

**The FSA's Conduct Regulation Regime**  
A review by

**The Financial Services Consumer Panel**

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## Foreword

Over the course of the last financial year the Panel has undertaken three case studies as part of its work on assessing the effectiveness of conduct regulation by the Financial Services Authority (FSA). We are also taking the opportunity to look forward to the era of conduct regulation by the Financial Conduct Authority (FCA) and to consider how regulatory action should be different under the FCA. As part of this, we have identified a series of six priorities for the FCA which will help deliver a step change in the regulatory approach to protecting consumers and delivering its vision to be a proactive regulator. These include:

- acting quickly to prevent widespread consumer detriment: the FCA must be prepared to adopt a judgement-led approach which, by definition, will mean acting swiftly and often without evidence of actual failure;
- making full use of consumer and market intelligence: the FCA must have access to the widest range of available information and have staff with the necessary skills - and access to the right technology - to make good use of it.
- Building a culture within the FCA to deliver its regulatory vision: senior management must display the necessary leadership and behaviour skills if staff are to feel empowered to take bold, judgement-based action.

We are grateful to the staff of the FSA for their help in producing these case study reports.

The subjects to be covered by the case studies were decided on as the result of an objective selection process and are intended to be indicative of the current overall approach to conduct regulation by the FSA. The three areas are the FSA's regulatory work around products designed to replace Payment Protection Insurance (PPI) policies; packaged bank accounts; and the impact of in-house reward structures.

Adam Phillips  
Chair  
Financial Services Consumer Panel

24 July 2012

## Executive summary

### *About the Panel*

The Financial Services Consumer Panel is an independent statutory body, set up to represent the interests of consumers in the development of policy for the regulation of financial services. We work to advise and challenge the FSA from the earliest stages of its policy development to ensure they take into account the consumer interest.

As part of our day-to-day work we engage closely with the FSA on numerous aspects of its regulatory strategy and operations, including the effectiveness of the tools it uses to identify risks, supervise firms' conduct and enforce compliance.

### *Background to this report*

The Panel has undertaken a review of the effectiveness of the FSA as a conduct regulator focusing on three key areas of its recent work: PPI replacement products; packaged bank accounts; and the impact of firms' in-house reward and incentive structures. These case studies were chosen as ones which would indicate the relative strengths and weaknesses of the FSA's regulatory approach.

### *Panel's recommendations*

Based on the findings of these case studies, the Panel sets out below a series of recommendations for the FCA's approach to conduct regulation, which we believe it must deliver to ensure the interests of consumers are better protected under the new regulatory structure.

We believe the FCA must:

1. *Act quickly to prevent widespread consumer detriment*

While external factors such as policy being developed within Europe can have an impact on the FSA's flexibility to act, all three of the Panel's case studies are characterised by the reluctance, or inability, of the FSA to identify and tackle market failures quickly. In the case of PPI mis-selling, this was one of the contributing factors which led to widespread consumer detriment over many years. Many of the FCA's new powers, such as that to intervene in the product design and sales process, rely on its willingness to take quick and decisive action in the light of a risk of consumer detriment. The FCA must therefore be prepared to take forward a judgement-led approach and be willing to take action without incontrovertible evidence of a market failure.

2. *Make effective use of consumer and market intelligence*

The FCA must ensure it has the necessary access to the right information to empower the organisation to deliver its interventionist

approach, as well as the skillset to analyse and make appropriate use of that information. Access to primary intelligence, through either market data, data from external sources or relationships with other organisations, will be crucial to establishing an effective early warning system. Both our PPI and packaged bank account case studies highlight how the FSA did not have adequate access to information about the profitability associated with products which were being widely sold to a large number of consumers.

3. *Utilise the full suite of its powers*

The FCA is inheriting a large number of powers to enable it to deliver its consumer protection mandate. A number of new powers are due to be granted through the Financial Services Bill including competition powers and a competition objective. We consider these particularly important given many market failures are borne out of ineffective competition. The FCA must put in place a strategy for how it will get the most from these powers and how they can be used in combination to deliver its regulatory vision. In the case of PPI products for example, the FSA raised questions about the structure of some products as long ago as 2005. Under the FCA we would expect such issues to be identified early addressed without delay, probably by way of product intervention powers.

4. *Ensure risks are prioritised and resources are used effectively*

The Panel recognises the FCA will have limited resources and it will not operate a zero failure regime. This will ultimately mean the FCA is unable to intervene in all areas of potential consumer detriment. However, to ensure the FCA deploys its resources proportionately and prevents significant consumer detriment, it is essential that risks, and any mitigating actions, are prioritised effectively. Both our packaged bank account and rewards case studies have highlighted, in our view, how the FSA should have taken action earlier to address emerging market failures. Building on these lessons, the FCA must not simply prioritise risks that have crystallised, but look to identify and tackle risks which may materialise in the medium to longer-term and assign its resources as appropriate.

5. *Deliver a credible deterrence*

The FCA's action must deter poor conduct behaviour in the firms it regulates. We have seen in the last couple of years the FSA take forward more high profile enforcement action. This includes holding individuals in Significant Influence Functions to account. The Panel applauds this approach and believes the FCA must build on this. As all three of our case studies highlight, even after many years of industry mis-selling scandals, firms are still willing to incentivise their staff to sell products that do not meet the needs of their customers. Only strong regulatory action against individuals and firms can help deter this behaviour.

6. *Build a culture within the FCA to deliver its regulatory vision*

Ensuring the FCA has the right powers, intelligence, and intention to become a proactive regulator is only part of delivering the new regulatory vision. Developing a culture within the FCA to take bold, judgement based action is potentially harder as is making sure that senior staff feel empowered to display key leadership behaviour and skills. Yet this is central to the FCA's ability to deliver a step change in consumer protection standards. Delivering this cultural change will not happen overnight, but steps should be taken now to encourage this change, including recruitment, training and a staff development process. The FSA needs to be devising now a clear in-house consumer strategy to which all staff have signed up and which puts consumers at the heart of their work. A robust framework has to be put in place for potential market failures to be brought to the attention of the FCA management, with all agreed actions followed through quickly and effectively.

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## Methodology

It would be impractical for the Panel to analyse and assess in detail every single aspect of the FSA's extensive conduct-related work. Instead we have chosen to focus on three particular work streams – replacement products for Payment Protection Insurance (PPI) policies; packaged bank accounts; and the impact of in-house reward strategies – as reliable indicators of the FSA's overall approach to conduct regulation and its effectiveness.

The criteria we used in deciding on these three areas included their importance to consumers, the likely impact of regulatory action and whether the risks/issues involved might be addressed differently under the anticipated FCA regulatory regime.

We set out to answer, so far as possible, a number of key questions in each of the three areas:

- Did the FSA know about the risk before it crystallised and did it act appropriately?
- How was the risk prioritised?
- Does the FSA know whether firms have complied with particular principles and rules? Has it undertaken firm-specific conduct supervision, or thematic work across the sector? Was that work representative of the sector and did it capture the extent of the issue/problem?
- Has the FSA's conduct regulation policy and process achieved the specific objective it set out to tackle?
- What has been the consumer experience in this area? To what extent is that directly related to FSA conduct supervision?
- What will the FCA have to do differently? On the basis of the FCA approach document and subsequent publications, would the FCA have dealt more effectively with the particular issue? To what extent would consumers have benefited from that different approach?

Each of the case studies captures a discrete piece of FSA regulatory action at a particular point in time, so it has not been possible to answer all these questions for all of the work streams. We have however answered as many as we can.

## *FCA approach*

When setting out the key priorities for the FCA, we have relied on public information which describes the FCA's future ambition to be a proactive and intrusive regulator. This has been set out in the FCA approach document<sup>1</sup> in June 2011, Martin Wheatley's speech to the British Bankers Association

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<sup>1</sup> Financial Conduct Authority: Approach to Regulation, June 2011 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

(BBA) in January 2012<sup>2</sup> on FCA Vision and Clive Adamson's April 2012 speech at the Bloomberg Conference<sup>3</sup> on future regulatory approach. Martin Wheatley set out some of the ways in which the FCA will have to be different:

- The FCA will need to ask tougher questions
- The FCA then needs to make better, bolder, faster decisions
- And the FCA must also be much more open, engaging and clear

Clive Adamson's speech embellished this and identified the key aims of the FCA as:

- *To be more forward-looking in assessment of potential problems* – looking at how the regulator can tackle issues before they start to go wrong. This will involve by necessity a high degree of judgement.
- *Intervene earlier when problems are seen* – the FCA will have greater appetite for earlier intervention than the FSA has had.
- *Address the underlying causes of problems*, not just the symptoms.
- *Secure redress for consumers if failures do occur*. In practice, this means a combination of appropriate redress for consumers, changes in their systems and controls and ensuring that post-sales processes deliver a fair outcome for consumers.
- *Take meaningful action* against firms that fail to meet the required standards, through levels of fines that have a credible deterrence.

We have used these key points as the context for our comments on how the FCA might have dealt with the particular areas covered in this report and our recommendations for how it should operate in the future.

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<sup>2</sup> Speech by Martin Wheatley at the BBA on 25 January

<sup>3</sup> Speech by Clive Adamson, Director of Supervision, Conduct Business Unit of the FSA at the Bloomberg Conference on 18 April at [www.fsa.gov.uk/library/communication/speeches/2012](http://www.fsa.gov.uk/library/communication/speeches/2012)



## Section 1: Payment protection products after the PPI mis-selling scandal – replacement products

### What are payment protection products?

Short term payment protection products that fall within the FSA's regulatory remit<sup>4</sup> are general insurance contracts. Broadly, their purpose is to cover a debt if an event such as sickness or unemployment affects the borrower's ability to meet the agreed payments. If a successful claim is made against a policy, the insurance company pays a sum of money either to meet a specific payment or a proportion of indebtedness. There are also similar products not tied to loans which provide an income if someone is made redundant or has an accident. These products are sold on an exception basis and are not individually underwritten. In this report therefore, we are not referring to policies such as permanent health insurance products where premiums are related to the probability of claims.

Payment protection and similar products can play a valuable role in the lives of consumers – the product is not intrinsically toxic – although evidently PPI was mis-sold to consumers.

### What does the market look like?

#### *Products*

According to data published by the Association of British Insurers (ABI)<sup>5</sup>, the number of single premium individual protection products sold has remained fairly static over the last two years (50mn in Q3 2011 compared to 55mn in Q3 2009); with regular premium business falling from 225mn in Q3 2009 to 96mn in Q3 2011.

The ABI's Q4 2011 Quarterly Consumer Survey<sup>6</sup> reports that respondents ranked PPI, as well as mortgage payment protection insurance and critical illness cover, 'bottom of the table' of 15 products in terms of the ease with which consumers are able to understand the products.

The FSA's product sales data trend report on pure protection contracts<sup>7</sup>, which is collected from returns submitted by FSA authorised firms, breaks some of the figures down in more detail. The pure protection contracts reported are standalone critical illness; income protection; and critical illness sold as a rider benefit to mortgage protection and term assurance. The 2011 data shows a slight decline over the year in the number of contracts sold, with critical illness sold as a rider benefit accounting for the majority of sales (79%); followed by income protection (16%); and stand alone critical illness

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<sup>4</sup> The FSA is responsible for regulating payment protection contracts that are general insurance contracts. Products that carry out a similar function but are not contracts of insurance include forms of protection such as debt freeze and debt waiver, where the terms of a mortgage or credit agreement are modified in certain specified circumstances, such as unemployment

<sup>5</sup> [www.abi.org.uk](http://www.abi.org.uk)

<sup>6</sup> ABI quarterly consumer survey 2011 Q4 at [www.abi.org.uk](http://www.abi.org.uk)

<sup>7</sup> At [www.fsa.gov.uk/doing/regulated/returns/psd/publications](http://www.fsa.gov.uk/doing/regulated/returns/psd/publications)

contracts (5%). Despite this downward trend, almost 600,000 pure protection contracts were sold in the financial year to March 2011.

In the 2010/11 financial year, 84% of pure protection contracts were sold as regular premium contracts rather than single premium contracts.

### **Firms**

The FSA breaks down the profile of the market into “provider firms” and “selling firms”. Selling firms either sell products provided by another firm (so they are pure distributors/intermediaries), or sell products they have created themselves. Over the 2010/11 financial year there was an average of 5,990 selling firms and 36 provider firms per quarter. Over the long term there has been a decline in the number of providers of pure protection contracts (down 24% from Q1 2006), which has accompanied a similar decline in the number of providers in the mortgage-based protection market (down 31% over the same period). Overall the number of selling firms has been more volatile than the number of provider firms – declining, recovering then declining again. Importantly, the FSA states that intermediaries have apparently turned to protection products “to fill the gap left by the decline in their mortgage income<sup>8</sup>”.

In 2010/11 the top five provider firms accounted for 59% of the market, the top ten for 85% and the top 20 for 99%. The top 15 provider firms sell *all* stand alone critical illness policies, 99% of critical illness sold as a rider benefit and 95% of all income protection policies.

Between April 2010 and March 2011, Banks and Building Societies dominated the market with 28% share of the market for pure protection contracts, followed by Personal Investment Firms, with 26%, Mortgage Businesses (15%) and General Insurance Intermediaries (10%)

### **Regulation of general insurance**

The focus of our case study is the work the FSA has undertaken on PPI replacement products, not the PPI mis-selling scandal. The regulatory history of these products is highly pertinent however and we have set this out in our report.

The FSA assumed responsibility for the regulation of general insurance products, including insurance based payment protection products, on 14 January 2005 and applied a regulatory framework mainly through the Insurance Conduct of Business Sourcebook (ICOB). Until then the general insurance sector had been subject to a degree of voluntary regulation by the General Insurance Standards Council and compliance with various industry codes of practice.

The overall objectives of the ICOB regime<sup>9</sup> were to ensure:

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<sup>8</sup> Page 5 of Pure Protection Contracts Product Sales Data at August 2011, [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>9</sup> According to FSA ICOB Review Interim Report March 2007 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

- Consumers buying insurance on a non-advised basis received adequate information to make an informed decision, and firms selling the insurance did not make inappropriate sales.
- Consumers buying insurance on an advised basis were recommended suitable policies that met their demands and needs.
- Consumers understand the key features of a policy, including significant exclusions, and the status of the service before buying.
- Consumers claiming on their insurance policies had their claims dealt with promptly and fairly.

The FSA went on to revise ICOB, which was eventually replaced by “ICOBS” from 6 January 2008. A post implementation review of ICOBS was carried out and a Report published in 2010<sup>10</sup>.

The report noted:

“parallel with the post-implementation review, we also took into account developments in how general insurance products are distributed since the ICOB review in 2006. Such changes in distribution models involve a range of different risks to those on which we based the ICOB review; this has caused concerns about particular market segments.

The FSA said that “general insurance market distribution models constantly change in response to firms’ business strategies, consumer demand, new technology and the economic environment. As regulators we need to keep a watching brief on whether our regulatory framework remains appropriate for its intended market.”

## Regulation and payment protection products

There is a long history of concerns being raised about payment protection insurance, principally in relation to the way in which it was sold, but also in terms of restrictions on cover or other ‘structural’ points. In 1998 Which? magazine published a report<sup>11</sup> which questioned whether payment protection products sold at that time provided value for money. In 2005 Citizens Advice published a report<sup>12</sup> entitled “Protection Racket” and submitted a super complaint to the Office of Fair Trading. Many clients of Citizens Advice had found that having bought a policy they could not make a successful claim because of exclusion clauses and administrative barriers.

When the FSA took over regulatory responsibility for general insurance in 2005 it announced that priority would be given to a thematic investigation into sales of payment protection insurance. The results (below), published in

<sup>10</sup> ICOBS Post implementation review June 2010 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>11</sup> No longer available electronically

<sup>12</sup> At [www.citizensadvice.org.uk/protection\\_racket](http://www.citizensadvice.org.uk/protection_racket), 13 September 2005

November 2005<sup>13</sup>, were so poor that a second round of thematic work was promised within a year:

- There was a risk of inappropriate sales;
- There were inadequate controls in place for non-advised sales;
- Advice on PPI was often likely to be poor;
- There was an over-reliance on product documentation given to the customer at the expense of explaining the policy to the customer orally;
- The quality and timeliness of product and price disclosure by some firms selling single premium policies was poor;
- The level and structure of inducements and targets for sales staff could encourage mis-selling in some firms;
- Training and competence of sales staff was not adequate in around half of firms;
- Compliance monitoring was variable and in some cases very poor.

Further regulatory work in 2006<sup>14</sup>, again focusing on sales of PPI rather than the product itself, revealed that many firms were still not providing clear information at the point of sale – for example, making it clear that PPI was optional and identifying parts of the policy under which a consumer might not be able to claim. The FSA was by that time also working with the Office of Fair Trading on its market study.

In view of the poor results of the 2006 thematic work on PPI, still further work on selling standards was carried out in 2007<sup>15</sup>. The results were a mixture of “disappointment” at the slow progress of some firms, and improvements in some areas. The FSA promised to strengthen its regulatory action.

By September 2008 the FSA had taken enforcement action against several firms in relation to sales of PPI<sup>16</sup> and updated its thematic review.<sup>17</sup> The findings were so poor, yet again, that the FSA promised to “escalate” its regulatory intervention and undertook to publish a further update on its thematic work in early 2009. The FSA was by then also considering the Financial Ombudsman Service’s concerns about PPI complaints, which had

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<sup>13</sup> The Sale of Payment Protection Insurance – Results of Thematic Work, November 2005, at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>14</sup> Press Notice FSA/PN/104/2006 19 October 2006, at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>15</sup> Press Notice FSA/PN/102/2007, 26 September 2007 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>16</sup> Including HFC Bank (£1.085mn fine) and Alliance & Leicester (£7mn fine), press notices FSA PN/004 and 115/2008 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>17</sup> Press Notice FSA/PN/112/2008, 30 September 2008 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

been raised in a 'wider implications'<sup>18</sup> letter (the letter itself has not been published).

The 2009 update,<sup>19</sup> comprising mainly a public message welcoming the move by five firms/groups to stop selling single premium PPI, was followed swiftly by letters to Chief Executive Officers<sup>20</sup> calling for all firms still selling single premium PPI with unsecured personal loans to withdraw the product; and a package of measures relating to PPI complaints<sup>21</sup>. Additional measures relating to complaints and sales practices followed just under a year later<sup>22</sup>. The FSA successfully contested a subsequent judicial review by the British Bankers' Association on the new PPI complaints handling measures and until 2011 the FSA's focus remained primarily on complaints handling and securing redress for consumers who had been mis-sold PPI.<sup>23</sup>

### **Critical illness cover**

In 2006 the FSA also undertook a thematic review of the sales of critical illness cover<sup>24</sup>. It involved 42 firms, mainly mortgage and financial advisers, but also included banks, building societies and insurers. Interviews were carried out with members of senior management, compliance and sales staff and customer files (sales, complaints and refused claims) were reviewed. The ultimate aim of the review was to assess the potential for detriment to customers buying critical illness cover.

There were some positive findings. But there were a far greater number of negative findings, including:

- Firms often assumed that the product was simple and gave advice accordingly.
- Documentation could be clearer.
- Justification of critical illness sales was poor.
- Insurance regulation had not been a priority for some firms.
- Firms did not do enough to make sure that customers disclosed relevant medical information.
- The relationship between providers and intermediaries did not always work well.

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<sup>18</sup> The Ombudsman was upholding a significant proportion of PPI complaints and additional information was arising from the FSA and the Competition Commission's PPI work. The Ombudsman Service concluded that there were systemic issues in relation to PPI which were causing widespread consumer detriment.

<sup>19</sup> Press Notice FSA/PN/012/2009, 20 January 2009, at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>20</sup> 23 February 2009 at [www.fsa.gov.uk/pubs/ceo/loan\\_ppi.pdf](http://www.fsa.gov.uk/pubs/ceo/loan_ppi.pdf)

<sup>21</sup> Press Notice FSA/PN/129/2009, 29 September 2009 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>22</sup> Press Notice FSA/PN/132/2010, 10 August 2010 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>23</sup> Press Notice FSA/PN/153/2010, 8 October 2010, at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>24</sup> The sale of critical illness cover: results of thematic work, May 2006 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

The FSA did not go on to undertake further work on critical illness cover in particular, other than providing feedback for firms.

## Guidance Consultation

The first major step in the FSA's work on replacement PPI products, and the one on which we have focused our specific attention, was the publication on 1 November 2011 of a Product Risk Report and Guidance Consultation<sup>25</sup> (jointly with the OFT) on payment protection products. It had been produced in the light of work by some firms to develop new forms of protection that aimed to meet similar needs as PPI, and which also posed similar risks to consumers. The message from the FSA was that guidance was needed because "the previous failings identified with PPI must not be repeated."

The Guidance was targeted at both providers and distributors of payment protection products and contained five key messages:

- Poor product design and distribution strategy can lead to unfair consumer outcomes.
- When designing new payment protection products (or reviewing the design and distribution of existing products) firms should ensure they have given due consideration to (i) identifying the target market for the protection, (ii) ensuring that the cover offered meets the needs of that target market, and (iii) ensuring that the product does not create barriers to comparing, exiting or switching cover.
- Firms should be able to demonstrate that they have sound product governance arrangements in place.
- The guidance (once finalised, following consultation) will inform the FSA's supervision of firms that provide or distribute payment protection products.
- The FSA will consider taking action against firms where breaches of the FSA's Principles or other rules are identified.

The OFT's proposed Guidance on payment protection products within OFT remit was included in Annex 2 of the document. We have not commented on the OFT's draft guidance.

## The Panel's perspective on the Guidance (FSA regulated products)

The Panel had raised the issue of risks around replacement PPI insurance with the FSA in the Spring of 2011. In May we were approached by the FSA for input into the development of the Guidance Consultation, which the Panel was pleased to provide. The final, published version recognised much of the Panel's input.

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<sup>25</sup> GC11/26/OFT1385 at [www.fsa.gov.uk/pages/Library/Policy/guidance\\_consultations/index.shtml](http://www.fsa.gov.uk/pages/Library/Policy/guidance_consultations/index.shtml)

The Panel thought the Guidance Consultation important in a number of respects:

- It contained important information for firms that provide<sup>26</sup> or distribute payment protection products
- It was a joint paper between the FSA and OFT, showing a welcome level of regulatory co-operation and recognition that similar products do not necessarily fall neatly into one regulatory remit or another
- It provided an indication of how the future Financial Conduct Authority's 'product intervention' powers might be put into practice.

### ***The draft Guidance***

The FSA draft guidance relates primarily to the FSA Principles for Businesses and a small number of specific rules in the Mortgage and Insurance Conduct of Business Sourcebooks. The OFT guidance takes the form of guidance to consumer credit licence holders and potential applicants; and information on how the OFT interprets the relevant sections of the Consumer Credit Act.

The FSA guidance is structured mainly around four key risks:

- The firm fails to identify the target market or the needs of likely consumers
- The life events covered by the protection are misaligned with the needs of the target market
- The benefit provided by the product in the event of a successful claim is unlikely to meet policyholder needs
- The product features or pricing structures create barriers to comparing, exiting or switching products.

Each risk is described in some detail and there is reference to relevant TCF outcomes, which the FSA describes as central to the delivery of its retail regulatory agenda. This aims to ensure an efficient and effective market and thereby help consumers achieve a fair deal<sup>27</sup>. The FSA devised the six outcomes as an aid for firms on how to treat their customers fairly and to ensure compliance with Principle 6 of the overarching Principles for Business:

- Outcome 1 - Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
- Outcome 2 - Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly

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<sup>26</sup> A "provider" in this context is a firm which develops the specifications of the payment protection product

<sup>27</sup> At [www.fsa.gov.uk](http://www.fsa.gov.uk)

- Outcome 3 - Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
- Outcome 4 - Where customers receive advice, the advice is suitable and takes account of their circumstances
- Outcome 5 - Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect
- Outcome 6 - Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

### *The Panel's response to the draft Guidance*

We agreed with the FSA that, as it said in the Guidance, “the previous failings identified with PPI must not be repeated.” It remained to be seen whether the final Guidance will play an important part in achieving that aim, but we saw it as a positive step. We supported the inclusive process of stakeholder engagement that the FSA put in place to enhance this particular consultation process.

Although the Panel did not comment on the OFT Guidance within the Paper, given the overlap between the products it was clear that consumer interests would be best served by continued constructive co-ordinated working by the FSA and OFT in this area. More detailed consideration would need to be given to how this will work once the OFT is replaced by the Consumer Protection and Markets Authority (CPMA).

The Panel was concerned that there may be a need for prescriptive rules to be put in place to protect consumers in the payment protection market, rather than Guidance. We were also disappointed that the guidance talked only in terms of ‘consideration’ of enforcement action in cases of breaches of the Principles/rules on which guidance has been provided. This seemed too tentative. We believed the FSA should be saying that once the guidance is in place there are no more excuses for non-compliance, and that breaches will be vigorously pursued.

We supported the use of a tailored consumer communications programme to deliver key messages about protection products and we were pleased to have been able to contribute to the development of this work, which was undertaken as a separate work stream. A targeted communications strategy, reminding consumers of both the benefits of protection and some of the pitfalls they need to bear in mind, would benefit both consumers and industry alike.

We were supportive of the overall content and format of the Guidance Consultation, with the guidance itself set out around clear messages, TCF outcomes and the identification of key risks. We would like to have seen



more emphasis on the need for consideration to be given at the time of contract renewal to any limitations or exclusions on cover that might begin to 'bite' from that point. It is easy for both firms and policyholders to lose sight of this risk once the initial decision to buy the policy has been taken.

Given the scale of the PPI mis-selling scandal we would have liked to have seen greater emphasis in the draft guidance on the risks presented by certain types of reward strategy, illustrated by specific examples. This would link in with the FSA's work on reward strategy, which was the subject of the case study in section 3 of this report.

We have asked the FSA to undertake a review of the effectiveness of the guidance in 2013, or at an earlier stage if there is an unexpected rise in the number of policies being written or the products become a disproportionately significant source of revenue, as was the case with PPI.

The Panel understands from the FSA that the final version of the Guidance will not be published until the second quarter of 2012.

## Conclusions

With each of the case studies, we have set out to address, so far as possible, a number of key questions in order to make an objective assessment of the effectiveness of the FSA's conduct regulation:

### ***Did the FSA know about the risk before it crystallised and did it act appropriately?***

When the FSA took over regulatory responsibility for general insurance in 2005 it announced that priority would be given to a thematic investigation into sales of payment protection insurance. That was because the regulator was already aware of well-documented risks within the market. It is clear from the FSA's extensive thematic work that the focus was almost exclusively selling processes and, latterly, complaints handling by firms. It appears therefore that the FSA's attention did not shift to payment protection product design and development until 2010/2011.

By the time that the FSA began working on its draft guidance on replacement PPI products therefore the risks would have been self evident from regulatory work going back some six or seven years, supported by information within publications such as the Citizens Advice Bureau "Protection Racket" Report referred to earlier, and the Office of Fair Trading's response to their super-complaint. As the draft guidance has not yet been finalised and published we do not know whether the guidance will be effective or whether, for example, prescriptive rules will be required.

We are pleased that the FSA and OFT worked together to produce the joint document, but we are not sure if the time needed for discussion and co-ordination and/or the process of enhanced stakeholder engagement added significantly to the development of the document. We are conscious that it took many months (at least six) for the Guidance to come to fruition and would

have liked to have seen this important document published earlier, without there having to be a trade-off with the inclusive approach that had been adopted.

In the future we expect the FCA, through its proactive and interventionist approach, will be able to tackle this type of consumer detriment much earlier. In particular, we believe this is a good example of when the FCA would have deployed its product intervention powers to prevent widespread mis-selling and consumer detriment from occurring.

### ***How was the risk prioritised?***

The FSA's approach to risk identification is always evolving and of course has been the subject of review and modification in the light of the restructuring of the FSA into an "internal twin peaks" model ahead of the forthcoming statutory split of financial services regulation between the FCA and the PRA.

As the Guidance Consultation itself says, the product risk report is an example of intervention by the regulator earlier in the product life-cycle. This is an approach we strongly support and which we believe must be an integral part of the FCA's approach. The fact remains however that concerns about the sale of Payment Protection Insurance and the products themselves, have been in the public domain for many years. The "Protection Racket" report by Citizens Advice Bureau referred to exclusion clauses and administrative barriers to claims and in 2005, Clive Briault – Managing Director for Retail Markets at the time – commented that<sup>28</sup> "When properly structured, explained and sold, payment protection insurance can provide worthwhile cover for consumers against unexpected changes in their personal circumstances." The clear implication was that payment protection products were not always properly structured at that time. It is worth noting that in the same press release Clive Briault also said that "The level and structure of inducements and targets for sales staff could encourage mis-selling in some firms."

We do not dispute the need to commit FSA resources to stopping PPI mis-selling and resolving the issues around PPI complaints handling, but we are still concerned that the FSA was not swifter to act to clamp down on detriment that was arising at the product design and development stage. It is essential for the FCA to learn from these past mistakes and ensure that it is able to deploy its regulatory powers more quickly to tackle failures in the product design and development phase.

### ***Does the FSA know whether firms have complied with particular principles and rules? Has it undertaken firm-specific conduct supervision, or thematic work across the sector? Was that work representative of the sector and did it capture the extent of the issue/problem?***

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<sup>28</sup> Press Notice FSA/PN/115/2005 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

In March 2010, the FSA launched its enhanced Consumer Protection Strategy<sup>29</sup>. This articulated a more proactive approach to regulating firms' conduct towards their retail customers. Amongst other things the FSA's strategy included an increased focus on product intervention, which was discussed in greater detail in the FSA's Product Intervention Discussion Paper<sup>30</sup>. Within the context of this strategy protection products and possible PPI replacement products were identified as a "potential risk"<sup>31</sup> in the FSA's February 2011 Retail Conduct Risk Outlook<sup>32</sup> and reference is made to the FSA's work with the OFT that resulted in the publication of the draft Guidance.

The Guidance Consultation document was built around a product risk report which identified four key risks and provided information to firms about how to address each risk, together with links between the guidance to TCF outcomes. The FSA does not however provide details of the work it has undertaken in order to identify the key risks, nor has the regulator commissioned any consumer research to assess the consumer experience of payment protection products – including any difficulties around claims and exclusions - other than mis-sold PPI.

Bearing in mind however the high profile risks involved in this market – also recognised in the FSA's Retail Conduct Risk Outlook – we understand that the FSA has undertaken extensive supervisory work in this area across relevant firms. Firms across most sectors are active in the provision and/or sale of payment protection products and the draft guidance is clearly aimed at all firms. Future work will however have to continue on this cross-sector basis

### ***Has the FSA's conduct regulation policy and process achieved the specific objective it set out to tackle?***

The impact of the final Guidance will not be known until the end of 2012 or early 2013. We have already expressed disappointment at the tentative nature of the approach to enforcement within the Guidance Consultation, and hope that this will be firmed up in the final Guidance. Given that firms will shortly have clear guidance on their responsibilities and appropriate TCF outcomes, we think the FSA should be prepared to take immediate and robust action against firm failure in this area.

In our response to the Guidance Consultation we also called for a review of the effectiveness of the Guidance in 2013, or earlier if circumstances demand. It is important that the FSA monitors the 'life cycle' of payment protection products if it is to be in a position to act to stop further consumer detriment. We aim to continue our dialogue with the FSA over the coming year and to publish the second stage of this case study in 2013.

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<sup>29</sup> Hector Sants, Chief Executive of the FSA outlined the FSA's new Consumer Protection Strategy in his speech at the annual Lubbock Lecture at Oxford University's Saïd Business School. See <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/044.shtml>

<sup>30</sup> DP11/1, January 2011, at [www.fsa.gov.uk](http://www.fsa.gov.uk). The Panel's response is at [www.fs-cp.org.uk](http://www.fs-cp.org.uk)

<sup>31</sup> Defined by the FSA as either risks that its supervisory work suggests are already present at an early stage of development, or risks that the FSA might expect to develop given its assessment of how firms and consumers may respond to the environment

<sup>32</sup> Retail Conduct Risk Outlook 2011 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

***What has been the consumer experience in this area? To what extent is that directly related to FSA conduct supervision?***

The consumer experience of mis-selling – and being unable to claim against policies - is well-documented. This experience is directly related to FSA conduct supervision, mainly in terms of TCF and requirements around issues such as suitability and product disclosure.

Payment protection products are an important means by which consumers can take steps to protect their financial interests in times of need and we are pleased to see that, despite all the fallout from the PPI mis-selling scandal, these products are still being developed and purchased. But we think that the FSA needs to actively monitor the market to ensure consumers continue to have access to suitable products that meet their needs. For example, it is essential for the FSA – and FCA – to be alert to market developments such as a trend towards the development of bundled products, such as packaged bank accounts, rather than more flexible products with a menu or ‘pick and mix’ type set of options from which consumers can make reasonable choices.

***On the basis of the FCA approach document and subsequent publications, would the FCA have dealt more effectively with the particular issue? To what extent would consumers have benefited from that different approach?***

The FCA’s approach to conduct regulation sets out to be more intrusive and interventionist than that of the FSA. The FCA aspires to be proactive, identifying underlying issues by extensive root cause analysis and in the case of product intervention in particular, acting earlier to prevent consumer detriment, rather than remedying it.

To deliver this, the Panel believes there will need to be a significant cultural shift within the conduct regulator. We are closely engaged with the FSA in work related to the transition to the FCA, and we recognise that ‘soft’ issues such as culture are more difficult to change than more procedural matters. The confidence and willingness of individuals to exercise their judgment and take bold decisions cannot be built overnight, but it will need to be achieved quickly if the FCA is to be effective from the outset. As Martin Wheatley said in his BBA speech<sup>33</sup> “Our culture will be to ask the difficult question, the ones that sometimes regulators have shied away from ... We’ll be looking to see if the basic rights for all consumers ... are being fulfilled in reality.”

To deliver this, it is imperative that robust targeted frameworks are established so potential issues can be brought to FCA management attention, prioritised and action taken quickly.

On the more practical side, there are few public indications of the FCA’s risk appetite, which would provide a much-needed context to the more dynamic overall approach that is being discussed. The Panel recognises that it is not

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<sup>33</sup> Speech by Martin Wheatley at the BBA on 25 January

appropriate for the FCA to operate a zero failure regime. However, the FCA must ensure its intelligence and risk analysis team has the necessary skills and access to all the right information to provide the insight to empower the organisation to deliver its interventionist approach. We therefore consider it essential for the team, and necessary resources, to be in place in good time before the FCA is formally established.

Monitoring profitability of retail product lines should be a central role for the FCA's new intelligence and analysis unit. Where this intelligence indicates that a single product line generates a disproportionate share of a provider or distributor's profits, as was the case with PPI, this should trigger an intervention alert.

For the FCA to address mis-selling issues much earlier, and before widespread consumer detriment has occurred, it will also need to make a more subjective judgement about when to intervene. In the past the FSA has waited to gather evidence through thematic work before taking action. Clearly this is important, but the success of early and proactive intervention relies on the willingness of the FCA to adopt a judgement-based approach. This is central to building consumer trust and confidence in the financial sector.

The Panel believes the FCA should have looked more closely at payment protection products at an earlier stage than the FSA, and at the effectiveness of firms' policies and procedures for product design and development.

### **Summary**

We support the action the FSA has taken on PPI replacement products, including working alongside the OFT. We have considerable concerns over the length of time taken to draft the proposed guidance, its publication and then finalisation. Added to that, the FSA (Clive Briault) indicated publicly, as long ago as 2005, that some payment protection products were not "structured" in an appropriate way. It is clear to us therefore that the FCA must be ready and willing to act earlier to prevent any repeat of the widespread consumer detriment we witnessed with PPI

## Section 2: Packaged bank accounts

### What are packaged bank accounts?

Packaged accounts are fee-bearing current bank accounts bundled with a number of other products, such as travel insurance and other options and facilities described as customer benefits. Packaged general insurance policies tend to be monthly rolling contracts without an annual review, and are not individually underwritten.

Typically the package would include preferential credit rates alongside other options. Generally packaged accounts are more likely to be offered to customers than chosen by them spontaneously – they are sold rather than bought.

### The market

#### *Sales of packaged accounts*

A report by Mintel<sup>34</sup> shows that there were 8.5mn packaged accounts in 2009. More recent information obtained by the FSA from firms<sup>35</sup> suggests that in January 2010 this had risen to approximately 10mn. The range of different packages available has almost doubled in the four years to 2010. For example, Lloyds TSB is said to offer four different packaged accounts, priced at between £7.95 and £25 a month.

A report in the Guardian on 12 June 2010, using information from Defaqto, said that there were 64 different packaged bank accounts on the market at that stage, compared with 33 in June 2006, typically charging a monthly fee ranging from £5 (Barclays Current Account Plus) to £25 (Lloyds TSB Premier), although customers could pay as much as £40 a month for, for example, Lloyds TSB's Mayfair Banking Service. At that point around 7 million consumers had a packaged account.

More recently, according to the FSA's 2011 Retail Conduct Risk Outlook, the volume of packaged current accounts has "grown sharply in recent years" (between 2006 and 2010) and they have been sold across all age groups, income brackets and socio-economic groups. The FSA estimates<sup>36</sup> that approximately one in five members of the UK adult population has a packaged bank account. However, despite consumers paying a monthly fee to access a package of additional insurance policies, such as travel insurance or breakdown cover, independent research shows a significant number of consumers do not use these policies<sup>37</sup>.

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<sup>34</sup> Mintel Current, Packaged and Premium Accounts, Finance Intelligence, June 2010

<sup>35</sup> CP11/20 packaged bank accounts at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>36</sup> CP11/20 packaged bank accounts at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>37</sup> See <http://www.which.co.uk/money/bank-accounts/guides/finding-the-right-bank-account/should-i-pay-a-fee-for-my-bank-account>

Different data sources consistently indicate that the growth in packaged account sales and choices between various options on offer, seems likely to continue.

## Regulation

The FSA took on regulatory responsibility for general insurance business on 14 January 2005 and applied a regulatory framework mainly through the Insurance Conduct of Business Sourcebook (ICOB). Until then the general insurance sector had been subject to a degree of voluntary regulation by the General Insurance Standards Council and compliance with various industry codes of practice.

The overall objectives of the ICOB regime<sup>38</sup> were to ensure:

- Consumers buying insurance on a non-advised basis received adequate information to make an informed decision, and firms selling the insurance did not make inappropriate sales.
- Consumers buying insurance on an advised basis were recommended suitable policies that met their demands and needs.
- Consumers understand the key features of a policy, including significant exclusions, and the status of the service before buying.
- Consumers claiming on their insurance policies had their claims dealt with promptly and fairly.

In 2006 the FSA began a review of ICOB to test how effectively the objectives set out above had been achieved. An Interim Report was published in 2007 and concluded that:

“For commoditised, general insurance products, the results suggest that these markets work reasonably well in the interests of consumers. We are not suggesting there are no problems for consumers in these markets. However, the results lead us to question whether some of the detailed rules and guidance are proportionate to the limited risk of detriment that consumers of these products face. One interesting finding that highlights this issue is about how consumers use written information for these products. Even though most consumers do not read the written information that we require firms to give them when purchasing general insurance products, there was little evidence of consumer detriment and most consumers ended up with broadly suitable insurance cover. This makes us question whether we need our detailed rules on this or whether we should target our efforts at encouraging consumers to read information that is more likely to have a significant impact on them.”

But importantly the Review does not appear to have covered general insurance policies sold with packaged bank accounts.

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<sup>38</sup> According to FSA ICOB Review Interim Report March 2007 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

In the wake of the Interim Report the FSA went on to revise ICOB, which was in fact replaced by “ICOBS” from 6 January 2008. In accordance with standard regulatory practice, a post implementation review of ICOBS was carried out and a Report published in 2010<sup>39</sup>. The report noted:

“parallel with the post-implementation review, we also took into account developments in how general insurance products are distributed since the ICOB review in 2006. Such changes in distribution models involve a range of different risks to those on which we based the ICOB review; this has caused concerns about particular market segments.

Two examples are the growth in the number and popularity of aggregator/comparison websites, and general insurance policies sold as part of packaged bank accounts.

So, although we focused on three key areas in the post-implementation review (product disclosure, claims handling and status disclosure), which we examined in the context of the home and motor insurance markets, we decided that in addition to our post-implementation review, we should examine whether our current policy is appropriate given other market developments.

General insurance market distribution models constantly change in response to firms’ business strategies, consumer demand, new technology and the economic environment. As regulators we need to keep a watching brief on whether our regulatory framework remains appropriate for its intended market.”

### ***Regulatory action after November 2009***

In November 2009 the FSA began regulating conduct of business by banks and building societies, but at that point the FSA’s financial promotions team already had responsibility for supervising some aspects of a banking firm’s financial promotions. Pre November 2009 the FSA had also provided support to the Banking Code Standards Board (BCSB) and had carried out a number of joint thematic reviews.

It was the BCSB however who “supervised” current accounts, including packaged current accounts, before November 2009. The BCSB’s approach was essentially reactive (to complaints), rather than proactive, although it undertook a series of themed reviews of subscribers’ sales of packaged accounts between 2006 and 2009<sup>40</sup>. Significantly these reviews did not cover the underlying insurance contracts sold with the packaged accounts, as since January 2005 regulatory responsibility for general insurance had rested with the FSA.

At the outset of full conduct of banking business regulation the FSA announced that it would carry out a review of packaged bank accounts “to get

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<sup>39</sup> ICOBS Post implementation review June 2010 at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>40</sup> [www.bankingcode.org.uk](http://www.bankingcode.org.uk)



a better understanding of the product and the market” and by the end of 2009 the FSA had begun reviewing the design, marketing and selling of packaged bank accounts. This involved staff from both the Conduct Risk area of the FSA as well as those involved in monitoring financial promotions. A limited qualitative piece of research was carried out which showed that some packages provided a reasonable product or products and that there was limited evidence of consumer detriment at that stage – although the FSA had concerns about detriment crystallising in future.

The 2011 Retail Conduct Risk Outlook included packaged accounts on a list of potential risks, both in terms of the product itself and as a source of replacement revenue once PPI sales had all but stopped:

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

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

### *Regulatory action in 2011*

The further work referred to in the RCRO comprised a more detailed review of some of the areas where the FSA had become concerned about possible future detriment. The context was important too – it seemed, anecdotally, packaged bank accounts were often being promoted quite heavily and tended to feature significantly in banks’ business plans.

The Panel was briefed at an early stage on the 2011 work and in response we wrote to the FSA team in March setting out a number of concerns around the nature of packaged bank accounts and their impact on competition. The key points were:

- The potential for mis-selling of packaged products, particularly where consumers are unable to compare prices of the separate elements of the product and unable to make an assessment of value.
- The need to monitor incentive structures to ensure that consumer requirements rather than sales rewards drive their promotion.
- The impediments to choice because the costs for separate elements of the product are not broken down, and are not easily ascertained and compared in the financial services market, such as the cost of current accounts.

- The possibility that basic services such as a current account or credit card may be conditional on taking other products as part of a package, effectively restricting access to these services.
- The impact on competition, especially in a market where there is little switching anyway, and packaged products provide the possibility of tying consumers into a fixed term deal.
- The suitability of the ancillary products, eg is the insurance coverage adequate and if not can it be supplemented or does it need to be duplicated?
- Are the ancillary products something the consumer needs, ie are they properly targeted or just a mass sale? Are they used?
- An objective assessment of value for money because consumers' perceptions may not be a guide of embedded value if the product is mis-sold or tied.
- What are the profit margins on PBAs and is this a business model that will deliver profits if free banking ends?

The Panel acknowledged that there were difficulties in ascertaining whether these services were likely to provide good value for consumers, but thought it important for the regulator to identify whether they were actually providing value for money or whether they were products of convenience. The Panel called for further focused consumer research to help to get to the heart of the issue. The Panel also suggested that consideration be given to the following safeguards in relation to the supervision of packaged products:

- A requirement to include a 14 day cooling off period with packaged products akin to the rules for supply of goods/services and credit packages.
- A further requirement for an annual review and a chance to unbundle at this juncture as most insurance contracts are renewable annually and this is the reminder that consumers often use to compare their current deal.
- A requirement to specify the costs of each element of the package and prescription about how these costs are presented, in particular a specification of costs on a monthly and annual basis.

In response, the FSA acknowledged many of the Panel's concerns. The FSA outlined plans to gather more specific evidence on factors arising from the lack of competition in the market by collecting (from early 2012) a range of information from packaged bank account providers about their product range, revenue from packaged accounts and additional data around complaints, switching and insurance claims. The FSA also undertook to explore further the question of transparency.

The FSA's work on packaged bank accounts - including its extensive review of the market – ultimately culminated in the publication of CP11/20\*\*  
Packaged bank accounts – new ICOBS rules for the sale of non-investment insurance contracts in October 2011.<sup>41</sup>

In its consultation paper the FSA set out an overview of the market at that point, saying that packaged bank accounts were generally sold rather than bought, with consumers being offered 'upgrades' or alternatives to the more conventional current account. All the major high street banks offered packaged accounts. The type of insurance policies provided as part of the package were described individually as 'low risk', but when a number of products and services were bundled together consumers might not always receive all the information they needed in order to weigh up whether, individually, the policies met their needs, or if cheaper/better unbundled options were available.

The FSA's headline conclusions from its 2011 review were that:

- There is a place in the market for packaged accounts. Some consumers could get value from the way they are packaged, depending on the features they use.
- Bundling many different products together can make it difficult for consumers to focus on important information when it comes to making informed decisions.
- The level of complexity might also further limit already low switching rates between accounts and providers of packaged bank accounts.

Although ICOBS does cover sales of general insurance products that are sold as part of packaged bank accounts, the FSA now considered the requirements "open to interpretation" in this particular area<sup>42</sup>. Consequently one of the key risks of packaged accounts that had emerged was that consumers might buy policies which were unsuitable, unnecessary or overpriced in a sales environment where the obligations on the sales force were unclear – although importantly the overriding principle of Treating Customers Fairly did apply.

The overall aim of the proposals in CP11/20\*\*\* was therefore to ensure that consumers would be in a position to make an informed decision about policies sold as part of a packaged bank account. In particular, the FSA was looking to limit the risk that consumers relied on one or more of these insurance policies, only to find that they were not able to claim or the policy was otherwise unsuitable.

To achieve these objectives the FSA intended to impose specific requirements on eligibility and suitability when policies were sold as part of a packaged bank account, including requiring banks to complete an eligibility

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<sup>41</sup> CP11/20\*\* at [www.fsa.gov.uk](http://www.fsa.gov.uk)

<sup>42</sup> CP11/20\*\* at [www.fsa.gov.uk](http://www.fsa.gov.uk)

assessment for each customer and each policy and provide customers with annual eligibility statement.

We have been advised that the Payment Services Regulations, which apply to packaged accounts, impose some constraints on the FSA's flexibility in areas such as the information a firm must give to a customer.

## The Panel's perspective on CP11/20

A copy of the Panel's response to CP11/20 is available on the Panel's website<sup>43</sup>. The key issues covered are set out below.

The Panel was supportive of all the work undertaken by the FSA in relation to the packaged account market and its attempts to resolve a number of issues arising from their sale, structure and operation. The Panel's key concerns, taking into account the information available at that time, were:

- the lack of transparency around price;
- the lack of clarity around the level of cover provided by the insurance policies;
- a risk that a consumer's eligibility to claim under an insurance policy only becomes clear at the point they try to make a claim;
- the requirement for some policies to be activated, which is not clear to consumers;
- the potential for mis-selling of packaged products, particularly where sales incentives are not aligned with the best interests of consumers - such as the requirement to take out a packaged account to access other services or preferential rates; and
- the value for money these packaged bank accounts provide for consumers.

Our view was that the new eligibility rules proposed by the FSA could go further to ensure consumers fully understood their eligibility to claim under the different insurance policies. This included requiring both the point-of sale and annual eligibility statements to highlight clearly which policies the consumer would need to activate. We also thought that the annual statement should help consumers understand whether their eligibility to claim under the different insurance policies has changed from one year to the next. This would require firms to tailor, to some degree, the annual statement sent to consumers.

We stressed the importance of increasing the level of price transparency of packaged bank accounts. While we accepted that it may not be appropriate to disclose the cost of the individual policies, in our opinion greater price transparency was needed to help consumers assess whether they were receiving value for money and compare different services. As a minimum, we thought that both the monthly and annual cost of these accounts should be disclosed.

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<sup>43</sup> At [www.fs-cp.org.uk](http://www.fs-cp.org.uk)

We also called on the FSA to conduct consumer research to consider whether packaged bank accounts offered value for money, or whether they were products of convenience. Given the historic and widely acknowledged potential future growth of packaged accounts, we thought it essential for the FSA to ensure the market is working effectively for consumers.

## Conclusions

As with each of the case studies, we have set out to address, so far as possible, a number of key questions:

***Did the FSA know about the risk before it crystallised and did it act appropriately? and***

***How was the risk prioritised? What process did the FSA use and what was the outcome?***

There is no doubt that there has been information in the public domain about potential failures in the packaged bank account market for some time. This includes:

- Research from Which? that considers the value of packaged bank accounts.<sup>44</sup> This analysis found that customers can often get the extra benefits provided by these accounts cheaper elsewhere and some of the 'benefits' are just not very useful.
- A recent survey of Which? members found that 30% had never used any of the benefits offered by their account;
- In 2010 Which? named packaged accounts as one of the top 10 "useless financial products" that most people really don't need.
- In 2010 Which? raised their concerns with the Panel, as part of our work to identify emerging risks. Consumer Focus also raised concerns in the Spring of 2011. These reports were discussed with the FSA, but by that time the FSA had already begun its review of the packaged account market.

The FSA has told us however that there was no evidence of large scale complaints about packaged bank accounts or the products and services provided with them, although the regulator does acknowledge that there was anecdotal evidence of some customers being sold a packaged account when another type of account might have been more appropriate. The FSA did not find evidence of systemic mis-selling or material consumer detriment although it was concerned about potential detriment in the sector.

The FSA's 2010 Financial Risk Outlook also suggested that packaged bank accounts might not be working well for all consumers. The FSA committed to undertaking further work in this area in 2011 and its market failure analysis

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<sup>44</sup> [www.which.co.uk](http://www.which.co.uk)

included in CP11/20 highlighted a number of areas where there was significant scope to improve consumer outcomes, as already indicated. The FSA was therefore clearly well-informed about potential detriment in the packaged bank account market. However, given the FSA's process to implement its recommendations has still to run its full course it has taken an exceptionally long time to achieve any real positive changes for consumers. We understand from the FSA that separately from this process supervisors have also been working with firms generally to improve sales and post-sale practices, and that this will continue.

Given that there has of course been a set of regulatory requirements around sales of general insurance business since 2005 a question which comes to mind is whether the regulator had sufficient information to indicate possible failings in the packaged account market between 2005, 2007 (when a review of ICOB was published) and 2009, when the FSA began regulating retail banking conduct of business. We believe there are indications that sales of insurance policies as part of packaged bank accounts might have been overlooked between 2005 and 2009 because the BCSB was monitoring the bank account element of packaged accounts, leaving the FSA to deal with the associated insurance policies. We accept that at this point it is difficult to look back with any certainty to that period of 'dual regulation' of these products, but we remain concerned that there might have been a lack of cohesion during this time. This is a historical issue in the context of packaged accounts, but is still an important factor in developing a regulatory approach where there is any form of split of regulatory responsibility. It certainly gives the impression that it has taken a long time to implement positive changes for consumers in this regard.

The FSA used its established processes of risk identification and mitigation in arriving at its decision to propose to impose specific requirements on eligibility and suitability when policies were sold as part of a packaged bank account. As we have already said, overall we believe this is the right approach, but it has taken time and there is more that we would like the FSA to do now.

***Does the FSA know whether firms have complied with particular principles and rules? Has it undertaken close firm-specific conduct supervision, or thematic work across the sector? Was that work representative of the sector and did it capture the extent of the issue/problem?***

As we understand it the FSA has conducted a comprehensive review of the sector over a long period. Although the Panel does not have access to firm-specific information, most, if not all, firms offering packaged bank accounts would be subject to the FSA's 'close and continuous' supervisory regime. We think this more firm-focused regulation, coupled with the specific work carried out on the packaged account market as a whole, means that the FSA has an informed and realistic picture of the market from the industry perspective.

***Has the FSA's conduct regulation policy and process achieved the specific objective it set out to tackle?***

We will be considering separately the FSA's response to its consultation exercise, as this does not fall within the scope of the current case study.

***What has been the consumer experience in this area? To what extent is that directly related to FSA conduct supervision?***

The consumer experience of using packaged bank accounts is set out in papers such as the Which? reports and the FSA's own consumer research, the aim of which was to provide an insight into consumer behaviour and experience (but not an assessment of whether the packages contained reasonable products). The consumer experience is strongly linked to the effectiveness of FSA conduct supervision – firms' compliance with FSA requirements is a key issue – but there are also wider factors to be considered, mainly arising from the impact of lack of competition in the sector and issues – perceived or real – around account/policy switching once a consumer is tied in to a packaged account.

***On the basis of the FCA approach document, would the FCA have dealt more effectively with the particular issue? To what extent would consumers have benefited from that different approach?***

Last year's FCA approach document, and subsequent debate, suggests that the FCA intends to adopt a more intrusive and interventionist approach than that of the FSA. To successfully deliver this vision, the FCA will need to take action to correct the market failures significantly quicker than the FSA. Martin Wheatley's speech to the BBA indicates that the FCA will do this<sup>45</sup>: "... building on the steps the FSA has begun taking in the last couple of years, with its staff using their judgements to head off problems early." We feel that in this instance the FSA failed to utilise fully its rules governing the sale of insurance policies to encourage better consumer outcomes in the packaged bank account market even though it initially did not have responsibility for regulating retail banking activities.

Under the Financial Services Bill, as currently drafted, the FCA will have a competition objective to promote effective competition in the interests of consumers. The Panel firmly believes that competitive forces in the personal current account are not effective, which is leading to consumer detriment.<sup>46</sup> These failures apply more strongly to packaged bank accounts, which are difficult to compare and make it less likely that consumers will consider shopping around. The Panel believes the FCA should consider these failures in the light of its competition objective and powers.

We would also expect the FCA to have a better understanding of the reward structures employed by firms selling packaged bank accounts. Martin Wheatley's BBA speech<sup>47</sup> boldly said that "the FCA is going to put at its core a much better way of protecting consumers and making sure they get a fair

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<sup>45</sup> Speech by Martin Wheatley at the BBA on 25 January

<sup>46</sup> Please see the Financial Services Consumer Panel's Better Banking Position Paper, *March 2012*

<sup>47</sup> *ibid*

deal.” To ensure products are sold appropriately, it is critical that the consumer requirements rather than sales rewards drive their promotion.

Likewise, it is important for the FCA to monitor the profit margins associated with these products to ensure packaged bank accounts are not being unfairly sold by banks as a revenue replacement for PPI. Indeed, the Panel understands that the FSA does not currently collect any data about the revenue and margins generated by these accounts. The FSA’s thematic work on incentives and rewards – covered in Section 3 below – looked at sales practices across a range of product types and taking better account of the practices being employed with regards to packaged accounts would have been helpful to the FSA and is the kind of information which should be better utilised by the FCA.

### *Summary*

We are pleased that the FSA decided to take action to improve consumer outcomes in the packaged account market by proposing specific rules on eligibility and suitability of insurance policies sold as part of the deal. We have some concerns that potential issues for consumers should have been identified and monitored earlier, particularly from 2005 when there may have been some confusion over responsibility for packaged accounts with the BCSB. This of course is largely historical now, but is an issue that could recur whenever there is a switch or sharing of regulatory responsibility. We have been pleased to learn that the FSA will continue to monitor the market with six-monthly surveys to firms alongside its work on improving transparency and routine banking supervision.

There is also a link between the FSA’s packaged accounts work and the reward project, which is the subject of the case study in section 3 of this report. The FSA’s 2011 Retail Conduct Risk Outlook stated that there were risks around packaged accounts as a source of replacement revenue once PPI sales had all but stopped. We think there was an opportunity within the reward project to focus more on sales of packaged accounts as a source of revenue and gain greater insight into this issue.



## **Section 3: The impact of incentives and rewards – FSA thematic work**

### **What is thematic work?**

Thematic work is one regulatory approach used by the FSA to supervise regulated firms. It involves analysing a particular product, market or practice to see if there are wide-scale issues that require regulatory action. Thematic work helps to identify the scale and nature of risks that might exist and provides an evidence base on which the FSA can decide what needs to be done, if anything, to address non-compliance or other potential or crystallised consumer detriment. It is also a useful means of engaging directly with firms to learn more about their approach and business operations, and to identify particular risks.

### **What is the Panel's case study about?**

This case study focuses on a specific piece of thematic work carried out by the FSA into the impact of financial incentives and rewards<sup>48</sup> for in-house sales staff. In particular, the FSA wanted to assess whether the incentives used by firms increased the risks of mis-selling to consumers arising and whether such risks were adequately controlled.

The nature of the issues being addressed in the thematic work would inevitably involve an intensive and intrusive approach that would encompass important aspects of a firm's culture – reward is a key driver of business culture. The project would therefore be a useful way for the FSA to hone its tools for assessing culture ahead of the move to the new FCA regulatory approach – one of the specific aims of the project was to develop a reward toolkit for supervisors, although assessing culture would always involve a large degree of judgement. This is an important area for future FCA regulation and therefore of importance to the Panel.

The objective of the Panel's case study is to assess and evaluate the processes used by the FSA to carry out the reward project, and to consider how this issue might be tackled by the FCA in future. In this case study our focus is the 'toolkit' used by the FSA. We have not focused on the findings of the thematic work or the subsequent regulatory response as at the time of preparing this report the FSA had not published their findings.

### **Why did the FSA carry out this work, and how was it done?**

#### ***Why a thematic review of reward?***

The Panel was first briefed on the reward project in October 2010. We were advised that evidence which had already been obtained by the FSA – which would have included the impact of financial incentives to sell PPI, as well as from various individual enforcement cases - suggested that sales staff reward

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<sup>48</sup> Incentives and rewards include salary, bonus, performance measurement and recognition schemes

structures were a high risk area. It was on the basis of this evidence that the FSA decided to review the impact of rewards and incentives by way of a cross-sector thematic project.

The overall context of the project was initially Principle 6<sup>49</sup> of the Principles for Business, Treating Customers Fairly. At the beginning of the project the FSA intended to assess whether firms were compliant with their TCF obligations, as well as with other relevant requirements such as Principle 3<sup>50</sup>. Latterly the FSA's focus shifted more to Principle 3.

The ultimate aim of the work was to reduce the risk to consumers from inappropriate reward practices and to raise standards within firms. The FSA also thought the project might have some useful read-across to other areas, such as the incentivisation of complaints handling staff.

The potential risk posed by reward policies and practices was specifically identified in the FSA's 2010/2011 Retail Conduct Risk Outlook and an overview of the project plan was set out within that document.

### **Scope**

The thematic work was focused on sales and limited to in-house sales staff within firms. A wide range of firms had been selected for review. All had significant in-house sales teams and there was a mix of business models covering insurance, investments, mortgages and banking products. The FSA aimed to visit 25 firms in total (5 as part of the pilot project and then 20 in the main review), and planned to be able to publish its findings by the end of Q2 2011, but this was subsequently delayed by almost twelve months.

By July 2011 the FSA team had assessed 20 firms and aimed to cover four more before the project was concluded. The total number of firms covered by the review eventually totalled 22.

### **Methodology, process and procedure**

The FSA's Supervisory Risk Committee (an executive committee of the FSA Board) approved the reward project plan in June 2010. In accordance with the FSA's internal procedures a project board was established to provide strategic oversight for the project and the board also approved key decisions taken during the course of the work. The project board was made up of members of the FSA's senior management team taken from across the organisation. The working group which supported the team carrying out the thematic review comprised members of staff from the Enforcement, Policy and General Counsel Divisions, aided by a senior adviser.

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<sup>49</sup> There are eleven Principles for Business with which all authorised firms are required to comply and which should underpin the way in which authorised businesses are run. Principle 6 (a firm must pay due regard to the interests of its customers and treat them fairly) is generally known as TCF

<sup>50</sup> A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems. Requirements are amplified by the SYSC (Senior Management Arrangement, System and Controls) section of the Handbook

The FSA team's operational aim was to assess how financial incentives increased the risk of inappropriate sales, and if controls and governance arrangements within individuals firms were adequate to mitigate such risk. The methodology was tested in a pilot phase, which led to some re-focusing of the "touch points" - the FSA's knowledge of the key features in schemes was broadened as was, consequently, the nature and extent of the potential risks of mis-selling to which reward schemes could lead.

The team's understanding of reward risks developed still further during the entirety of the project, leading to additional work and evidence-gathering. For example, this included the significance of conflicts of interest for sales managers whose reward structure was based on the sales results of their teams and who also played a key role in monitoring their teams' business quality. Although the reward project itself is now complete, the FSA intends to undertake a further review of the methodology used in order to streamline and focus further on key risks, issues and indicators as part of the continuing development of the reward toolkit for the FCA.

Members of senior management, such as relational sales managers, were investigated as part of the review and interviews took place with individuals up to the level at which reward policy was approved.

Details of incentive schemes, internal controls and governance were all analysed in great detail by the FSA team. This included reviewing management information; the design and sign-off of sales incentives; on-going risk review; the degree of challenge from firms' internal audit and compliance teams; the impact of supervisor conflicts of interest; marketing campaigns and firms' own use of mystery shopping. In this way the team was able to identify specific areas of risk arising from reward structures and to reach a view on the adequacy of risk mitigation.

The FSA's assessment of risk and mitigation within each firm was then subjected to a moderation (and then cross-moderation) exercise to ensure consistency and to check that the evidence and findings were robust. There was also a series of feedback sessions with individual firms, both verbal and written, at the end of the review.

## Conclusions

We think the development of the toolkit is a major step forward for both FSA and FCA conduct regulation and we would not like to see the toolkit lost or overlooked in the move to the FCA.

With each of the case studies, we have set out to address, so far as possible, a number of key questions in order to make an objective assessment of the effectiveness of the FSA's conduct regulation. As the FSA has not yet published the findings of their thematic review of incentives and rewards it has not been possible to comment on the outcome of this work. We have therefore focused on the FSA's approach.

### ***Did the FSA know about the risk before it crystallised and did it act appropriately?***

When the Panel was first briefed on the project in October 2010 the FSA already had evidence from other work such as enforcement cases that reward structures could increase the risk of poor consumer outcomes, such as mis-selling. The FSA was reasonably confident at that stage however that their action was pre-emptive, rather than a response to existing consumer detriment.

By October 2010 however the FSA would have been well aware of the scale of mis-selling of PPI and the extent to which the profitability of PPI products had been an influencing factor in that mis-selling scandal. While there is a distinction between reward strategies for individual sales staff and profits to a business as a whole, there is also a reasonable link and the impression is that the FSA was not quick enough to act in setting up the reward project.

The regulator will need to undertake further work to establish whether it was as successful as it hoped to be in pre-empting the crystallisation of consumer detriment.

### ***How was the risk prioritised?***

Even without the experience of PPI, on a common sense basis any reward structure for sales staff that is linked to volume or targets could be a source of risk of poor consumer outcomes. The FSA has in place principles and rules aimed at ensuring that firms have systems and controls in place to mitigate these risks – not least TCF – and there has to be some doubt as to whether this important project was adequately prioritised at a strategic level.

The FSA's 2008 Financial Risk Outlook<sup>51</sup> stated "the market oversight within some retail intermediary firms remains inadequate. This can result in a weak control environment and misaligned incentives under which consumer detriment can occur." Of course there have been many demands on FSA resources, but it seems the risk had been identified 3-4 years ago, but did not reach the 'top of the list' very quickly.

### ***Does the FSA know whether firms have complied with particular principles and rules? Has it undertaken firm-specific conduct supervision, or thematic work across the sector? Was that work representative of the sector and did it capture the extent of the issue/problem?***

The findings of the FSA's work have not yet been published and we understand that the regulator is still considering its options in terms of possibly making new rules. Questions must again be asked of the length of time this will have taken since problems were originally identified.

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<sup>51</sup> At [www.fsa.gov.uk/library/corporate/outlook/fro\\_2008.shtml](http://www.fsa.gov.uk/library/corporate/outlook/fro_2008.shtml)

Although the reward project was limited to 22 firms, the FSA has stated clearly that those firms have been taken from all the main retail sectors and that each firm had a significant in-house sales team. We understand that there was a mix of business models amongst the 22 and that they sold one or more key retail products - insurance, investments, mortgages and banking. Generally the Panel does not have access to firm-specific information, so we expect to see reports of any enforcement action taken against individual firms some time after the review findings have been published.

There is a link between the reward project and the FSA's work on packaged accounts, which is covered in section 2 of this case study report. The FSA's 2011 Retail Conduct Risk Outlook identified issues around packaged bank accounts as a source of revenue after income from PPI sales dried up. There could have been greater use made of the reward project to probe this suggestion deeper as we do not feel this was taken into consideration as part of the packaged bank account work.

***Has the FSA's conduct regulation policy and process achieved the specific objective it set out to tackle?***

The main aim of the project team was to assess how financial incentives increased the risk of inappropriate sales, and if controls and governance arrangements within individuals firms were adequate to mitigate such risk. Again, to a degree this is dependent on the outcome but we were pleased to see that the FSA was happy to look critically at the pilot phase of the project and to continue developing methodology and thinking behind the project up until the conclusion of the work. We understand that the FSA intends to undertake a further review of the methodology used as part of the continuing development of the reward toolkit for the FCA. This suggests that considerable progress has been made towards achieving the FSA's secondary objective – that of developing a reward toolkit for supervisors. We believe that this is a crucial and necessary addition to the range of options available to supervisors as the FCA is created.

***What has been the consumer experience in this area? To what extent is that directly related to FSA conduct supervision?***

On the basis of PPI alone, consumers have suffered detriment through mis-selling driven by volume/sales reward structures. As the FSA team stated when they came to see the Panel in 2010 however, it would be difficult to capture the consumer experience as influenced by reward strategies as mystery shopping alone does not always provide the necessary evidence. What is clear however is that the FSA's conduct regulation is a key determining factor in consumer outcomes. If firms are not exercising adequate controls and other risk mitigation tools, there is almost certain to be an adverse impact on consumer interests.

***On the basis of the FCA approach document and subsequent publications, would the FCA have dealt more effectively with the particular issue? To what extent would consumers have benefited from that different approach?***

The FCA is aiming for a more proactive, pre-emptive approach to conduct regulation with a 'lower' risk tolerance. It is essential that this leads to more prompt action as the FSA has taken considerable time to identify the likely risk arising from firms' incentive structures and develop a strategy to mitigate these risks. While we recognise that some of the delay was outside the control of the FSA, due to wider European developments, this project was initiated in late 2010 yet the findings and mitigating action had not been published in June 2012.

We would also expect the FCA to apply the lessons learnt through this work to other priority areas. The FSA acknowledged at an early stage that the rewards project could have read across to complaints handling procedures. The Panel strongly supports this intention and would like to see this pursued soon. However, it is important that the findings are communicated appropriately throughout the FCA so this can be applied more widely. In particular, we believe this could, and should, have an influence on the work to correct failures in the packaged bank account market.

The Panel believes the FSA, through their work on rewards and incentives, has developed a useful supervisory toolkit which should help the FCA deliver their aim to be a proactive and intrusive regulator. It is important for the FCA to continually develop this toolkit based on its day-to-day experience of supervising firms.

### **Summary**

We are supportive of this work stream and believe it has been productive and informative. The toolkit used by the team seems to be subject to continuous development with the aim of making it more effective for the future. This is a positive approach from the team and again we are strongly supportive of this.

We do however have considerable concerns about the total length of time taken from inception of the work to completion. This is due in part to elements of the work being driven by policy-makers within Europe and also the time taken to secure and plan an appropriate spread of firms from across all sectors. We accept that the FSA has a difficult balancing act to perform in being swift to act and the need to take account of developments elsewhere, but overall we would have liked to have seen the project commenced and concluded more quickly than has proved to be the case.