marchés Financiers (AMF), which regulates investment in financial instruments in France, has recently published a position paper that takes a similar approach to the one considered here. They have determined criteria for assessing the risk of mis-selling complex products using direct marketing and state that (except in certain, specified conditions) it will be particularly difficult to sell certain products in the retail market in a compliant manner. Where the product is still to be marketed, they require providers of highly complex structured financial instruments with a high risk of mis-selling to include a warning in their financial promotions, in very visible print, that: 'The AMF considers that this product is too complex to be marketed to retail investors and therefore did not examine the promotion'.

Mandated risk warnings

6.52 We could also consider further disclosure-based solutions focused on particular products. One option, like health warnings on cigarette packs, would be to mandate the warnings to be disclosed on products that are of significant concern to us, including the format, font, position and size of those warnings on disclosure documents.

6.53 Bold and clear statements that take up a minimum proportion of a financial promotion or meet a predefined font size on the first page of suitability reports could act as 'wealth warnings' on products. Flagging risks in this way might help to counter consumers' difficulty in making judgements about product quality that can lead to mis-sales. As described above, this is similar to the approach taken by the AMF in France on certain highly-complex, structured financial instruments with a high risk of mis-selling.

6.54 However, disclosure can only work if consumers read and act on the warnings. It may also be that over-used warnings might lose their power and, if we were to focus on only the most important risks, others might be over-looked. It may therefore be difficult to find the right balance in adopting this approach.

Preventing non-advised sales and limiting sales by client category

6.55 For products that are particularly complicated, or where there is high risk of consumer detriment, we have specified in some cases that it is generally inappropriate to sell certain products using non-advised distribution channels. We will continue to keep this option open.

58 AMF position no. 2010-05, *Marketing of complex financial instruments*, 15 October 2010

6.56 Our work on pension transfers and distributor-influenced funds are examples of cases where we have said that it is generally inappropriate to use non-advised sales approaches.[59] Firms who do use non-advised sales methods for these products would need to be able to justify their decision.

6.57 Consumer protections are higher for advised sales than non-advised sales. The suitability assessment for investments, for example, requires advisers to recommend only suitable products that are in the best interests of the customer after due consideration of their knowledge and experience, financial situation and investment objectives.

6.58 However, receiving advice costs money. Adviser remuneration can form a significant part of the charges that customers face. Consumers willing and able to make their own decisions would therefore be forced to pay more to obtain financial products through an adviser if non-advised sales channels are prevented. This option may also rule out online sales, which are an important means of stimulating price competition in some markets and for consumers, particularly younger consumers, accessing financial services. This would not, therefore, be an approach we would expect to use widely, but only for products where the risks are such that they outweigh the costs involved.

6.59 Another option we anticipate may be useful would be to restrict sales to certain categories of client only. It may be, for example, that specific investments, which are particularly complicated, should only be permitted to be sold to professional clients (or retail clients who have elected to be treated as professionals and meet the necessary criteria).

Additional competence requirements for advisers

6.60 The RDR is already increasing qualification standards for all investment advisers to improve competence. However, as we suggested in DP07/01, we consider there is scope for more specialist requirements where an adviser is advising on non-mainstream products.[60] The challenge has been to define non-mainstream products.

59 The FSA November 2007 financial adviser newsletter and smaller firms website state that, although pension transfers are not prohibited via direct offer financial promotions, we do not think it is likely that customers will receive fair outcomes for transactions conducted on this basis. Pension transfers are not a simple exercise and it would be difficult to couch complicated financial concepts in simple and clear language or to ensure that customers are treated fairly. The ‘Communications with clients’ section of the adviser factsheet on distributor-influenced funds explains that we consider it to be unlikely to be fair to use non-advised sales methods for these products.

60 DP07/01 *A review of retail distribution*, Discussion Paper, June 2007

6.61 At present, there are already qualification requirements, in the Training and Competence (TC) sourcebook for the following types of specialist advice:[61]

- long-term care insurance contracts;
- pension transfers; and
- equity-release mortgages.

6.62 On the same basis, where we are concerned about the potential for certain non-mainstream products to lead to poor customer outcomes, we could introduce a new requirement for an appropriate qualification in addition to the qualification requirement for the mainstream activity (such as advice on packaged products).

6.63 For example, as mentioned in Chapter 4, our recent review of advice on UCIS identified poor customer outcomes – additional competence requirements might lead to better outcomes for consumers. The growing sophistication of investments generally, might mean that advisers with only the minimum qualification (such as that for advising on packaged products) should be restricted to advising on more mainstream investments.

6.64 This approach could be teamed with the earlier suggestion to prevent non-advised sales of certain products, to ensure that customers are only exposed to complex products under the advice process by advisers who can demonstrate a higher level of knowledge and skill in that market by attaining a relevant additional qualification and carrying out relevant additional continuing professional development.

6.65 We confirmed in PS10/18 that we will own and oversee the development of examination standards that underpin our appropriate qualifications.[62] We retain the view that these standards will be developed by the industry for the industry. We welcome views on which activities we might define as specialisms, to be included in any additional qualifications. We encourage the industry to discuss this with us.

Summary

6.66 The options discussed in this chapter start with the most radical interventions and move on to less intrusive (but still robust and potentially costly) interventions. Significant further analysis and debate is required before determining whether these interventions should be part of the regulatory toolkit.

6.67 We summarise below, however, our current thinking on the likelihood that these different categories of intervention would be appropriate. We welcome responses which argue either for a more interventionist or less interventionist approach.

61 TC Appendix 1.1.1R. There was also, until recently, a specific appropriate examination requirement for acting as a broker fund adviser; however, this was moved into the 'managing investments' category from December 2010.

62 PS10/18, *Competence and ethics, feedback to CP10/12 and final rules*, Policy Statement, December 2010

Product approval	• We believe we should rule out becoming a pre-approver of all products at present. • Pre-approval of a niche product may be appropriate in some circumstances but we would need additional powers to facilitate this. • We could envisage requiring pre-notification of product launch or changes to existing products for particular firms or particular types of product.
Banning products	• This should be considered where products have the potential to cause significant detriment. We would expect this to be relatively rare.
Mandating or banning product features or exclusions	• This should be considered where particular features are causing detriment.
Price interventions	• We consider a more proactive approach to intervening in price should be adopted. • Price capping is very challenging to get right but should not be ruled out for use in extreme circumstances, perhaps as an interim measure. • The other price interventions discussed should be considered as possible options.
Increasing the prudential requirements on providers	• This may be feasible and effective only for small providers in some markets and in conjunction with other tools.
Consumer and industry warnings	• These should be considered as a possible option, where we have significant concerns about a product.
Mandated risk warnings	• These should be considered as a possible option, where such disclosures would be likely to change behaviour.
Preventing non-advised sales	• We have already adopted this measure in some cases and consider that it is an option to consider using again in the future.
Additional competence requirements for advisers	• This should be considered as a possible option.

Q11: Do you have any comments on any of the possible additional interventions?

Q12: Which activities could we define as non-mainstream advice for the purposes of developing additional qualifications?

Q13: Are there any other interventions we should consider?

Q14: What would the impact of these specific interventions be on the market?

Annex 1

Summary of DP questions

Chapter	Question
1	Q1: What issues should we consider in relation to how our product intervention approach affects equality and diversity? Q2: How could we use our focus on products to promote equality and diversity?
2	No questions
3	Q3: Do you have any comments on our market failure analysis? Q4: What do you think are the criteria by which we should judge when to intervene further? Q5: Are there any other relevant indicators that would help us identify potential problems?
4	Q6: Do you have any comments on the supervisory approach we have adopted, or suggestions to help develop it?
5	Q7: Should we give further consideration to new rules to prescribe conduct by firms when designing and managing products? Q8: If so, what should be covered? Q9: What would the impact be on the market? Q10: What would the implications be if we consider similar interventions for services as those discussed in this paper for products?
6	Q11: Do you have any comments on any of the possible additional interventions? Q12: Which activities could we define as non-mainstream advice for the purposes of developing additional qualifications? Q13: Are there any other interventions we should consider? Q14: What would the impact of these specific interventions be on the market?

Annex 2
The wider legal context

1. Here we give an overview of the legal framework in which we operate: comprised both of UK and European Union (EU) law.

2. We do not attempt to provide an exhaustive list of all the potentially relevant legal issues, a more detailed analysis would accompany any specific future proposals on which we consulted.

Domestic law

3. We need to take account of relevant considerations under domestic law, including FSMA, the Human Rights Act 1998 and general law. We would also need to consider the implications of competition law for any proposals. We recognise that the transition to the new regulatory regime will mean we need to reassess the domestic law context and its implications for the implementation of our product intervention approach.

4. In relation to FSMA, we have very broad powers to make new rules. Proposed rules are subject to consultation and cost-benefit analysis, and we need to explain why we consider we are acting in the most appropriate way to meet our statutory objectives. We also need to have regard to the principles of good regulation in FSMA when making rules and to general principles of public law.

5. In relation to competition law, Chapter I and II prohibitions in the Competition Act 1998 which refer to the prevention, restriction or distortion of competition and the abuse of a dominant position in a market, do not apply to the agreements, practice and conduct of authorised persons and others subject to our regulatory provisions, to the extent that such activities are encouraged by our regulatory provisions. However, in return for this exemption, our regulatory provisions and practices are subject to scrutiny by the Office of Fair Trading (OFT) and, where necessary, by the Competition Commission.

6. If we were to develop certain proposals discussed in this paper, we would need to work with the competition authorities to ensure they do not have a significantly adverse effect on competition.

EU law

7. Various EU financial services directives seek to remove barriers to cross-border activity in financial services in the EU, with the aim of stimulating competition and making it easier for EU citizens to live and work in other member states. EU law is a significant component of the legal framework in which we operate and any product interventions need to be compatible with our obligations under it.

8. Our ability to create new rules is likely to be particularly constrained by maximum harmonising directives, within the scope of which we generally cannot impose requirements that go beyond or fall beneath those prescribed at the EU level. As the degree of harmonisation at the EU level varies across different sectors, we would need to consider our ability to introduce new rules in line with EU law on a sector-by-sector or issue-by-issue basis. However, this approach corresponds to our stated intention that any future interventions would respond to specific market failures.

9. For some directives, depending on the passporting provisions, if we implement super-equivalent requirements within the scope of the directive, they may not apply to firms passporting into the UK from elsewhere in the European Economic Area (but may apply to UK firms passporting to other countries). We would need to consider the regulatory and competition implications of allowing different standards for different types of firms, and the likely impact on UK competitiveness.

10. Any proposals that could have a discriminatory effect (i.e. impose a different burden on incoming firms compared to domestic firms) or that could inhibit access to the UK market (i.e. that hinder or make it less attractive to establish a branch or exercise the freedom to provide cross-border services in the UK) may be subject to challenge under EU law.

11. However, additional restrictions that are outside the scope of EU directives can be justified if the restrictions pursue an objective of the ‘general good’ (such as consumer protection), are objectively necessary, are proportionate to the objective pursued and do not duplicate similar rules to which the firm is already subject.

12. It is important to note that EU law continues to evolve. For example, the European Commission (EC) is developing new proposals concerning Packaged Retail Investment Products (PRIPs), and several directives are currently under review. This evolution gives rise to both challenges and opportunities, as we need to ensure that:

- any proposals for greater product intervention are as ‘future proof’ as possible (i.e. will not be incompatible with forthcoming EU legislation); and

- we share our experience in more actively scrutinising products and their governance with the EC and other member states and influence the future EU consumer protection agenda.

13. We are not the only regulator in the EU with concerns about product governance. And the EC's current review of MiFID is considering similar ideas to some of those discussed in this DP. Our DP is therefore likely to prove of interest to them.

14. We also note that the European Supervisory Authorities (ESAs) will have a role in product oversight that is consistent with and complementary to the FSA's current consumer protection objective.

15. Given the EC's willingness to consider similar issues in the MiFID review, responses to this DP may be used to influence our position in EU negotiations rather than to set new standards at UK level. It may be that an appropriate action for us is to work with our colleagues at EU level, rather than pursuing a national approach.

Annex 3

Case studies

1. Here we consider three examples of problems in the retail financial services markets, to explain the issues in more detail and discuss how increased product scrutiny might have helped reduce customer detriment:

- broker funds;
- structured capital at risk products (SCARPs); and
- self-certification mortgages.

2. We have chosen to illustrate the discussion using some case studies from the past. While there are many more recent case studies available, we are conducting ongoing supervisory action on many of these issues and it would be inappropriate for us to comment here on those actions.

3. As noted elsewhere, we are not now saying that the only problems were in relation to product governance: there have been point-of-sale problems in all of these examples. Where in the past we focused mainly on the point-of-sale, in future we will focus on the full value chain, starting with the product itself and also considering the product's sale and after-sale servicing. This will mean we are more likely to take action with all firms involved in the product, including both providers and distributors.

4. The defining characteristic of **broker funds**, which were popular in the 1980s and 1990s, was that the client's adviser (the broker) took an active role in managing the investment (a life fund, a pension fund or a collective investment scheme), either by assuming an investment adviser role or by sub-contracting a manager of their own choice. Given this structure, broker fund advisers usually had a dual role as adviser to the retail customer and as investment adviser for the broker fund.

5. As well as the provider's charges for operating the scheme, therefore, there generally was a second set of charges payable to the broker fund adviser for their role as investment adviser. Often, the funds also paid commission to the intermediary for their role as the client's adviser. The charges on broker funds could therefore be much higher than on competing funds in the market.

6. Some broker funds out-performed their benchmark index and the broker fund provider's own managed funds. However, research showed that the majority of broker funds did not justify the additional charges.

7. Regulatory action at the time focused mainly on distribution. For example, there were additional disclosure requirements and the product had to be re-assessed as suitable for the customer on an annual basis. Some interventions were made that could be characterised as product interventions: there was a ban on non-advised sales and broker fund advisers were required to gain an additional qualification to demonstrate competence in fund management.

8. Under our new strategy, we could pursue product interventions further and would expect the providers that enabled broker funds to do more to demonstrate how they offered good customer outcomes. Broker funds carried inherent conflicts of interest, could be much more expensive than alternative funds and often offered worse performance than those alternatives. We would want providers to be able to explain how they had mitigated the risks of detriment to customers when setting up and running these funds. We might want to read this approach across to cover distributor-influenced funds, which may face some similar issues to broker funds.

9. If providers in the future prove unable to act sufficiently on their own, we would be willing to step in and introduce additional measures specifically designed to guard against the product risks. This might include action in areas where we have traditionally been unwilling to intervene, including price intervention.

10. **SCARPs** are a type of structured product in which capital is at risk if the underlying investment falls in value. In the late 1990s there were problems in this market when these products were sold in volume to customers unwilling to take risk with their capital. The market downturn in 2003 meant many products matured with capital losses.

11. Around 450,000 SCARPs were sold between April 1997 and February 2004 and our work to investigate the issues led to around £159m in redress for customers.[1]

12. Acting under the regulatory approach at the time, we sought to improve distribution standards. Guidance issued by the FSA and one of its predecessor organisations, the Personal Investment Authority, before the market downturn showed awareness of the product risks and attempted to improve distributor understanding of the possible problems.

13. The mismatch between customer needs and product outcomes, however, suggests problems also existed in terms of product governance and distribution strategies. SCARPs can meet the investment needs of certain customers but clearly did not meet the needs of anyone not willing to accept any risk of capital loss. Many of the customers were in retirement and using investments to generate an income to supplement their pension and therefore lacked the capacity to absorb significant losses to their capital.

1 Detailed summary of our review of SCARPs mis-selling, 2005

14. It appears that providers did not engage sufficiently with our guidance by seeking to control distribution (for example, by looking to improve disclosure standards to ensure adviser understanding of the products) or by checking that their customers were aware of the risks and willing to accept them. They could have done more to ensure that their customer profile was consistent with the nature of the product.

15. **Self-certification mortgage** product issues have been discussed already in the Mortgage Market Review (MMR) Discussion and Consultation Papers.[2] This type of mortgage, where the lender markets the fact that they will not check income, was originally aimed at the self-employed, but became more widely available over time to other groups including the employed.

16. Our analysis shows that arrears rates are significantly higher for self-certified mortgages than for income-verified mortgages, so the potential for customer detriment is significant, in addition to the fraud risks posed by this type of mortgage.

17. Although self-certification mortgages have been withdrawn by lenders as a result of tightened credit conditions following the financial crisis, we are concerned that firms will come under increasing pressure to re-introduce them when credit availability improves. As the market is unlikely to resolve these problems on its own, one of the first steps by us to enact our product intervention strategy has been to propose that all lenders must verify borrower income before providing a mortgage. If this proposal is implemented, it will in effect end the self-certification mortgage market.

2 DP09/03, *Mortgage Market Review*, Discussion Paper, October 2009 and CP10/16, *Mortgage Market Review: Responsible lending*, Consultation Paper, July 2010.

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