Product Intervention in Financial Regulation: Keeping the Customer’s Interests at Heart

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Summary

• UK financial conduct regulation has undergone a profound and permanent change. Too much of what came before in regulation was unable to meet real world challenges. Not just the prudential challenges – issues over gearing, liquidity and capital – but also conduct challenges.

• Firms can expect the FCA to intervene earlier, and more intrusively, to address threats to consumers. It will use this advance all three of the FCA’s objectives, and step in earlier when it identifies the risk of harm to consumers, to competition or to the integrity of the market.

• And to achieve this, the FCA has developed a new approach to product intervention. It has developed a range of tools which it will use to ensure firms develop products that are right for their consumers, and which allow it to directly intervene where it sees potentially harmful products.

• Providers can expect more challenges on areas like value-for-money and on the design of charging structures, and how sales staff are remunerated. Overall, supervisors will be making sure that firms place the consumer’s best interests at the centre of every stage of product design and marketing.

• The prize is clear. Firms with good product governance are likely to see a reduced risk of other interventions such as product bans. If governance is weak, consumers can be harmed even by superficially innocuous products.

• The FCA has already used this approach on products it considered unacceptably risky. In November 2011, the FSA consulted on guidance for UK distributors that restricted traded life policy investments (TLPIs) for many UK retail investors. In June 2013, the FCA made rules prohibiting the promotion of some Unregulated Collective Investment Schemes (UCIS) to ordinary retail customers.
CII Introduction: a major feature of the new Financial Conduct Authority’s approach to regulating financial markets will be the body’s plan for product intervention. Since the body came into being in April this year, and started to set out how this approach would look in its Business Plan, there has been much debate about how this complex activity will work in practice. In this Thinkpiece, FCA Policy, Risk and Research Division director Christopher Woolard provides some insight on this potentially complex area, and more importantly sets out the thinking behind the regulator’s strategy.

Introduction: the history of the future

In 1875, economist Alfred Marshall embarked on a grand tour of the United States to see, in his words: ‘the history of the future’.

For those looking to understand how the modern regulatory world will unfurl in the years ahead, Marshall’s rationale for visiting America provides a useful starting point.

By looking backwards – by unpicking the causes of the economic crisis and various financial scandals – we can better appreciate why regulation in the UK has changed so profoundly.

The truth is too much of what came before in regulation was unable to meet real world challenges. Not just the prudential challenges – issues over gearing, liquidity and capital – but also conduct challenges. The headline grabbers like miss-selling, poor products, information asymmetries and irrational (in the classical economic sense of the word) consumer behaviour.

We think we can better achieve our objectives by acting earlier where we see risks, rather than compensating consumers after the event for any harm that they suffer.

This means that the FCA will address problems when we see them in the design and marketing of products, rather than just at the point of sale. To make sure that our new strategy succeeds, we’ve developed a new approach to product intervention.

Our early intervention philosophy

In the past, the FSA’s focus was on advice, distribution and disclosure. FSA rules concentrated on making sure that firms’ sales were of an appropriate standard. Where there were breaches of the rules, the FSA punished firms with fines and made them provide redress to customers.

This approach was used in the FSA response to a great number of problems, including PPI, Mortgage endowments, structured Capital-at Risk Products, and self-certificated mortgages.

Consumers don’t exhibit the kind of perfectly rational behaviour that they do in economic models. They might not have access to all the information that providers do, or be able to accurately assess the risk posed by certain products

However, over time it became clear that bad product design and not just bad sales practice can result in harm to customers. Because fundamental aspects of product design can make markets work badly for consumers, an exclusive focus on distribution could be insufficient.

One reason for this is that in real life consumers don’t exhibit the kind of perfectly rational behaviour that they do in economic models. They might not have access to all the information that providers do, or be able to accurately assess the risk posed by certain
products. Our recent paper on behavioural economics shows how we will use this knowledge in order to make our policy-making more effective.

Similarly, behaviour by firms – either deliberate or unwitting – might exacerbate these problems:

- We know some firms could design products to meet the needs of intermediaries rather than the end users, which can result in retail customers bearing an excessive amount of risk;
- they might sell mass market products that are so complex that neither customers nor intermediaries can properly understand the risks (as we saw with some unregulated collective investment schemes); and
- they might produce products that have such large fees attached, or are so unlikely to pay out on any claim, that customers would be better off buying almost any other product, or no product at all.

Armed with these insights, we developed an early intervention strategy, which we will use to advance all three of the FCA’s objectives. We will step in earlier when we identify the risk of harm to consumers, to competition or to the integrity of the market.

By intervening earlier, we will stop bad products from reaching the consumer, and possibly requiring time-consuming and wasteful redress processes. Our aim is to give customers the best chance of signing the right contract – whether this means intervening before products reach the market, or altering (or even banning) products that are already on the market.

How FCA intervention will help customers make the right choices

The FCA will use our new approach to ensure good outcomes for consumers throughout the life cycle of a product.

The first tool we will use is our new supervisory approach to product governance. This is already a key element of our new approach to supervision. Our supervisors will be making sure that firms place the consumer’s best interests at the centre of every stage of product design and marketing.

Providers can expect more challenges on areas like value-for-money and on the design of charging structures, and how sales staff are remunerated

Our supervisory approach to product governance will examine a firm’s strategy for bringing products to market. It will encompass product design itself, and how the firm establishes a target market for the product and selects routes to market (such as which intermediaries to use). And it doesn’t stop at product launch. We will also look at how firms review their products to make sure that in practice they aren’t reaching the wrong customers.

In some areas, FCA supervisors will be looking harder than previously. Providers can expect more challenges on areas like value-for-money and on the design of charging structures, and how sales staff are remunerated. The central question supervisors will ask will be whether the firm places the interests of consumers at the heart of how it is run.

Addressing poor behaviour at the product design stage has many advantages, for the regulator, for firms, and most importantly for consumers. The FCA will prevent harm to consumers before it has the chance to occur; firms will face fewer challenges later in the lifecycle of a product; and consumers will have greater confidence that they are buying the right products.

The prize is clear. Firms with good product governance are likely to see a reduced risk of other interventions like product bans. If governance is weak, consumers can be harmed even by superficially innocuous products (as we saw with PPI).

Where necessary, the FCA will also use product intervention rules. In 2011, the FSA introduced a range of specific rules that we may make to address issues with certain products or types of products. These interventions include issuing warnings about
risky products, banning or mandating certain features, restricting sales or marketing to certain groups of consumers, and for the most extreme cases, the possibility of outright product bans.

In the past, our ability to make product intervention rules has been characterised as a ‘product banning power’, but the range of interventions we might use is much wider than this (and not necessarily as severe). We will only consider a total ban if the threat of detriment is so high that we cannot tolerate the product being on the market in any form.

The FCA will also have a new power to make rules before consultation, which will have a maximum duration of up to twelve months. We call these temporary product intervention rules, and the recent Financial Services Act specifically provided for their use. Where we see the kind of threat to consumers which requires prompt action, we will consider the making temporary rules.

The third tool is the existing Conduct of Business rules, which the FCA will continue to use to make sure that firms at the point of sale give the right information to consumers, and at the right time.

Distributors will still be responsible for making sure the product is sold appropriately, so that consumers can make an informed decision about the risk involved in a product before deciding to purchase it. (And it will still be appropriate for the consumer to bear some risks).

Product providers cannot absolve themselves of responsibility for the end consumer. The FCA’s new approach throughout the product lifecycle will ensure that providers should take reasonable action to ensure the customer buys a product that is right for them.

Some things that we are already doing…

Even though the FCA is only a few months old, our new approach is well in place.

We have already used product intervention tools against products which we believe carry unacceptable risks. One such type is unregulated collective investment scheme (UCIS) products. These are complex and potentially risky products which involve investment in often esoteric assets like classic cars, teak farming or overseas property. In June 2013 we made rules, which will be effective from January 2014, prohibiting the promotion of some UCIS products to ordinary retail customers.

The FCA has not imposed a blanket ban on the sale or marketing of UCIS products. Whilst we have acted to protect ordinary retail investors, the products may still be promoted to sophisticated or high net worth customers.

By doing this, we adhere to the FCA’s objective of securing an appropriate degree of consumer protection. The FCA has not imposed a blanket ban on the sale or marketing of these products, but have sought to shield those who may be harmed by them. Whilst we have acted to protect ordinary retail investors, the products may still be promoted to sophisticated or high net worth customers, for whom they are more likely to be suitable.

Previously, in November 2011 the FSA consulted on guidance for UK distributors, in which it was stated that the FSA did not believe that traded life policy investments (TLPIs) are suitable for the majority of UK retail investors. TLPIs are complex and high risk pooled investments into (predominantly US) life assurance policies. Supervisory work demonstrated unsuitable advice in the majority of cases examined, and a series of product failures had led to substantial losses for consumers.
The FSA’s view was that these products should not have been sold to ordinary retail investors, who were unlikely to have the necessary knowledge or experience to understand the product’s risks.

This was a difficult decision, as it impacted existing investors in TLPIs, many of whom sought to redeem their investments, with the result that funds closed to new business and to redemption requests. However, with a risky product still on the market, it was the FSA’s duty to balance the interests of existing and future consumers who might be placed at risk. It took backbone to publish the guidance – but it was the right thing to do to protect consumers.

The FCA will continue to use these tools where we think it is the right course of action to protect consumers and we will also engage with firms wherever possible before making such interventions.

Such interventions are dramatic, but we believe that they were justified. Whilst the FCA will continue to use these tools where we think it is the right course of action to protect consumers, or to advance our competition or market integrity objectives, we will engage with firms wherever possible before making such interventions, and the decision to intervene will be underpinned by robust analysis.

…and some things that we won’t do

We are often asked if our new approach means that the FCA will become a price regulator. The FCA will not set acceptable rates of return for firms as part of our normal work, in the way that a utility regulator (such as OFWAT) might.

We have no intention to rubber-stamp products ahead of launch. To do so is neither desirable nor realistic for a regulator operating in a market this size.

But we will take an interest in price as an indicator of potential competition issues, or as an indication of other issues which may harm consumers. A temporary price cap, for example, might be a useful measure to limit harm to consumers arising from a competition problem, whilst we search for a better long-term solution.

We should be clear that product intervention does not equate to product pre-approval. We will always take an interest in new and innovative products, but we have no intention to rubber-stamp all products ahead of launch. To do so is neither desirable nor realistic for a regulator operating in a market the size of the UK, and could even have undesirable results, such as creating a perception amongst consumers that products and the risks that they carry have been endorsed by the FCA.

Finally, early intervention is not a panacea, and does not mark the start of a zero-failure regime. In pursuit of giving consumers what they want, it is likely that firms will still make mistakes, products will still fail and some consumers will still suffer harm. We recognise this and we will still have some tolerance for risk, although this will be lower than in the past.

Conclusion

We are a new regulator and this is a new approach to regulation- but we strongly believe that it is the right approach. We will not tolerate episodes like we saw with PPI, which cause huge damage consumer confidence and to the industry’s reputation. There is a careful balance to be struck because there will always be a place for products which are innovative but which benefit consumers.

By weeding out the worst products, our new approach will help those consumers can feel confident that the product they buy will bring those benefits.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

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Previous CII Thinkpieces

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Recent articles in the series:


In the months leading up to the implementation of the regulatory reforms to the UK financial advice sector, known as the Retail Distribution Review (RDR), there was much speculation of how firms would respond. Tim Hines and Nick Siddle offer some suggestions on how advice businesses can operate in this new environment.


Much of the debate around the splitting of the old FSA into two had focused on the structural implications of regulation. Richard Hobbs looks at some of the new emerging themes: the new competition powers, the focus on behavioural economics, and the challenge for firms to understand and engage with the new culture rather than merely don compliance helmets.

No.97: Managing the new normal: five facts and five “do’s” and “don’ts” for sustainable underwriting, by Andrew Kendrick (18 June).

There are two things in the insurance industry that seem as reliable as the phases of the moon. One is the inevitability of the insurance cycle. The other is the unwritten rule that CEOs will call, at regular intervals, for underwriting discipline. Given the volatility of industry results, it could be concluded that these exhortations have not been successful. Instead we need to get used to underwriting in a 'new normal'.


A case study of the payment protection insurance experience from the perspective of the consumer group that first published the report that eventually led to the OFT, FSA, Competition Commission and High Court actions. While the current issues in the wider general insurance are nowhere near the scale of PPI, readers should be mindful of that experience, and why consumers had to suffer for so long before the appropriate safeguards were triggered.

No.95: Supporting Strategic Objectives or Another Compliance Exercise? Understanding Corporate Risk Culture in Insurance, by Dr Simon Ashby, Dr Tommaso Palermo and Professor Michael Power (20 May).

Looks at some preliminary findings from a CII member survey, drawing some conclusions regarding cultures and attitudes towards corporate risk management in the insurance sector. It is part of a wider study on risk culture in insurance.

No.94: General Insurance in the Twenty-First Century: Meeting the Challenges, by Robin Spencer (13 May).

An insurer perspective of some of the challenges facing the GI sector. The CEO of Aviva UK starts by acknowledging that the social value of insurance is being lost in the lack of trust. He explains that rising to this will help the industry confront other issues such as emerging technology and dealing with public policy themes such as flood risk, reform to personal motor insurance and fraud.


Stephen Lowe of Just Retirement discusses the results of the UK’s largest research study into consumer attitudes towards housing equity withdrawal and the steps needed to make it a viable option for current and future generations of retirees.
Learning Objectives

Having read this Thinkpiece, readers will be able to:

- Summarise the main thinking behind the new approach to financial regulation and how this came about, particularly the development of the principles of early intervention.
- Better understand how the regulator will apply product intervention in real situations.
- To be able to provide two examples of how product intervention has recently been applied in financial regulation and explain how the new approach differs with how those issues would have been dealt with under the previous regulator.

Reflective Questions

1. Early in the article, the author describes a significant change in the way the regulator is approaching its task. Using some of the materials published on the Financial Conduct Authority website and your own experiences, describe your views on how this relationship has changed. How does this relate to other regulatory policy areas, and explain how this links to the regulator’s broader strategy?

2. The author describes the various forms that product intervention could take in practice, including a new supervisory approach that looks at how the product is designed to meet the needs of a range of customers. What are your own experiences in this approach? Do you agree with the author’s views on this?

3. The author provides two recent examples of how product intervention has played a part in recent regulatory decisions. What are your views on the challenges presented by this approach? What other types of products do you think should be subject to a more detailed product intervention regime?

4. If you have not already done so, read Thinkpiece 96 “The great British PPI truth and reconciliation scandal” (http://bit.ly/16P4iAC). We published it to serve as an historical case study of the PPI episode, written by the former Director of Policy at Citizens Advice (the organisation that submitted the Supercomplaint leading to the Competition Commission investigation and subsequent compensation rulings). Taking the information from that article and perhaps combining with your own views, do you think the product intervention strategy described in the present Thinkpiece would have prevented the PPI episode from occurring? Would the regulator have responded more promptly? What do you think would have been the implications for consumer confidence and the reputation of the market as a whole?