House of Commons

Treasury Committee

Financial Services Authority: annual report scrutiny

Oral and written evidence

HC 1594-i & ii

House of Commons

Treasury Committee

Financial Services Authority: annual report scrutiny

Oral and written evidence

Tuesday 10 October 2006

Mr Richard Lambert, Mr Peter Vicary-Smith and Mr Keith Satchell, Retail Financial Services Group
Mr John Howard, Financial Services Consumer Panel
Mr Keith Satchell and Mr Stephen Haddrill, Association of British Insurers

Tuesday 24 October 2006

Sir Callum McCarthy and Mr John Tiner, Financial Services Authority

Ordered by The House of Commons
to be printed 10 and 24 October 2006 and 16 January 2007

HC 1594-i & ii
[Incorporating HC 193, Session 2006–07]
Published on 22 January 2007
by authority of the House of Commons
London: The Stationery Office Limited
£13.00

The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of HM Treasury and its associated public bodies.

Current membership

Rt Hon John McFall MP (*Labour, West Dunbartonshire*) (Chairman)
Mr Colin Breed MP (*Liberal Democrat, South East Cornwall*)
Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Angela Eagle MP (*Labour, Wallasey*)
Mr Michael Fallon MP (*Conservative, Sevenoaks*), (Chairman, Sub-Committee)
Mr David Gauke MP (*Conservative, South West Hertfordshire*)
Ms Sally Keeble MP (*Labour, Northampton North*)
Mr Andrew Love MP (*Labour, Edmonton*)
Kerry McCarthy MP (*Labour, Bristol East*)
Mr George Mudie MP (*Labour, Leeds East*)
Mr Brooks Newmark MP (*Conservative, Braintree*)
John Thurso MP (*Liberal Democrat, Caithness, Sutherland and Easter Ross*)
Mr Mark Todd MP (*Labour, South Derbyshire*)
Peter Viggers MP (*Conservative, Gosport*)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via www.parliament.uk. The Committee has power to appoint a Sub-Committee, which has similar powers to the main Committee, except that it reports to the main Committee, which then reports to the House. All members of the Committee are members of the Sub-Committee, and its Chairman is Mr Michael Fallon.

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) from Session 1997–98 onwards are available on the Internet at www.parliament.uk/parliamentary_committees/treasury_committee

Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk and Clerk of the Sub-Committee), Adam Wales and Aruni Muthumala (Committee Specialists), Lis McCracken (Committee Assistant), Michelle Edney (Secretary), Tes Stranger (Senior Office Clerk) and Laura Humble (Media Officer).

Contacts

All correspondence should be addressed to the Clerk of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk. Media inquiries should be addressed to Laura Humble on 020 7219 2003.

List of witnesses

Tuesday 10 October 2006 *Page*

Tuesday 24 October 2006

List of written evidence

Oral evidence

Taken before the Treasury Committee

on Tuesday 10 October 2006

Members present:

John McFall, in the Chair

Mr Colin Breed	Ms Sally Keeble
Jim Cousins	Mr Andrew Love
Angela Eagle	Kerry McCarthy
Mr Michael Fallon	Mr Brooks Newmark
Mr David Gauke	Mr Mark Todd

Witnesses: **Mr Richard Lambert,** Former Chairman of the Retail Financial Services Group and current Director General of the CBI, **Mr Peter Vicary-Smith,** Chief Executive of *Which?* and RFS Group member and **Mr Keith Satchell,** Chief Executive of Friends Provident, Chairman of the Association of British Insurers and RFS Group member, gave evidence.

Q1 Chairman: Mr Lambert, welcome to the Committee's hearing in advance of the FSA appearing before us on 24 October. Can I, first of all, congratulate you on your new appointment at the CBI and thank you for the work you have undertaken with the Retail Financial Services Group in the past year. Given that this is a State of the Nation address from you, first of all, was it worthwhile establishing this group, because the retail services report the Treasury Committee came out with mentions that there was little dialogue between the industry representatives and the consumer groups; so has the establishment of the group been worthwhile in that respect and maybe in other respects?

Mr Lambert: Thank you, Chairman. May I start by thanking the Committee for having us along. We were very keen to report back to you after a year and let you know how we have got on in our deliberations. I would answer your question in this way: at the end of our first year we asked all members whether they were keen and enthusiastic for the group to continue in existence. We said there was no point in going on if it was not serving some purpose. As you know, all members are senior people in companies or in the consumer groups which they represent—the Treasury and the FSA have important representation on it—and they all said they wanted it to go on; they thought it served a purpose and that it met a need. My sense of it, coming pretty much as a newcomer to this world—and I chaired five meetings and subsequently there has been another meeting which Ron Sandler chaired (and he sends his deep apologies for the fact he cannot make it today)—was that the early meetings were quite stilted, in a way, and conversation did not flow all that freely; but after we got to know each other I felt that we were making real progress; we have had good and lively discussions; and that we were being frank and open with each other in a way that perhaps it had not been easy to do when such a group did not exist. I think you said in your report it was a bit odd that here was a world where people had only spoken to each other through megaphones; I think we have found an alternative to the megaphone approach. Perhaps I might ask my colleagues for their comments on how they see the performance over the last year.

Mr Satchell: I would very much echo what Richard says. I think it is a valuable forum. It is a unique forum; it is the only place where we do all come together—all the various constituent parts who have an interest in the industry—and we sit round the table and talk about things. Obviously, when you do get a bunch of people together who do not know each other very well then those early exchanges are quite stilted, as Richard said; but I certainly have noticed a growing confidence amongst the group. The other benefit I would point up is that, because you do get to know the guys, you do bump into them on the circuit and those private snatches of conversation which go on outside the group I think now go on to a greater extent then perhaps they did before. That is all very valuable in building the relationships. I think the work we have done has contributed to the mission that we set ourselves—which is to contribute towards policy initiatives; to act as an early warning system for any things that might be happening in the marketplace that we do not quite like; and also to promote best practice in the marketplace. I can see those features coming through within the group and wholeheartedly endorse what Richard has said. These are senior people who are at that group; if they did not feel it was of some value then they would not be there.

Mr Vicary-Smith: I would say that for me the most useful aspect has been the chance to put views directly to CEOs of major players. We often have an opportunity to put things through trade bodies and so forth, but speaking directly to the CEOs is a very different business. This is the only forum I am aware of where we can do that to that degree on such a wide range of interests. The other thing that is interesting is, as we have gone through and have perhaps got to trust each other a bit more that things are going to stay discussed within the group, I think there is a

surprising commonality of analysis of the problems and of where we are trying to get to; lots of difference at times about solutions, obviously; but what seems to emerge in a number of areas is much more of a common understanding of where issues are coming up, what problems might be arising in the future and, therefore, a good base for a discussion about how to approach it collectively.

Q2 Chairman: I think it is important to emphasise that CEOs are there. I think that was one of the early recommendations we had, nothing less than that, so if any decisions were made they were made at the top. You have stuck to that over the year, have you not?
Mr Lambert: That is right, yes. The good idea of the Committee's at the start was, although we would persuade the trade associations to fund it, that the people sitting round the table would actually be the chief executives of the companies, the most actively involved in this business.
Chairman: I think the work the Financial Services Authority, the ABI, the British Bankers' Association, the Investment Management Association and *Which?* did, to get the group established, should be recorded as well.

Q3 Ms Keeble: I wanted to ask some questions about equity release. I wonder if you could say, what were the main reasons that led the group to examine that market, and what were the main points of discussions?
Mr Lambert: I was very interested that it was actually both sides of the table who wanted to discuss this question. The consumer groups wanted to discuss it because of their concerns, manifested most obviously in the FSA's mystery shopping exercise in 2005, which rasied some serious questions about the way these products were being sold; but the companies were also very anxious to talk about it as well. I sensed that was because they could see that there were large numbers of citizens who had substantial capital tied up in their homes which, if the right sort of products could be designed for them to capitalise on that, would help them in their older years; but that companies were concerned, rightly so, for their reputation; because here was a product which, in previous guises, had not served the public well at all and companies were anxious, I felt, to get a good idea of what the issues were because at the time there were very few companies selling these products and they wanted to have a better idea of what the issues were before they jumped into the marketplace. That was how we came to talk about it. It was just about the first thing we all agreed to do, and everybody around the table was keen to have that on our agenda.

Q4 Ms Keeble: Can I just ask a bit about advice. There is an issue which the FSA noted about financial advisers encouraging consumers to release more equity than they needed and then reinvest the "spare equity" as it were in different products, thereby getting two lots of commission. That is one issue. The second issue is do you think it is the advice that is a problem or the product design that is a problem?
Mr Lambert: I will start off trying to answer that and then I will ask my expert colleagues to answer. My personal feeling was that the evidence thrown up in that first FSA mystery shopping, which showed that in some cases salespeople were selling a product and then urging the customer reinvest it in another product, was very poor advice. I could not imagine easily circumstances in which that would not be poor advice where, in a sense, double commissions were being taken, and it is a very expensive way of raising money. For me that seemed a clear case in the FSA's judgment that that was not to be encouraged.

Q5 Ms Keeble: Are not some of the products designed inherently risky, and should there not be some regulation around those; or should there not be some tighter pointing towards—
Mr Lambert: If I may say so, that is a slightly different question. Question one was: "How about selling this thing and then reinvesting immediately?" That is what I was commenting about. Before I get completely out of my depth I would just say this: the conclusion we came to was that the problem is about advice; and that these are very complex products which have different impacts on different customers, depending on their age, their total wealth, experience and expectations; and that to sell them you would need to have a very broad understanding of tax structures and of the individual's own position. It is for this reason, as I understand it, that relatively few IFAs are actually selling this product.
Mr Satchell: Just to echo what Richard said, it is around the advice area I think we have the real issue; because it is such a complex personal set of circumstances that you have to deal with. If you take the equity release, it can affect your taxation position; it can affect your interaction with state benefits. So you have a whole range of things which need to be considered when you look at that product and look at the person who is potentially taking the product. As Richard said, it is only a small proportion of advisers who are sufficiently qualified to act in this area. I noted that the Financial Services Skills Council was actually looking at introducing a qualification on this. I think anything that can be done of that nature we would welcome as an industry because we do need to lift the quality and expertise within that area. As to whether the product design can help, yes, it can. I think I would step back from regulating products. We have regulation of sales advice as a regime. I think to regulate both products and sales regime, which we saw for example in stakeholder, tends to then get you into an area where it is just too regulated. We can help as an industry with some best practice guides—we have produced one already as the ABI—but there is definitely a need there for people to turn capital into income. That may mean reinvesting in another product, so again I would not necessarily damn the fact that people reinvest in another product. I think it is the appropriateness of the product that they invest in, and to be absolutely clear about the

rewards for the adviser that that entails. I think that there must be absolute openness in this. Product design has moved on. For example, we now have drawdown equity release so that people can take down tranches which can replicate an income; so this is an evolving area of product design and advice. There is a lot to be done.

Q6 Ms Keeble: Just before Peter comes in, can I just add my final question because this deals in particular with some of the views of consumer groups which would maintain that equity release should be a product of last resort. Is this reasonable given the pressures on pension income and strong rises in house prices? Given the interest in step-up debts, set-down arrangements for share in equity in property, do you think that equity release should perhaps be seen, rather than as an option of last resort, as a reasonable option for people who might otherwise be asset-rich and cash-poor? Where does a balance lie?

Mr Vicary-Smith: Let me roll those two questions together, if I may. I would say that the issue, to my mind, is that there are some poor products, there is some poor advice and there is some poor marketing; and certainly in two of those areas, if not all three, things are getting better than they were a while ago. There have been changes and there has been movement but there are still problems in this marketplace. In terms of the nature of the products (and this deals with your comment about last resort) we have been clear that we feel that home reversion loans are not generally a good deal for consumers because of the poor market value that consumers tend to get for it. Within the lifetime mortgages we have been much more supportive of drawdown mortgages than we have of other types because then you can only pay interest on the amount you need to borrow at any one time. The introduction of that product was an improvement in the marketplace, and that is a comparatively recent phenomenon. I think there are still a lot of products out there. Why we say it is an option of last resort: it can still represent quite bad value for many consumers in many situations; the interest rates can be higher; and there are often early repayment charges. We have one *Which?* member who is paying an 8.1% rate of interest at the moment and has a £27,000 early redemption charge so cannot get out of that to remortgage onto a lower rate. That is an example of where we feel there is bad product design which is putting people in positions where they do not have the flexibility they need later on. I have not looked at the scheme in detail but I understand the Age Concern scheme where the rate of interest charge is, I believe, just above a number of standard variable rates; and I think I am right in saying there is not an early redemption charge. That kind of product design then means it is a product you can use much more flexibly. With most products at the moment, by and large, other forms of borrowing—borrowing from families, looking for local authority help with grants for housing repairs and so on—are better routes to go first before you get into equity release.

Q7 Jim Cousins: One of the things you looked at was the state second pension and advice on whether to opt out of the state second pension. Do you think now there is a reasonable consistency of practice?

Mr Lambert: What we were concerned about was that around the table there was a sense that it was not clear what the Government intended in the contracting out regime; so we asked for clarity on that and then it was dropped. One way or another, the picture was clearer!

Mr Satchell: We did write to the Government because there is a general feeling within the industry that we are not quite clear about the Government's strategy on this; whether the general view is that the Government is encouraging people to opt out or opt in; or what does "neutral" mean?; so the letter went off. I think to some extent we have got clarity through the publication of the White Paper, because in 2012 of course contracting out will be scrapped for those in the defined contribution environment. There is certainly clarity about the figure from 2012. There is a slightly uncomfortable period in the run-up there because of course it is an annual decision that people have to take. I think that is leading companies generally to be rather more cautious as the perception is that the value of the rebates is falling.

Q8 Jim Cousins: As I understand it the concern of the group was not just with what the future Government policy will be—you have made your position clear about that; you think it is going to be more or less resolved by 2012—but at present the state second pension is probably one of the best pension products available to low income earners. There was some concern by your group about the kind of advice that was being given to low income workers about whether or not to stay in the state second pension. Was that an issue that you took up? Is it something that gives you concern? Do you now feel that there is a broad consistency of advice between the various product providers about this issue? I think it is very much a question for you.

Mr Satchell: Absolutely. I think the first thing to say is that most of this business is actually transacted in the independent intermediary marketplace. Your providers can give some form of guidance but we are not directly responsible for—

Q9 Jim Cousins: That is a bit of a cop-out.

Mr Satchell: It is the clarity between what the distributor is responsible for, which is advice to his client, and the guidance which we as companies give. If we feel very strongly about particular issues then we will give really quite strong guidance to customers and to the distributors. There is still, I have to say, a variety of views across providers as to the strategy to take depending on particular ages and how it cuts into the income groups. Generally, providers are now being very cautious about that. If in doubt, generally providers are suggesting that people opt back in or stay opted into the state scheme.

Q10 Jim Cousins: Let me be clear about this. You are saying that the general practice now is not to advise low income earners to opt-out but indeed, where appropriate, to advise people (typically in their 50s going back to work, many of them women) to opt into the state second pension?
Mr Satchell: What I am saying is that the balance is moving that way. For me to generalise right the way across the market is very difficult when it is a distribution issue.

Q11 Jim Cousins: There is no code of practice about this? There is no written guidance to which the Committee could be referred that would inform us about what people actually do?
Mr Satchell: I do not believe that there is a general piece of information that would give and draw all that together across the marketplace.
Mr Lambert: If I could be clear about what the group was concerned about. We were looking forward on this question; we were not looking back in the past. We were saying there was no clear impression from Government as to the basis upon which terms the contracting out should be set. Indeed, over time the indications, according to our members, seemed to be different. Sometimes it would seem to be encouraging contracting out and sometimes not encouraging contracting out. We felt we should write not to discuss the merits of particular alternatives but to say we would like clarity on this policy question, otherwise giving advice was very difficult because you did not have a sense of where you were coming from.

Q12 Jim Cousins: Contracting out rebates at present, the scale of them is roughly (and I do not have the figures in front of me) £10 billion or £11 billion a year. It is not small change; this is a big component of the welfare system that we have.
Mr Lambert: Indeed.

Q13 Jim Cousins: It is important to be clear about whether this huge scale of investment in rebates is good value for money for consumers?
Mr Lambert: That was why we asked for clarity, because our members did not feel they had the basis upon which to give clear advice going forward.

Q14 Angela Eagle: I think some of your answers to those questions have hit on this issue of the business model itself and who is the real customer, which we have often considered in this Committee. In fact, Mr Satchell, you have just illustrated that very well by saying that it was a matter for the distributors when Mr Cousins asked a question not for you as product providers, which might be a cop-out but just demonstrates some of the problems with the business model, with the commission-led model which has been described as "unhealthy" and "harmful" by somebody like Callum McCarthy, who recently said that it is based on commission incentives which produce unattractive results to reputable providers, unattractive to consumers and whose benefits to intermediaries are questionable. When are we going to be able to break the industry out of this unhealthy business model, this commission-based driven model which has created suspicion and worry amongst consumers, and a lack of clarity actually about who your customers are—whether it is the distributor who is on commission or the actual customer whose money is being involved? When can we break free of this rotten business model?
Mr Lambert: If I could explain the role of our group. It is not to redesign business models for the insurance industry, or any other industry; nor is it a regulator, and it has no statutory responsibility.

Q15 Angela Eagle: Have you had any discussions about this?
Mr Lambert: We have had discussions about commissions and you will not be surprised to know we did not come to a clear consensus on the way forward. The ABI has done some good and interesting work on commissions, which it is continuing to do as I understand it; and obviously *Which?* has its own views on these subjects as well.
Chairman: I think it is going to be a question for the ABI when it comes before us this morning.

Q16 Angela Eagle: This is quite frustrating because everybody knows that this is a rotten business market. Every time we ask any group of people—and I absolutely accept your point that you are not prepared to redesign the business, but talking about it is a good start—everybody says, "Oh, it's not us, guv. It's somebody else who has got to do it". When the Government introduces Sandler products to try to at least create a section of the industry that is not run on that model they get throttled.
Mr Lambert: I personally think what the FSA is now doing is interesting. It is, as it were, deconstructing models, as far as I can understand it, with its report on review of retail distribution. I think that will be a very interesting step and will answer some of your questions; and it will also, I expect, show some of the benefits of the current structure as well.
Mr Vicary-Smith: You will not be surprised to know that we share a lot of frustrations about the distorting effect that commission can have within the advice given to consumers. What is interesting in terms of how this group can take forward an issue like that, we have not reached agreement, we are not going to reach agreement but I think we are ready to sit there and have a frank discussion which enables us to put directly to the CEOs responsible for these business models the issues that it creates for ordinary consumers, and have much more of an open discussion than we could possibly have within the pages of a newspaper. That may be a limited benefit but it is *a* benefit. In some areas—like on contracting-out, like on the compensation bill—there are specific routes the group can take as a matter of consensus and write collectively to those who make the decisions and say, "We, across all the different arms of this industry, believe there is a route which collectively should be taken". I think that has a degree of power that it does not, if you like, individually.

Q17 Angela Eagle: It is a kind of very slow, Darwinesque, evolution?
Mr Vicary-Smith: Some things are quick; some things are slow, inevitably.

Q18 Chairman: I think this group was established to foster dialogue in the first instance and then to identify issues with which you could talk to others, for example what Angela is talking about there. Your discussions could feed into the retail distribution review which John Tiner established in June. I think that is a model for this group rather than talking fundamental problems and coming up with answers.
Mr Lambert: That is exactly it. We can find points of consensus and we can find points of disagreement. As long as we are open and frank about where we disagree I think that is fine if we have had a constructive discussion beforehand.

Q19 Mr Breed: I think that clears it up. Quite frankly, the vast majority of people believe that commission-based advice is biased. The people who are actually prepared to go onto a fee-based situation tend to be the high net worth individuals who will be those who understand, and understand the need and everything else. How are we going to get to a system, with so many people who today are under-insured, have not saved, are not putting the greatest priority onto the sort of planning they need, without resorting to a fee-based system which, quite frankly, they will not pay because they do not believe they can afford that sort of money? I think it is so important to the vast majority of people (who are basically under-insured, under-pensioned and under-save at a time of high indebtedness and everything else) and is such an important issue that someone has got to grab it by the throat and you seem to be the people.
Mr Lambert: Our mission is discussion and trying to analyse and identify points of agreement and points of disagreement and, from that, allow others to take things forward.
Mr Satchell: Perhaps I could just make one comment on customers and providers and then run onto advice. If you wish to come back to commission later on then we can do. We are very concerned about customers and we have been treating customers fairly as a high level principle working with the FSA. The ABI has its own 'Customer Impact' scheme which translates some of those things into our own practice. They are accepted at Board level; they run through to product design; they are meant to look at how products interplay with broad bands of customers. My comments really for advisers were down into the individual customer and giving advice there. We do not wish to distance ourselves from *the* customer and the products we provide being generally suitable—far from it. We are all interested in very satisfied customers. It is a great business model. That is where I would be on that. In terms of the advice, yes, we do have to find a way of extending advice into the low to medium income groups. The basic advice regime was designed to go some way to that. Unfortunately, that has been overlayed with a level of FSA regulation, which has taken it out of there.

Q20 Angela Eagle: I do not want to get too involved with this, but the answer is simpler products for lower income people. When the Sandler products were produced they were throttled by the industry.
Mr Lambert: I have been very impressed by the work of a number of trade associations, particularly the ABI. I think the ABI has recognised some of the issues you are talking about. I do think its work on customer impact, its surveying a wide range of clients over a period of time, will show up important and relevant material. I think that is a good start and there are things to be built on around that. I would just like to commend the ABI if I may for the work they have done there—it is a start.

Q21 Mr Love: Last week the *Dispatches* programme and *Channel 4 News* ran an exposé on information leaks in Indian call centres where the personal data of hundreds of thousands of people appeared to be available for sale. Have the Retail Financial Services Group heard about that report; and is it a role that you ought to be undertaking to investigate what has happened here?
Mr Lambert: I personally have not heard of the report, and I would be surprised if it was something we should investigate since we do not have any investigative powers. If there was an issue that there was some systemic failing in the way products were sold and private details collected, if there was a systemic failing that jeopardised consumer confidence then I think that would be something the group might want to consider going forward. We do not have the good fortune of being able to summon witnesses and challenge them, so I would be surprised.
Mr Vicary-Smith: I would agree.
Mr Love: The Information Commission is going to look into this matter based on the evidence provided to them by *Dispatches*; but in their statement over the weekend the Commission said, "If UK companies used an outsource call centre they are required to ensure security was adequate". Is that not something for the group to look at, to see whether its members, the retail, financial services members of the group, have adequate security for the call centres?
Chairman: It is maybe something you could come back to in the second session, but I do not think it is for this group, but perhaps for the ABI themselves.

Q22 Mr Gauke: Can I ask about the meeting on 29 September. I know, Mr Lambert, you had already moved on at that point. I know the group discussed the FSA's Treating Customers Fairly initiative. Can I ask what views were expressed at that meeting and the attitude of the group to this initiative and, more broadly, the movement more towards principles-based regulation, rather than rules-based? What do you see as the particular issues there?

Mr Vicary-Smith: I think the general view around the table was that the concept of moving towards principles-based regulation is a laudable one but that there are enormous difficulties in getting there. In particular, we welcome the work the FSA has been doing in that regard. I think there were two significant concerns that were shared around the group. One is over trying to avoid the expectation that you can do all this very fast; that you can actually say, "We're now going to start treating customers fairly", and within the year therefore it is happening, and therefore you can start dismantling other forms of protection and so on. This is a cultural change, if you like, which will take a long time to run through and therefore ensure that expectations are kept at a sensible level. I think the second thing that struck me was also saying, what is it the industry can actually do in translating the principles into what happens on the doorstep; what happens on the telephone calls? How easy is it going to be for intermediaries and so on to actually be comfortable and confident that they are selling in a way that is compatible with treating customers fairly? There are a lot of issues the industry has on how to actually get best practice and enable it to be implemented correctly. The concept I would say we all felt very comfortable with; but I think there was a lot of concern about how it can actually happen in principle. A lot of work has been going on by the FSA and others to try to ensure those concerns are allayed.

Mr Satchell: I very much agree with Peter on this. It is relatively early days for principles-based. I think the industry can play a part here, and is playing a part, by introducing guides that can sit underneath the principles, such that we can give some guidance to the industry but without stifling innovation. I would absolutely concur with Peter about this being cultural. You need to get this thing right down the organisation for everyone to understand. There is a natural tendency for people to rely on rules. That is true within the regulator, and it is true within companies as well. People like the comfort of rules. It is a big challenge for both the regulator and the industry to make sure we get these things operating really effectively. I can only speak for my own company where we have been doing a lot of work on customer service initiatives for some years now. For us TCF is a natural corollary of what we have been doing and what we will continue to do. You have got to drive it and continue to drive it through the organisation.

Q23 Mr Gauke: To what extent do you think there is a real concern looking at it from the perspective of the regulator, if you like the frontline regulator, that they will want to rely upon rules? The senior management at the FSA will talk about principles-based but it is easier and safer for the frontline regulator to always revert to rules. To what extent do you see that as a real issue? How optimistic are you that the FSA will be able to address that?

Mr Satchell: We see it as a big issue, but I think it is absolutely recognised by John Tiner and Callum McCarthy. They are putting their people through training and development in order to move it that way. We need to do the same on the industry side, and it will take some time to bed down. The other thing that does help in this is the nature of the continuous regulation, the continuous supervision that we get because we are getting feedback on the regulator's view of how we are embedding those principles into the business. That is very, very helpful, so the quality of that feedback is essential.

Mr Lambert: My understanding was that at the end of the discussion you agreed for continuing to take this forward with the FSA and that there would be further discussions going forward, particularly on thinking about how consumer outcomes are measured.

Mr Vicary-Smith: If I could make two other points. You asked about the confidence in the FSA taking this decision forward—one of the things which made us a lot more confident about this actually being instituted, as we said to the FSA and publicly on a number of occasions, is that we do not feel that it helps engender cultural change if those who fall short of the marks are not named. *Which?* has always had a long tradition of naming good and bad practice, and we have found it a very strong vehicle. The lack of naming and shaming on this will actually make the cultural change harder to achieve. The second thing I would like to say is on the issue of enforcement of current regulations. Let us not fall into the trap of feeling that treating customers fairly is moving on from a situation where existing regulations are enforced. Our own mystery shopping exercise a couple of months ago showed that something like half of tied advisers in our mystery shopping exercise were not indicating that they were tied but implying they could shop the whole market, when they cannot. That is a straight breach of the regulations. There is a long way to go in enforcing what is there and getting even that embedded down throughout a massive intermediary community and then there is a cultural change to actually move to principles-based regulation. It is a huge agenda.

Q24 Mr Gauke: Can I just ask one final point on this. From the industry perspective, do you think it would be easier for larger entities to cope with principles-based regulation as opposed to smaller entities, when you have got large compliance departments and access to legal advice and so on? Is there a potential issue with this?

Mr Satchell: I think arguably it could go the other way round. I think the burden of the rules on small firms is actually very high, because they have not got the infrastructure to actually have these large compliance departments. I think if you can distil it to a relatively simple basic set of principles and do the right thing then arguably it is better for small companies and arguably a little more difficult for larger companies to get that standardised approach to principles across the organisations.

Q25 Chairman: One of the recommendations and issues we have focussed on in our restoring confidence in long-term savings report was the issue of risk ratings and the issue of traffic lights with risk.

We suggested that the industry must improve the quality of the information provided to consumers about long-term saving products. What were the views of the members on the FSA's decision not to proceed with measures to improve the way risk was communicated to consumers?

Mr Lambert: As you know, the FSA decided that they could not capture enough in simple form to make it valuable. The members around the table, industry and consumers, felt that they could take ideas forward on this and would have further discussions among themselves to do that. I do not exactly know where they have got to, but my impression is that some of the members and indeed *Which?* would be interested a voluntary approach to this and are engaged in some discussions around that.

Mr Satchell: We are still working on it; and still hopeful of bringing something through that could be workable.

Q26 Chairman: Just speaking from my point of view, I think the FSA has been a bit weak in this area because it does not seem to be beyond the wit of man to introduce some risk rating element to it. It would be interesting to know if this was still on your agenda and if there were ways you could take this forward with industry and consumer groups?

Mr Vicary-Smith: It is definitely still on the agenda. I agree with your analysis that what consumers need is simple advice to help them; and, in fact, a number of firms are already giving some form of simple advice themselves, albeit not within the regulatory regime in that sense—an FSA-blessed scheme, if you like. I think we would like to take it forward. I think we intend to come back to this. *Which?* and the ABI are already talking about ways in which we can look together at how a scheme could be introduced. That is a good example of the group being able to work together in a way that perhaps could not have been envisaged 18 months ago.

Q27 Chairman: Maybe this is one of the messages from this hearing, that under the chairmanship of Ron Sandler you could look at that and maybe at some stage report back to us. With that in mind, may I thank you for coming along this morning. Thank you for establishing the group, particularly your work, Richard, on that and taking the group forward. There is no doubt there is a common setting here for discussing problems and that can only be good. Can I wish you every success with your work again, and thank the secretariat, Matt Inniss and others, for the work they have done. Thank you and we look forward to continuing the dialogue.

Mr Lambert: Thank you for your friendly and generous support over the period as well. I am personally grateful to you for that.

Witness: **Mr John Howard,** Chairman, Financial Services Consumer Panel, gave evidence.

Q28 Chairman: Good morning. Welcome to this session on the Financial Services Authority Annual Report. Could I start off with questions on regulation of the general insurance market. You rated the FSA's performance on general insurance regulation as acceptable. What aspects of the FSA's performance have you been pleased with, and where is there a need for further improvement?

Mr Howard: I think the main thing that we were commending the FSA for (although there are still a lot of weaknesses) was the fact that they really decided to use the tool of mystery shopping in a big way in this area, to find out really for the first time what the customer experience was. It is all very well relying on returns from insurance companies about the number of complaints and whether they are complying with the rules, but it does not necessarily (in fact I would say rarely) reflect what consumers are actually experiencing in the high street. The fact they went out and looked and, once they had turned the stone over, discovered some rather horrible things there, I think was very credible because it allowed them to move forward and actually try and tackle some of the issues they discovered. PPI, payment protection insurance, in particular was a big issue for us. The mystery shopping revealed there were real problems there. At the moment we are pleased with the way the FSA is going forward on trying to tackle the issues that they uncovered.

Q29 Chairman: The Panel has expressed concern that consumers buying insurance from firms that had been part of the FSA's initial amnesty would not have access to the protection afforded by the FOS and FSCS scheme. Has a lack of protection led to any consumers losing out?

Mr Howard: I do not know the answer to that, to be honest. It is a little bit difficult to judge. Every time that the FSA has brought another area of financial services under its regulation it has decided to place the risk with the consumer rather than the industry by saying, "Well, we're going to check out everybody and give them an authorisation to start with, and if we feel unhappy about that we'll delay and look into them". During that period though they will be able to continue selling the products that they are selling, but they will not be in the position of being able to say to their customers, "Well, if we've got it wrong, as we're not authorised you can't go to the Financial Ombudsman Service; you can't claim compensation". That is putting, in our view, the risk on consumers unfairly. Each time they have moved an area of financial services into financial services regulation under their belt they have had the same attitude. We did not feel that was fair to consumers.

Q30 Chairman: I notice from a recent comment from a Norwich Union representative he was mentioning there are important gaps that need to be plugged in the market, and he referred to travel insurance and extended warranties. I presume you will agree with

that? We know the Treasury has undertaken a consultation exercise in that at the moment. Should the FSA regulation be extended to cover this area?
Mr Howard: We have said from the outset that we think it should. We were disappointed that the Treasury did not take that view in its original discussions. Subsequently they drew up the regulations and left out those two important aspects. We feel there has been consumer detriment during that period, and the sooner those areas are brought under FSA regulation the better.

Q31 Chairman: We hope to look at that in the future as part of our inquiry into the FSA and general insurance industry as a whole. Are there any other areas of the general insurance industry outside of the scope of the FSA regulation that we should address?
Mr Howard: I do not think there are any others. The bulk of the market is now under FSA regulation which is why those two areas being left out stick out like sore thumbs really. I do not think there are any others that come immediately to mind.

Q32 Chairman: So these are the big issues for us?
Mr Howard: Yes.

Q33 Chairman: The FSA is currently consulting on whether to remove the requirement for direct insurers to provide status disclosure and a demand and needs statement. First of all, do you support this change and, if you do, will this change bring any benefits to consumers in your opinion?
Mr Howard: The whole question of disclosure documents is a difficult one. Some of this now comes under the Markets in Financial Instruments Directive so the FSA's hands are tied to some extent on what it can do about some aspects of disclosure. We feel that there is a big job to be done on the disclosure documents that people get. We have indicated that to the FSA but they have clearly got to wait to see what the implications of MiFID are in this area. Overall, we think it important that all documents that consumers receive are in simple English; and they are fair and brief I think would be the other thing I would add to that. The other aspect I think that is of concern in the disclosure regime at the moment is when you have telephone sales. We went and visited a firm to see how they were dealing with the regulations and it was very clear to us that the amount of information that they had to give over the telephone was far too big. That was partly because of FSA regulation, but partly because it was car insurance we were looking at and the Motor Insurance Bureau required them to say certain things, Companies House required them to say certain things and the Data Protection Registrar required them to say certain things. So there were four lots of regulation requiring that insurer to give information over the telephone. The effect of that was they had a huge script to read which each adviser on the phone had to read out something like 40 times a day. You can imagine how much of an automaton they sounded at the end of the day, and they could hear people on the other end of the phone having conversations, talking and going off and doing other things while they were reading it out. There clearly is a big job to be done in simplifying the information certainly in that area in telephone sales.

Q34 Jim Cousins: You described yourself in your opening statement as happy with the FSA's actions on payment protection insurance; but in your annual report you said that you wanted more enforcement action. Has there been more enforcement action?
Mr Howard: They have now lined that up. I think one of the big areas that creates the mis-sale is in the high street again; that is where mis-selling always happens. It is the relationship between the person who is selling PPI and the customer. The customer usually goes in with one purpose in mind, and that is to buy some particular product, or a house even if it is a payment protection insurance to cover a house. They are not thinking about the insurance aspects. This is very often subtly tagged on in the spur of the moment. The purchaser is very keen to get on with the deal, sign whatever bits of paper are put in front of them and I think that situation is really detrimental to the consumer. I think that is where the FSA has to target a lot of what it is doing. They have been out already to sample what is happening in the marketplace. They have already taken some firms to task about the way that their advisers are dealing with customers but this is a big job of course, because payment protection insurance is sold by a lot of companies whose main business is not insurance, it is selling other items and other products. Many of them are not necessarily big organisations with the training initiatives in place to train people to sell insurance; that is not their main task. I think the FSA has got a big job on its hands to turn that round.

Q35 Jim Cousins: Indeed. The FSA has taken action to identify just those problems you have now set out. What I asked you is, what is being done about them? What is being done about better tests of suitability? Has there been any enforcement action?
Mr Howard: There has been enforcement action already, yes.

Q36 Jim Cousins: Of what form? Not the issuing of advice and the general tap on the shoulder, but actual enforcement?
Mr Howard: There have been enforcement cases. I cannot remember the name of the big case recently which had publicity, but there has been enforcement action. They have required companies to change the wording of their documents. You can now, we understand, recover original payments you have made if you subsequently cancel. A lot of the documentation meant that you could not recover the sums you had paid out if you wanted to cancel the policy subsequently; and the FSA has negotiated with companies to take that provision out, so things are happening.

Q37 Jim Cousins: In how many cases do you think there are these refund conditions? There were companies that were not giving any refunds at all

when people discovered that there were exclusions and limitations, which meant they could not take advantage of the product. Can you tell the Committee that in every case now people will be able to get refunds on some basis?

Mr Howard: As I understand it, and we spoke to the FSA staff responsible only last week, that is now the situation. What we did query with the FSA was that they did not seem to have done much about promoting the fact that people with policies who wanted to cancel them could go back and get a refund; so we have pressed them to make sure that they make as much publicity about this as possible because, clearly, getting an agreement from the companies is one thing but making sure consumers know about it is very much another.

Q38 Ms Keeble: Do you not think you are being a bit naïve or disingenuous in saying that the mis-selling just occurs on the high street; let us see the local person who does that? Often the companies who are doing this are very big companies, and the person who has got the face-to-face encounter with the customer is reading to a script and doing what they are trained to do; they are meeting company targets; and is it not about the major companies, who sell all kinds of products, just tagging this stuff on the end, sometimes giving huge incentives? I am just thinking about going into a shop where you have got a glass of champagne before they have proceeded to sell you all kinds of things, including insurance. This is company policy, is it not?

Mr Howard: I was very interested in the debate you were having about commission bias just before, and I was itching to have a say on that because this is one of our biggest issues on the Consumer Panel—commission bias. We, like you, really want to see something done about this. You say, "Why hasn't the industry done something about it?" My view is that it is very much not in the industry's interest to do something about it; because in marketing departments the use of commission to buy market share is the main lever that they have and they are not going to let that go easily. We have been looking at this in some detail now. In the annual report we said we were going to make this an issue we wanted to encourage debate upon because we would certainly like to see commission bias ended. My view is that there are ways of doing that. Some Scandinavian countries have now done away with commission. It is outlawed under the law. I think they felt they had to do it that way to make it work in the marketplace because producers and providers of products see it as such a valuable marketing tool to be able to manipulate commission levels that it required legislation to change it. There may be a case for legislation to change it, because unless you get all insurance companies and all the other providers doing it at the same time, those that do go down this route will be disadvantaged. There is a real problem here in keeping a level playing field for all the firms in the industry if we get rid of commission altogether. There are ways of getting rid of commission and we are investigating those and hoping to continue this debate. I am always pleased to see what the Committee says about this, because we feel very much the same way about it—that there ought to be another model. I was extremely pleased with Sir Callum McCarthy's comments on this as well, because it shows the FSA is thinking in this direction too.

Chairman: I think we discovered trail commission, did we not?

Q39 Angela Eagle: I am glad to hear what you have been saying and perhaps you could tell us a little more about how they are changing these models in Scandinavia. I would certainly be very interested if you could say a word about that, and then I am going to ask you about promotion and advertising, which I think is also a similar problem.

Mr Howard: Yes. What we have discovered at the moment, I think it is Norway, Sweden and Finland have banned commission as a method of rewarding advisers. I am not entirely sure how their system works at the moment, but clearly one aspect of it is to have gone over completely to fees. That is what some parts of the marketplace are doing here. There are other ways of structuring payments so that you can get rid of commission but still ensure that advisers are paid fees but the consumer does not have to pay that upfront. One of the ways of doing that is to attach the fees to the cost of the product; so that at the outset the adviser would say, "These are my fees. Whatever product I select from you; whichever provider, that provider will be asked to attach the cost of my advice to the product". In most cases I can see that being the same amount of money as commission is at the moment. The thing is that you have taken the bias out of the process by saying that the fee is the same upfront no matter which provider is selected. There are models which could be pursued further and that is what we are interested in doing.

Q40 Angela Eagle: That is very interesting. I was also interested in your comments on financial promotion, and the fact that breaches of the rules seem to be extremely widespread. I think the overall percentage of non-compliance with the rules is 57%, which is bad enough, but it went up to 79% in general insurance promotions, and 47% in mortgage promotions and 43% in investment promotions. The key issue here is that if some people are breaching the rules and basically paying for dodgy adverts you are rewarding the bad people instead of rewarding good behaviour; because everybody else thinks, "Well, if they're getting away with it, we've got to do the same and its our competition". What do you think can actually be done? Do you think breaches of the rules are being handled well enough or there should be bigger penalties for breaches of the rules?

Mr Howard: The Panel feels that the solution to this is in making financial promotions an exception to the rest of the FSA's regime, and that here we would like very quick naming and shaming, because I think that is the way that you bring the marketplace into line over this quite strict advertising rules regime. At the moment the FSA has the policy of seeing an advert, maybe in a Sunday newspaper, which is in breach of the rules; on Monday or Tuesday the staff

will ring up and negotiate with that individual firm to make sure that advert does not appear again, or negotiate a way in which it can be altered for the next time it is published, and it is left there, which means that the advert has gone out on Sunday, other parts of the industry may have seen it: "Look what they have done;" (because they are all watching how each other is advertising) "maybe we could get away with that", and so the fact that the FSA has decided that something is not clear, fair or is misleading is not communicated to the marketplace.

Q41 Angela Eagle: It is all in retrospect; it does not actually stop the breaches happening, does it?
Mr Howard: No, but that is because the FSA, unlike the Advertising Standards Authority, does not feel it is able to provide advice on advertisements before they appear.

Q42 Angela Eagle: You say that if we could give the FSA a kind of Advertising Standards Authority role that would need a change of the Financial Services Markets Act. Is there some other way that does not require primary legislation in which we can actually get a handle on this?
Mr Howard: There is, but the Advertising Standards Authority is a voluntary industry code, and perhaps that is the way forward for the FSA: to maintain those rules but to encourage a voluntary code amongst all financial services advertisers which would allow those enforcing that code to immediately publicise adverts which are breaking the rules. So there is a model for that.
Angela Eagle: That is a very interesting suggestion.

Q43 Kerry McCarthy: Does the FSA's move away from a rules-based system of regulation to a principles-based system cause you any concern?
Mr Howard: We support the move to principles-based regulation, but a number of things that have started to crop up worry us. The first is that the industry, being so wedded to the idea of rules, especially compliance officers who seem to hold on to rules like a handrail to save themselves from falling into the arms of the regulator, still wants some sort of rules, and it looks as if they are tending towards creating their own guidance and codes. The worry about that, of course, is that you are setting up here a system of self-regulation if you are not careful. What particularly concerns us about that is that at the moment any rule changes have to be subject to wide public consultation; the FSA ensures that; that is the way it works. If the industry starts creating its own codes and guidance what public consultation will there be about those? So there is a real concern that although the FSA maintains the high principle, basically, of treating customers fairly, the way "fairness" is interpreted by the industry, if left to its own devices, may not be as fair as we might think and the Financial Ombudsman Service might think. Once you have created guidance and codes you have to wonder about their status in the marketplace. Will those codes be something that the Financial Ombudsman will have to take account of, or will he say: "We are not having anything to do with those"? So the status of them is extremely important, I think. One of the other big concerns that we have about the way that this will work is that the FSA itself will have to change the job of its supervisors because at the moment they are enforcing rules, and that is a job which you can do, reasonably well trained to a certain level, to enforce those rules. If you are now going to a principles-based regime those same supervisors (or, maybe, the FSA has to look for different people—it depends what you think about the qualities that are needed) they will have to exercise judgment, and quite sophisticated, judgments in this area. So that is going to be a very different role for those FSA supervisors to undertake. We think there are risks there.

Q44 Mr Breed: I agree with all that but the smaller firms are going to find it very difficult to challenge because, presumably, what you are saying is the FSA decides what the principles are and the FCS decides what the definitions are. "If you do not like it, hard luck; come and challenge us". That might be all right if you are the Prudential or something, but if you are a tiny company and your ability to challenge the FSA is either going to be costly or difficult, or both, why should there be a system whereby some particular body not only lays down rather general principles but when the specific comes up decides what the interpretation will be?
Mr Howard: That is the difficulty of moving to principles, is it not? The big advantage of moving to principles is that with rules you have always got gaps between the rules which can be exploited by companies who want to exploit the gaps between the rules. If you have got a principle then there are no gaps, or there should not be, but it is open to someone's judgment. I think that is a very difficult issue. It is clear now the FSA has got to do a lot of thinking down the line to see how this is actually going to work in practice. You have highlighted, I think, one difficulty for small firms. I think the advantage that small firms have is that they are already, one would hope, closer to what the FSA, in my view, is trying to achieve. Small firms know their customers, maybe, much better than large firms do, and if you are moving to a principles-based form of regulation what you are trying to do is encourage large organisations which are anonymous to have a more human face; to be able to look at individual cases and say: "On the basis of your individual case, Mr So-and-so, we think we have treated you unfairly and we are going to recompense you." If a small firm is already much closer to its customers and thinking about its customers and their point of view, one would say that they stand a better chance of getting it right. They have not got all these systems in place, all the rules that have been imposed from head office, which bind them into making decisions which may be unfair in individual cases.

Q45 Mr Todd: What do you think the FSA should actually do? You said they should think about this issue—I am sure they are doing that.

Mr Howard: So are we. There are a lot of issues down the line in all of this. The FSA says: "We have got 8,500 pages of rules and we really want to slim those down." The way to do that is to have high level principles and then you can ditch a lot of the rules, but I think it is already acknowledged that you can never get rid of all the rules. So now I think we are starting to think how many rules can you get rid of—can you get rid of half? Can you get rid of three-quarters?—and maintain the confidence in the industry but allow the degree of flexibility for them to make more appropriate decisions on behalf of consumers, decisions that are fair. Leave them the latitude to make decisions with individual consumers which are fair.

Q46 Mr Todd: Is there a methodology they should follow in deconstructing their rulebook along those lines? What you have basically done is repeat the statement they need to think very carefully about this, with which I think we would all agree.
Mr Howard: What we are waiting for is to see which rules they are actually going to dump. We have not seen that yet. Which ones are going to be struck out? We are waiting with bated breath to see how they approach this. It is their idea. We will give them the latitude of thinking how they are going to do it, but we reserve the opportunity to—

Q47 Mr Todd: The impression I have is that it is their idea that you do not entirely endorse.
Mr Howard: We endorse the idea of reducing the size of that rulebook. We like the idea of moving to principles but we would be very concerned if we just replaced the rulebook with 8,500 pages of guidance and industry codes.

Q48 Mr Todd: You have suggested that a far broader approach should be taken to measuring the benefits of regulation. How do you think that should be done?
Mr Howard: I am sorry; could you explain what you mean by that?

Q49 Mr Todd: The Panel has suggested that the FSA needs to take a far broader approach to measuring the benefits of regulation. How do you think that should be done?
Mr Howard: Again, I have not got a solution but I would hope those with much greater knowledge and experience might be able to come up with one. The work they have done on benefits at the moment is through an organisation called Oxera which looked at a framework of how the benefits might be quantified. If I can give you an example of how I think it is difficult to quantify the benefits in trying to balance out costs and benefits, it is when you think about market confidence. How do you evaluate a particular change in rules or a particular decision made by the FSA when it comes to the level of market confidence that that decision might engender? There is no doubt that we all feel that confidence in the marketplace is the big missing element at the moment—there is huge lack of confidence on the part of consumers. If you start to undermine the regulatory process you damage that confidence even further. So that has to be a big benefit in the equation and it is very difficult to measure the benefit from individual actions taken by the FSA. I think that is the problem that we are up against.

Q50 Mr Todd: I think the report you referred to indicated that perhaps too much stress was placed on the economic efficiency argument of regulation and its benefits as opposed to the supposed benefits to the consumer in terms of outcomes—say, addressing financial exclusion or something like that. Do you agree with that view?
Mr Howard: Yes, there are clearly consumer benefits that you can measure, like the degree of advice available, the quality of that advice; you can measure those sorts of things, but there are a number of aspects as I have indicated there that it is much harder to measure. I think we must try and do that because it is no good just saying: "This costs an awful lot so we will get rid of it"; you have got to see what it is doing on the other side of the equation; you could be undermining the marketplace even more.

Q51 Mr Todd: Do you feel that the proposed widening of the range of funds that could be marketed direct to retail investors is being addressed appropriately? You have expressed a concern there.
Mr Howard: Yes, that the FSA could not identify consumers who were more sophisticated and able to deal with more sophisticated products. We thought it was disappointing that they had not been able to grasp that nettle—a little bit like the risk-ratings, I think they felt that it was too troublesome for them but, perhaps, did not deny it would be valuable to do it if it could be done. I still think there must be ways of doing that to discriminate between different sorts of consumers to enable those products to be more specifically targeted. One of the things that the FSA's approach to principles-based regulation says is that in the design of particular products you must have the target market in mind. If you cannot divide up your target market how are providers going to be able to target? So I think the FSA, although it said: "We are not prepared to do this", is still expecting someone else to do it—maybe in the industry—because they have got to clearly identify their target market when they are designing the products and selling them.

Q52 Mr Todd: So, clearly, it is inappropriate to market hedge funds to unsophisticated consumers. What ideas do you have as to how they can separate out consumers into groups who could possibly handle those sorts of opportunities for themselves?
Mr Howard: I think their previous history has got quite a bit to do with that. If they have a history and a background of investing in products then they are more likely to have an understanding of what is going on. There is also a role here, I think, for the FSA's task in educating consumers and providing them with more knowledge and background. If the FSA can tackle that and deal with that in a way

which becomes effective and spreads knowledge and experience round the marketplace then that is going to help, too.

Q53 Chairman: Regarding hedge funds, if funds were being distributed to retail investors would you agree with that?
Mr Howard: That clearly spreads the risk but I am still worried about the nature of those products. When you look at the FSA's research, which says that most people do not recognise that an equity ISA is invested in shares, you do worry, don't you?

Q54 Mr Newmark: I have been involved with financial services for 20 years and every year that goes by is the same message: the regulations are getting more and more complex and there is an inverse relationship between those that you want to protect and the increasing complexity of the actual warnings or health warnings that go with them. I have been sitting listening to you and I still get no warm fuzzy feeling in my stomach that, at the end of the day, for those that we ultimately want to protect, which are the widows and orphans and the most vulnerable of investors, you have a solution, other than sticking something up which says *caveat emptor* (most of which they would not understand but "let the buyer beware" which is the simplest message that you can give). Really, what is it you are going about in any form of granularity to simplifying it, as you said at the beginning of your talk, and trying to give these health warnings in very simple terms? Most people switch off as soon as the health warning comes on, whether it is over the 'phone, on the TV or even the microscopic print which you need a microscope to actually read, and they do not actually help the consumers we are trying to protect. I still do not know where you are heading in terms of protecting those people.
Mr Howard: Shall I give you my solution, for what it is worth (which does not have Panel endorsement, by the way)? This is how I view the marketplace and how we might try and deal with this. First of all, there is no doubt that the most influential interaction is person-to-person, so an adviser to an individual consumer is the most influential arrangement. My suggestion would be that what we need is an easy entry point for all consumers to advice, to a generic advice service. So that they would go along to a generic advice service and get very basic advice about their situation, which may end up with them being told: "Well, what you need is this particular product now. You have got everything else sorted out; you need this particular product; now go out into the marketplace and find an independent financial adviser who is not paid for by commission but paid in some other way, who can give you truly independent advice and get a product suggested by him as the best one for you in your circumstances." So we need a generic advice service and then we need independent financial advisers who are not financed by commission. This is my design. I think the generic advice service will then take out a lot of the work that the independent financial adviser has to do in the first place, and make their model of advice more economic, because the generic advice service will have done a lot of the groundwork, the basis—"Pay off your debts first". That sort of advice will be taken out of the equation.

Q55 Mr Newmark: A great model, but who pays for it? The people you are trying to protect are those that invest least and have the least money.
Mr Howard: There are now, fortunately, a number of possibilities coming through. I think Resolution Foundation's latest research shows that there are huge savings to be made if you set up a generic advice service. Also, the new savings bank which will use the unclaimed assets is another possibility for providing finance for a generic advice service. Can I give you one example from the Panel's own experience of the level of advice that can be beneficial? We took a trip to Glasgow and we were struck by the number of cheque-cashing services there were in Glasgow—shops where you go in and cash a cheque. When we enquired further we discovered these cheque-cashing shops charged 15% of the value of the cheque to cash the cheque. A lot of the people going into those cheque-cashing shops were going in there with cheques they had acquired for loans to get them through the next month or the next period. They were not very large sums of money but 15% was being taken out in a cheque-cashing shop. It does not need a terribly sophisticated advice service to point all those people to a bank or to credit unions. The level of advice need not be terribly sophisticated but you can save some of the poorest people an enormous amount of money overall.

Q56 Chairman: You have given us simple solutions to very complex problems. We are grateful for it all the same.
Mr Howard: I do not mean to suggest that it is completely easy.

Q57 Chairman: We have looked at it as a Committee and we are still looking at it in the financial exclusion report. Last question: the FSA is currently undertaking a review of its regulation of the general insurance market. What outcomes would you like to see from this process that would benefit consumers?
Mr Howard: The general insurance market?

Q58 Chairman: Yes.
Mr Howard: One of them would be that they again look at the remuneration model that we have got here. At least in the other areas the commission paid is disclosed but in insurance it is not. I think that would be helpful. The outcome that consumers really need at the end of the day is to be able to rely on and feel confident in the sales process; that they are getting all the information that they need; that they are getting a product that really does suit them

and then, at the other end of the chain, that their complaints and their claims are dealt with efficiently and effectively. So those are the outcomes we really want to see being targeted by the FSA.

Q59 Chairman: Thank you for your evidence this morning, Mr Howard. We are very grateful to you for that.
Mr Howard: Thank you.

Witnesses: **Mr Keith Satchell,** Chief Executive of Friends Provident, Chairman of the Association of British Insurers, and **Mr Stephen Haddrill,** Director-General, Association of British Insurers, gave evidence.

Q60 Chairman: Mr Haddrill, welcome to this session. Can I start then with a question regarding the FSA. Do you think it is successfully applying risk-based regulation to the general insurance industry by targeting intervention on those areas with the greatest risk of consumer detriment while taking a light touch approach to sectors where markets are working well?
Mr Haddrill: I think you have hit absolutely on a problem with the new general insurance regime. We feel that the product is very different in some parts of general insurance than others, and the regulatory regime should be targeted. We feel, at the moment, we have got a regulatory regime which cuts the same across all of the products. We did some research and published that earlier in the year, and that identified that there was, for example, consumer benefit from the existing regime in relation to quite complex products, like critical illness protection products, but a consumer detriment in relation to products that people better understand, like motor insurance and household insurance. So we have been rather encouraged recently that, firstly, the FSA has agreed to review the whole area and, secondly, that in reviewing it it has indicated that it wants to look at the distinctions between the products. We feel it should also look at the distinctions between the way the product is sold: are you getting the product direct from an insurer, through a broker or through some other form of intermediary?

Q61 Chairman: What sectors of the market are working well, what are working not so well and what areas should the FSA give higher priority to?
Mr Haddrill: In relation to general insurance the areas that I think are working well are those where the product is relatively straightforward and where people understand it—so motor insurance, household insurance. We do not see any significant problems there. The Treasury is obviously reviewing the travel insurance market at the moment. We feel, again, it is a relatively cheap product but, obviously, if something goes wrong when you are abroad that can have quite serious consequences, so we can understand why the Government is looking at that, but we feel that there can still be a relatively light touch regime across the whole sector, however it is sold—through the high street or direct from an insurer. The area where we felt there was more difficulty, where the product was complicated, was in the critical illness area. That is why the ABI, over the last few months, has issued a statement of best practice that is now being adopted by the industry. So within the general insurance area we feel that as problems emerge we, as an industry, want to address them, whether it is on issues like critical illness or on issues like PPI.

Q62 Chairman: On travel insurance and extended warranties, would you like something to be done about them?
Mr Haddrill: Well, as I said, on travel insurance we do feel that there should be a level playing field across the market as a whole. We do not feel it needs a heavy regulatory regime; we feel a light touch regime is appropriate. So, yes, we would like to see regulation extended into shops and the high street. I think there is probably a question that needs some careful thought about whether the FSA is then some kind of enforcement authority, given how much else it has got to do, or whether it is just setting the regulatory regime. Maybe there is a role for trading standards; maybe there is a role for other bodies.

Q63 Chairman: Your submission notes that the implementation of the Insurance Mediation Directive has been gold-plated by applying the requirement for intermediaries to direct sales by insurance companies. Is this imposing significant costs? What can the Government do about it?
Mr Haddrill: The Directive was designed to apply just to intermediaries, not to the providers, and in some countries it has only been applied to intermediaries. We know that there is quite a significant level of costs—I think it is about £250 million—and obviously that is falling both on intermediaries and on the product providers. Some of that cost could be reduced if the FSA had not extended it to the whole sector but just concentrated on the intermediaries, which is where the European Union felt the problem existed.

Q64 Jim Cousins: PPI. You probably heard the exchange we had earlier. I would like to ask your views about that. Is it the case now that refunds are universally available?
Mr Haddrill: The ABI members are committing now, for their part, to make refunds available whenever a loan is repaid early. So yes, that is the case. We have been working with the BBA and other trade associations to establish that.

Q65 Jim Cousins: I am not clear from that answer whether this is something that applies now or something that is going to apply.
Mr Haddrill: It does apply now, yes.

Q66 Jim Cousins: On the question of eligibility, whether the product being sold is even appropriate for the particular individual (I do not mean "appropriate"; whether they are even in a position, given their circumstances, to ever make a claim) what guidance and tests are you making about that?
Mr Haddrill: I think this is an absolutely essential issue. As the FSA has said, this is a very valuable product for very many people. It is supporting the level of debt we have got in this country and being without it would be a dangerous thing for many people in the country. However, suitability is an important issue. So the ABI, with the BBA and with the intermediaries, have worked out a customer code, a customer guidance that will be published shortly, I think. So we are determined to get that out into the marketplace. The other thing which I think also came up earlier, forgive me, was the whole question of training of staff who sell PPI, and across the trade associations and the member companies we are also looking to raise the quality of training of staff.

Q67 Jim Cousins: This code of guidance on the question of entitlement and eligibility has not yet been produced.
Mr Haddrill: It has been drafted and it is with the FSA for commentary.

Q68 Jim Cousins: I am sure this is something the Committee would like to see in due course, but I am still concerned about this because at point of sale will this guidance actually percolate down and will the consumer actually understand what is being communicated?
Mr Haddrill: That is our intention. It is our intention that this guidance is simple and straightforward and that it is available at the point of sale, yes.

Q69 Jim Cousins: Will people purchasing PPI policies, of whatever kind, after this new regime is in place actually get some piece of paper that very simply explains to them—and not lost in a great deal of other documentation—that refunds are available and that the question of eligibility is going to be taken into account, and that that is something that they should also check for themselves?
Mr Haddrill: I agree. I do not think we will ever achieve our objectives unless the consumer knows and has something to remind them in the future that that is the case. Yes, so we must make sure that happens.

Q70 Jim Cousins: Bearing in mind that a lot of these policies are being sold in the high street, they are not being sold, sometimes, in a conventional arena where financial service products are bought and sold, how do you intend to take that into account?
Mr Haddrill: They are being sold through the banks, very largely, so I would dispute whether they are not sold in a conventional, financial arena. I think that is the biggest distribution channel; very little is sold directly by insurers. As I said, we are working with all the trade associations who have an interest to make sure that this information, this guidance, is agreed and that it is endorsed by the FSA. Just to pick up on what John Howard was saying: whenever we produce this sort of material we do consult with consumer groups and with public groups more widely. We are very much involved with Citizens Advice, and I hope that they will take our guidance if they see it as appropriate as well.

Q71 Jim Cousins: How do you propose to deal with the issue of where there are loans which are secondary loans—ie, there is a primary loan and there is a secondary loan on top of that? How do you propose to deal with that?
Mr Haddrill: It is important. Can I write to you separately on that, because that is not something personally I have looked into? I would be grateful if I could do that.[1]

Q72 Mr Gauke: Can I return to the subject of rules and principles, which we have already discussed with Mr Satchell? Perhaps we could ask Mr Haddrill whether you have any concerns as to the move from rules to principles and whether there are any particular worries. I know that Stephen Sklaroff stated that regulatory autonomy is frightening. Do you have any concerns about that?
Mr Haddrill: Firstly, I think it is absolutely the right way to go, but yes there are challenges that it gives rise to. The first one is within the companies there is often a compliance culture that grows up; people feel that if they can demonstrate that they have stuck very closely to a set of rules they are in a better position vis-à-vis the FSA or, indeed, the FOS. So there is a cultural issue for the boards of the companies to address. Certainly all the chief executives I spoke to are up for that change; they want to see that happen. Similarly, there is an issue for the FSA in relation to its own supervisors, to make sure that supervisors are not, effectively, putting in rules by the back door. We are, therefore, very glad that the FSA is putting more effort into training of its supervisors. I think there is an issue about supervisory teams staying in place for longer periods of time. A number of companies find that they change their supervisors really quite quickly, so are they getting a real understanding of the business? You need a real and qualitative understanding of the business, I think, in order to adopt a principles-based rather than a tick-the-rules box regime.

Q73 Mr Gauke: Do you think there is any danger that you could be coming back here in three or four years' time and saying: "We yearn for the days of the certainty of rules and can we not return to it"? Is that a possibility?
Mr Haddrill: Well, I have been involved in regulation for a large proportion of my life and I know these things go in cycles. So I hate to say I do not rule it out entirely. I was looking at the general insurance rulebook last night. It has some really good, clear principles written into it. It says that on disclosure information, and so on, the principle is that the company should produce information that

[1] Ev 41

is clear, fair and not misleading. If the Ombudsman were working underneath just that line, they would be able to take some pretty clear decisions, I think, on it. As it is, we have 194 pages which tells you about the use of colour, the use of logos and so on and so on, and I think it actually distracts the business, which has a limited amount of resource, from thinking about what really matters, which is: "Do I really understand my customers? What will my customers understand from this piece of paper?" to "Have I got the logo in the right position?"

Q74 Mr Gauke: Can I ask about the Financial Ombudsman Service? When I worked as a lawyer in this area there was a concern that there was an element of "palm tree" justice about the FOS. How important is that relationship between the FSA principles and the FOS in this area? If it is going to work what would be the role of the FOS?
Mr Haddrill: I would not support the idea that it is "palm tree" justice, not least because there are 1,000 people under the palm tree.
Chairman: Can you explain that term?

Q75 Mr Gauke: The sense of sort of sitting under a palm tree; what is the right thing to do here, and taking a case-by-case approach. That is how I interpreted it, anyway.
Mr Haddrill: Yes.

Q76 Jim Cousins: I thought it was something to do with avoiding being hit by a coconut!
Mr Haddrill: I think there is a risk that if the FOS, in taking judgments and explaining those judgments, produces a rulebook that companies then, in order to avoid having a judgment against them by the FOS, effectively a rulebook comes into being by the back door. That is something that I do not think any of us have bottomed act yet, and that does require a lot of further discussion between the industry, consumer groups, the FSA and the FOS, and it does require us all to work that one out. I think you are right, there is a risk there.
Mr Satchell: I absolutely endorse what Stephen said there but just to go back to something that John Howard made clear, we will not be getting rid of all of the rulebook. There will still be, I think, a significant body of rules in place and the key is to identify which ones should be dismantled and which should not. Going back to Stephen Sklaroff's speech, I think he was suggesting that we need to pick some pilot areas and just try to dismantle rules in those areas to see how it would work. That is where we do need to work with FSA, also to get an understanding of how the Ombudsman Service would actually approach their deliberations in those areas.

Q77 Mr Gauke: Given that we are going down the principles-based route, the other point that Stephen Sklaroff made is the point about guidance produced—I think guidance on the paths of righteousness, to use his phrase. Do you think more guidance will be produced? Who will be producing it? Is there a danger that that guidance may itself become "rules by the back door", as it were?
Mr Satchell: I think there is definitely a place for industry guidance. We have seen a number of ABI guides come out in different areas over the last two or three years. Those are not going to get endorsed by the regulator but we involve the regulator in developing those. I think the benefits of the guides is that they can be responsive, so they can change relatively quickly over time if needs be; they can be relatively loose; they can be a framework within which companies can innovate, can promote competition and the development of competition, which is good for the consumer. I think there is definitely a place for those guides. I think you are absolutely right, the key is we must make sure they do not become too definitive, so that ultimately we have companies relying upon the ABI guide and when talking to the FSA staff the response is: "Well, it was in the ABI guide so it was okay". It would be helpful if there was some form of breakwater there, but I think it has been made very clear that ABI guides will not become safe harbours.

Q78 Mr Gauke: In your submission you say that in the past you have been inhibited by producing such guidance in some circumstances for that very reason—the concern about the FSA treating it, if you like, as rules. Are there other examples you can give of that, and how can that be solved in the future?
Mr Haddrill: I think it is still relative. Until the last year the FSA has not particularly welcomed guidance. Indeed, the FSA has been taking over the role of guidance that was produced in the 1990s and before then. Just to add to what Keith was saying, another thing I have seen over the last year is that the generation of guidance by the industry gives the industry ownership of the guide, and if we are going to discuss the guide with consumer groups, as we would, and with the FSA, the process of producing it means we have got something palpable that the industry has adopted rather than something it sees as being done to it.

Q79 Angela Eagle: Mr Haddrill, your evening reading sounds fascinating.
Mr Haddrill: It is a sad life I lead!

Q80 Angela Eagle: You said that in the general insurance rulebook it said that information has to be clear, fair and not misleading. What percentage of current information produced do you think, in this market, actually accords with that very simple statement?
Mr Haddrill: I do not think I am going to be drawn to give you a percentage—

Q81 Angela Eagle: It might not be a very high one.
Mr Haddrill: The FSA is now regulating according to that principle and also according to a lot of detail underneath it. My test for how well the industry is doing is what is happening in relation to the Financial Ombudsman Service. Are we seeing more

cases coming forward in the general insurance area? That is not really the case. So I do feel that, in a way, that is my measure of whether the industry is being fair: are there cases coming forward and are they being upheld or not by the FOS. I think that is something well worth looking into.

Q82 Angela Eagle: In terms of the financial promotions as well, here we have information but we also have advertising which sometimes melts into sort of information as well. You heard my question to the Consumer Panel about the very worryingly high levels of breach of the rules on advertising that are happening in these general insurance markets. Do you worry about that and what would be your solution to what is going on there? 80% of the general insurance promotions do not comply with the FSA rules.
Mr Haddrill: The figure that I do not have but I think we all ought to look at is what percentage of that non-compliance is due to a fundamental problem that is important to consumers, what they say that they want to know about—the total price and so on—and to what extent it is due to the logo being in the wrong place. I think that is worth a bit more exploration. I thought John had an interesting point, and so did you, about when there was a problem that the problem was dealt with quickly. I think the FSA does do that, and I do not think we should be too quick to say that you need to name and shame in order to make that stronger. They are there the following day; naming and shaming is not going to make the advertisement that has already been put out go away.

Q83 Angela Eagle: But their activity is in retrospect, so the advertisement is out there and loads of other people are thinking: "If they can get away with it then we need to market our stuff like that". They are chasing the breach, whereas a different system would actually prevent that breach happening. Do you not agree we should shift to try to prevent rather than be chasing after breaches?
Mr Haddrill: Which is why in the Customer Impact Scheme that we have been developing for the life industry we are producing guidance on the whole cycle from the development of the product, through its promotion and advertising so that there is advice and guidance out there on best practice for firms just to try and improve that. I can see why the FSA does not want to get into the business of vetting every advertisement before it comes out; I do not think it is that sort of regulator.

Q84 Angela Eagle: What do you think of the idea of having a kind of voluntary code like the Advertising Standards Agency that the industry could set up, which would essentially try to reward the people that stick by the rules rather than this idea that people who can breach the rules get away with it and get their ads out there and somehow steal a march on a very competitive industry and on their rivals?
Mr Haddrill: I think we are moving towards it because on the Customer Impact Scheme, as I said, we are producing guidance. We do have a panel that oversees the whole area that includes external members as well as internal members. It is going to be chaired next year by Melanie Johnson coming, obviously, from outside the industry. Whether we want to go a further step and say that we actually need to have a separate body to the FSA I am not so sure, because I think if the FSA is, as you heard, taking action after the fact, I do not know that we need an additional authority to do that.

Q85 Angela Eagle: This is at the preventative end rather than after the breach has occurred.
Mr Haddrill: Beforehand we are producing guidance. We can look at whether that guidance is adequate and see whether it needs to be strengthened. I think that is the question for this panel we have set up to look at.

Q86 Angela Eagle: Finally, on the issue of structuring the industry, are you attracted by what seems to be going on in Scandinavia where commissions and the commission bias that we were talking about earlier and the business model we have at the moment appears to be fading into history and being replaced by something more objective and a bit more reassuring?
Mr Haddrill: I do not think that we can leap into that Scandinavian world very easily because, firstly, we have talked today about the need for advice and particularly a need for advice with people who are disadvantaged, vulnerable and so on—even in relation to quite simple products. If advice is there it needs to be paid for. What the ABI is doing is looking at whether there are commission structures that would enable that advice to be delivered in a better way than the current commission structure.

Q87 Angela Eagle: You are trying to modernise the commission structure rather than move beyond it?
Mr Haddrill: We are looking at options for modernisation. It will be for the companies to decide whether or not to adopt any of those models. The ABI would actually be operating in breach of competition law if we were to say: "There is a model here; you must all adopt it." We cannot do that. The regulator could possibly do it, but we cannot do that.
Mr Satchell: If I could just add, there is now the offer of a fee or commission as part of the disclosure—

Q88 Angela Eagle: The point was made earlier that the fees are too comfortable and that, in fact, if you are going to shift away from the harmful business model—
Mr Satchell: It needs to be attached—

Q89 Angela Eagle: Everybody needs to be in a position where they do it straightaway; you cannot make the shift.
Mr Satchell: I understand. I was interested in what John Howard said, but interestingly that was imposed by legislation. The fee attaching to the product is something, in essence, that is done within the market today. Some of the commission models

have changed quite a lot. A number of advisers are moving across to fees, to level loads, so that that is a moving piece of the market.

Q90 Angela Eagle: You are responsible for a kind of business model, albeit in a wider market, where everybody else is working the harmful one. I am just interested in how we can shift from where we are now to something that is healthier for everybody.
Mr Haddrill: The FSA is conducting half-a-dozen reviews around various aspects of distribution, and the first thing we would like to see is to make sure that those half-dozen reviews have a strategic coherence to them; that where they overlap they produce coherent results. However, it does seem to me that the regulator does have a role here and we are very pleased that John Tiner has stepped up to the plate. So the process of getting there, I think, is through this work that the FSA has taken on.

Q91 Angela Eagle: So you think that the way of moving away from the harmful business model and into something more healthy for everybody is for the regulator to lead it, not for the captains of industry to think: "Our business models are awful; we need to think about doing it"? Or is that because everybody needs to be in the same environment and, therefore, the shift can only happen by regulation or legislation?
Mr Haddrill: It may be that some things can only be achieved through regulation because no one firm can move ahead of the others, but that is not the only answer. You are seeing a market in transition and we know that different firms are developing different solutions in their own space and their own time. I think this is an area where the industry's model and regulation are fundamentally interwoven. So it is not a case of the regulator doing something because the industry cannot; we have to move together because the two fundamentally interlock.

Q92 Mr Todd: The FSA have rather bravely asserted that they do not gold-plate EU requirements. Is that the way you see it?
Mr Satchell: I think we have one example within the general insurance industry where they have: in introducing in the Mediation Directive requirements for direct selling as well as intermediaries. That is one example, as Stephen said earlier. There are areas where that happens. I think we welcome the FSA review of their introduction to the general insurance regulation; I am sure that is one area that they will look again at, and we would certainly welcome some differentiation across products and distribution channels so that the customer if he wishes to buy a relatively cheap, pretty simple product can do that relatively easily. We heard John Howard talking earlier this morning about all the various disclosures that have to be given, the interaction of FSA regulation and other regulation, and I think we are all of a mind where if you can distil the disclosure down to three or four key facts that the customer must understand we would all welcome that.

Q93 Mr Todd: Are you a bit concerned about the FSA's approach to implementing MiFID? Particularly the scope of where it is going to apply.
Mr Haddrill: The jury is out on that, at the moment. We have a Directive here that does not apply to insurance, but where there are insurance investment products that sit in the marketplace alongside other investment products I think it does make sense for the FSA to make sure there is a level playing field across the products, and that the consumer gets the same sort of level of protection that is appropriate to that product. That is the dialogue that we are having with them at the moment. More generally, what we would like to see more of is the FSA looking around Europe to find out what other people are doing, and seeing whether there are other ways of achieving outcomes for consumers that have been achieved elsewhere. There are quite radically different models adopted in Scandinavia, for example, in this general insurance area.
Mr Satchell: Some specific comments on MiFID. I think, for example, in the area of complaints handling where it can move more towards principles-based then we would welcome that. So wherever MiFID equates to the implementation of principles-based we would applaud that. Where it actually gets into rather more detail than perhaps we have even now (there is appropriateness of product for sale), that would seem to us to drive us down into ever more detail and actually put in another set of rules, potentially, over suitability of products for customers.

Q94 Mr Todd: In your submission to us you made the rather coded reference: "a cost benefit case cannot be made for extending MiFID's scope in some areas." I assume you are communicating rather more directly than that with the FSA, are you?
Mr Haddrill: Yes—protection products, or something like that.

Q95 Mr Todd: The FSA have given you notice to produce a marketplace solution on contract certainty. Are you going to comply with their target at the end of this year?
Mr Haddrill: Yes, the FSA has continued to monitor this as it has gone along. I think the percentage of the market that is now completely compliant is around about 85–90%. Whether it is 100% by the end of the year, or indeed what the FSA means by "complete contract certainty", is still a matter at issue. There are occasions where for emergency reasons or others you are not going to get the contract written on the day, but it is going well and I think the FSA endorsed that view.

Q96 Mr Todd: You, presumably, commend an approach which allowed a market solution to develop rather than simply setting another set of rules.
Mr Haddrill: Absolutely. I think it was one of the sea changes in thinking when that was promoted by the FSA.

Q97 Mr Todd: I think both of you were here when I was asking about the Oxera report and the discussion over how to place a value on the regulatory process, and whether there was perhaps insufficient value on the delivery of outcomes, particularly to disadvantaged consumers. Would you agree with that?
Mr Haddrill: I think that is absolutely right. There are some very direct costs that you can measure, and that is the easy bit. I think the very difficult bit is to measure the intangibles: have we, in effect, withdrawn products or advice from the market in some way? Have we stifled innovation? Have we stifled competition by virtue of the regulation? Very, very difficult to measure. We all have a feel that that is, indeed, the case, and I think it is beholden on the industry to try and point to those circumstances where we have real evidence that that is not happening. I suppose getting back to the basic advice scenario and simple products was an area where, perhaps, more could have been done, and there is a disadvantage in the market to an overlay of FSA suitability.

Q98 Chairman: I have a final question. Can I go back to the PPI aspect, which Jim was asking about. Have all your members signed up to provide refunds in single premium Payment Protection Insurance if the loan or credit agreement is repaid early?
Mr Haddrill: I can speak for the ABI committee that has looked at this, and the answer to that is yes.

Q99 Chairman: When you say "the ABI committee" that is not all your members.
Mr Haddrill: No, but normally once that has been decided at senior level in the ABI then the members will follow suit. I cannot promise that every member has decided—

Q100 Chairman: Do you promise to write to us on that and say if all your members have signed up, because I think that is important? Some companies do not allow the payment protection insurance to be cancelled unless the loan is also repaid in full. Do you think that is reasonable?
Mr Haddrill: That is not the gist of what we are trying to achieve, no.

Q101 Chairman: I am trying to ask you this question.
Mr Haddrill: If you are going to cancel it you will cancel it partway through before you have repaid the loan, I think. So I do not see why that would arise.

Q102 Chairman: Let me try and make it simple. Some companies do not allow it to be cancelled unless the loan is repaid in full. Is that reasonable?
Mr Satchell: I am sorry, Chairman, I do not know the answer to that. I would have to come back to you on that. It is not an area that I actually deal in.[2]

[2] Ev 41

Q103 Chairman: It does not seem reasonable, from our point of view. It does not seem reasonable to the consumers that contacted us on that.
Mr Haddrill: I think the question here is: say you have a period of unemployment and in that period you cannot repay the loan. Does the insurance then kick in and sort of clear everything off or do you say: "Well, no, we won't do that; we will just pay the bit that cannot be repaid in that period of unemployment and then when the person goes back into work—"

Q104 Chairman: The FSA have commented on this and what they have said is: "We consider such nil refund clauses may be unfair under the Unfair Terms in Consumer Contracts Regulations 1999."
Mr Haddrill: I entirely agree with you that a nil refund approach is not—

Q105 Chairman: On Payment Protection Insurance, the FSA in their examination of that have said that they found examples of rates as high as 80% of premiums, and the OFT have looked at it as well and they have found commission rates for Payment Protection Insurance can be around 66% for an unsecured loan. From our calculations this means that if I take a loan for £5,000 over 36 months with a total charge for insurance of £1,162 over £750 will be paid in commission. That seems pretty high. In common language it would indicate that the consumer is getting fleeced here.
Mr Haddrill: I think the OFT has also found that there is a high level of competition and that there is no real detriment in terms of the underwriting of the product, which is what our members do.

Q106 Chairman: If I was a consumer and I took a £5,000 loan over 36 months and I found I was paying £750 in commission, I would think I was getting done.
Mr Haddrill: Yes, and I think some of those problems are arising downstream from the—

Q107 Chairman: What does "downstream" mean?
Mr Haddrill: I am sorry, through the distribution chain rather than by the product providers.

Q108 Chairman: Again, as Angela is whispering to me, back to the business model. That seems almost unacceptably high commission. Do you not think so, Keith?
Mr Satchell: This is an area where we have, effectively, factory gate pricing, and the distribution is added on, if you like, beyond the members.

Q109 Chairman: So you think the model is wrong?
Mr Satchell: Most of this is distributed through the banks with the insurers providing the product at a certain price into the major distributors. As Stephen said, across the market what the OFT found is that within the insurance underwriting the pricing actually works. So you have got a competitive—

Q110 Chairman: I refer you back to the point earlier on by Mark about the FSA taking the industry forward and treating customers fairly. It is really for the FSA to pull the industry forward. Would you agree with that?
Mr Satchell: I think the FSA has done a lot to promote confidence—

Q111 Chairman: It does not seem to me to be in line with treating customers fairly if, again, you have a £5,000 loan over three years and you are paying £750 in commission.
Mr Haddrill: I think what we are saying is we believe the insurance industry is treating customers fairly; what happens further down the distribution chain—

Q112 Chairman: No, no. I do not think anybody agrees here with that, at the end of the day. "It is not my responsibility". You have set that up. At the end of the day we are focused on the consumer. So do not let us leave on a bad note here.
Mr Haddrill: We do not favour very high levels of commission or charging for a product—

Q113 Chairman: Would you be quite happy to be paying £750 commission on a £5,000 loan?
Mr Haddrill: No.

Q114 Chairman: I think that tells all. Last point: the OFT found prices for PPI for a five-year, £5,000 unsecured loan varied from £960 to £2,400 with very little obvious difference in the cover provided. In fact, it did say that prices for PPI differ greatly, which cannot be accounted for by differences in quality. Do you think many consumers have been over-charged for PPI?
Mr Haddrill: I think it is clear from the evidence that some consumers have paid a lot for that protection. I think what the OFT is finding is that there is competition and acceptable pricing of the underwriting, and they are still looking at what is happening further down the chain.

Q115 Chairman: Thanks very much, both for your written and oral evidence. It will be very helpful to us in our examination of the FSA on 24 October.
Mr Haddrill: Thank you very much.
Mr Satchell: Thank you.

Tuesday 24 October 2006

Members present:

John McFall, in the Chair

Mr Colin Breed
Jim Cousins
Angela Eagle
Mr David Gauke
Ms Sally Keeble
Mr Andrew Love
Kerry McCarthy
Mr Brooks Newmark
John Thurso
Mr Mark Todd
Peter Viggers

Witnesses: **Sir Callum McCarthy,** Chairman, and **Mr John Tiner,** Chief Executive, Financial Services Authority, gave evidence.

Q116 Chairman: Sir Callum and Mr Tiner, welcome to the Committee and our FSA evidence session. Can you introduce yourselves for the Shorthand Writer, please?
Sir Callum McCarthy: I am Callum McCarthy, Chairman of the FSA.
Mr Tiner: I am John Tiner, Chief Executive of the FSA.

Q117 Chairman: Welcome. You know that we have taken evidence from the ABI and others before you came along and no doubt you have seen that. One of the issues in the general insurance market was the amount of regulation; it was felt that there was, maybe, regulation in certain parts of the industry which was unnecessary but, maybe, in other parts of the industry regulation should be applied. Could you give us your views on that and, also, your views on how the market is working? Is it generally working well?
Sir Callum McCarthy: On general insurance I think we would agree that there is the prospect for the responsibilities given to the FSA to be changed, and there are a number of sectors of insurance where we think there are strong reasons for having a different regulatory regime.
Mr Tiner: I think, clearly, we started regulating general insurance as a result of the Insurance Mediation Directive that was enacted here in January 2005, and this covered the whole waterfront of general insurance activities from the London wholesale market to dentists who were suggesting that their patients should take out some dental insurance cover. I think it has become apparent to us in the 18 months or so since that there are a number of product areas which do not require the full rigours of the Financial Services and Markets Act, which is how the IMD was implemented in the UK, in order to secure the necessary protections for consumers, and I think we think of those sectors as the motor insurance sector, the household insurance sector and the sort of pet, dental or optical areas where, quite frankly, the market works reasonably well, and I think a much reduced regime down to the minimum of the Directive rather than the full rigours of the Financial Services and Markets Act would be fine, in our view. The areas, however, that we think are absolutely ripe for a robust risk-based approach are Payment Protection Insurance, Income Protection and term assurance, which we would recommend very strongly should not be taken out of the existing regime.

Q118 Chairman: On that area, you have had reports on PPI which have been pretty critical and, also, areas such as insurance protection and critical illness. These seem to me to be ones where more regulation is needed, given that you have just had responsibility for the general insurance market as one issue which our Committee will be looking at pretty shortly. I am looking for your advice in those areas on how we go about our business. It seems to me that PPI, critical illness and insurance protection are ripe for further examination.
Mr Tiner: I think these are areas that we were certainly worried about from the very moment we took over insurance regulation in January 2005. On payment protection, of course, the OFT are also concerned about the competition issues there. On critical illness we mainly worried about the levels of exclusions for certain types of illnesses and whether the policy holders are aware that they may be excluded from claiming when they fall ill with certain types of sickness. Income protection—that it does what it says on the tin. So these are all areas in which there is need for improved standards.

Q119 Chairman: The way critical illness is sold could give the impression it is income protection when it is not.
Mr Tiner: It could do. It could give that impression.
Sir Callum McCarthy: Critically, I think, for both PPI and critical illness insurance it is going to be essential that people set out clearly what the exclusions are because the worst issues of mis-selling have been where people have had sold to them policies which do not actually cover their own circumstances.

Q120 Chairman: As we know, the Treasury is looking at travel insurance and there is also an issue which has been brought to our attention in terms of extended warranties. Is that an insurance contract which for many people will be an issue? Certainly it is a live issue for politicians. Could you give us your views on those?

Mr Tiner: The Treasury consulted on both those products at the time they were deciding the scope of the January 2005 regulation and decided that as far as extended warranties were concerned they should be excluded. I think there is some debate about whether they are insurance contracts or whether they are maintenance contracts.

Q121 Chairman: What side would you come down on?
Mr Tiner: I have not looked at it because it is a Treasury decision. The scope is set by them; it is not something we have looked into in detail. On travel, there is a slightly curious position where travel that is purchased from an insurance company is covered but travel insurance which is purchased at the time you buy a holiday is not. So there is a level playing field that I think the Treasury are thinking about at the moment. I think on travel they would have to look very carefully at what is the level of detriment that is trying to be addressed, and does that require, again, the full rigours of the Financial Services and Markets Act regime.

Q122 Chairman: On extended warranties it is nebulous, is it not, on whether it is an insurance contract or not?
Mr Tiner: That is my understanding, yes.

Q123 Chairman: The wholesale market seems to be working better. Maybe I could ask you about contract certainty. It is my understanding that policies were not provided when insurance was arranged, and you have given the industry two years' notice to get that right. If I am correct, that notice is up in December. Has any progress been made on that?
Mr Tiner: Yes, there has. I thought it was quite astonishing when we were just preparing to take over the regulation of this business in 2005 that in late-2004 it was evident that a very large percentage of insurance contracts between insurance companies and their commercial customers (this does not really apply in the retail market) did not have a policy issued, in some cases for months, in some cases for years—and some cases never. The terrible events of the World Trade Centre in 2001 ended up in court because there was not a clear policy, and there are many cases that end up in court, and basically the winners are the lawyers and the claimants take many years to get paid. So we challenged the industry in December 2004, before we started regulating the market, to sort this out within two years, as you say, Chairman, and the two years is up in December this year. We have been keeping very close tabs on this and our feeling, at the moment, is that the market has responded positively, and by December they will get something like 85–90% of contracts now being issued within a 30-day period of the cover being provided by agreement between the underwriter and the company.

Q124 Chairman: As a Committee we would be interested in the 10–15% that are, maybe, not doing it by the end of December. It is something we could come back to. Also, on the issue of commission disclosure, that is not mandated presently, I believe. Obviously, there are big problems there with competition regarding the product provider and the distributor, and it appeared to me that in that area the customer is forgotten about.
Mr Tiner: We wrote a rule into our rulebook at the time we started this which said that if a customer asked for commission disclosure then the broker would be required to provide it. What is, in a way, surprising is that the clients, the assured companies, have not asked for that—and this is not retail, this is in the wholesale market; these are companies. We have tried to encourage market solutions to this in the way that we have with contract certainty, but I think the incentives are so clear and, in a way, so divided between the underwriter, the broker and the insured that we now want to see whether there is a market failure that only the regulators can fix and the market cannot fix it itself.

Q125 Chairman: So that is still a very live issue.
Mr Tiner: Yes.

Q126 Chairman: On the issue of contracts for difference, the Association of Investment Companies (the new name for it) have written to us arguing that these products have been used by some investors to build stakes in companies in a less than transparent market. As a result of that correspondence, I want to raise that issue with you. Is there progress that can be taken in that area?
Sir Callum McCarthy: Yes. At the moment, we are considering what the policy on this should be because it is an issue which raises quite polarised views. There are some who argue, correctly, that there is an economic interest which is achieved by contracts for difference, and some people argue that there is a disclosure regime which is based very clearly on direct ownership. There are some quite difficult questions to sort out, on which we are consulting at the moment, but we have not come to any conclusion; it is a polarised and difficult issue.

Q127 Chairman: We will look at Payment Protection Insurance, and I will hand over to Angela. Before that, I mentioned that the ABI had been before us and they gave us a memorandum on this issue. You stated your concerns regarding policy terms that, in your words, provide no refund of the single insurance premium if the consumer wishes to cancel the PPI policy without early repayment of the loan. The ABI told us in their evidence that they were not aware of companies that refused to cancel a PPI policy unless the loan has been repaid in full. However, our Committee has looked at the website of a major high street bank which says that once the initial 30-day period is over (and I quote): "You will not be able to cancel your loan protection insurance policy unless you also settle your loan early in accordance with the terms of your loan agreement". Do you think that is reasonable?
Mr Tiner: I am not sure it is. We were very worried about this; that consumers were being persuaded to take out a single premium policy rather than a

regular monthly policy, and then if they did terminate the policy halfway through they were losing their premium. We have said to the industry this is not fair on the consumer. All the ABI members have now agreed that that will not happen and that they will provide refunds if customers do terminate the contract before its maturity. That is to our understanding what the ABI members are doing, and it is working.

Q128 Chairman: They gave us different information when they came before us. Let us get the ball rolling: if we give you the name of this high street bank (we will not mention it this morning—no naming and shaming or anything so vulgar) will you contact them and ask them to amend their practice?
Mr Tiner: We will absolutely say to them that if they are members of the ABI they should fall into line with the ABI code of practice.

Q129 Angela Eagle: Mr Tiner, on Payment Protection Insurance, you did last year make some fairly worrying conclusions when you found poor selling practices, mis-selling, poor information, high prices, and people being sold Payment Protection Insurance who were not eligible, actually, to claim when those selling knew they were not eligible to claim. What have you done to try to put that right?
Sir Callum McCarthy: We did a variety of things. First of all, we published in November 2005 the results of our work. We wrote what we call a Dear CEO letter to all the major and medium-sized firms and we set out a general letter to the smaller firms. We have followed that up by a second survey of some 40 firms. That showed some improvement but not a good enough improvement. We have already taken enforcement action and fined one firm and we have about ten other firms which we are investigating with a view to possible enforcement action as well. In addition to that, we have set out strong advice for potential customers of PPI, and we have also, as John has just mentioned, agreed with the ABI, and, I believe, also a number of other trade associations, the treatment of single premium PPI payments which was a particularly objectionable practice. All those things have been done. What we are not doing is tackling the rather complicated competition issues which are basically questions of bundling products, which the OFT has just referred to the Competition Commission. We are concentrating on the issues of mis-selling, appropriateness, treating customers fairly and leaving the competition issues to the Competition Commission.

Q130 Angela Eagle: You fined one company and you are pursuing potential enforcement action against 10 others?
Sir Callum McCarthy: Yes.

Q131 Angela Eagle: How many companies actually sell Payment Protection Insurance in this way?
Sir Callum McCarthy: A large number. I am sorry I do not know the number.

Q132 Angela Eagle: So quite a small amount of enforcement action you have taken, then.
Sir Callum McCarthy: I would not agree with that because we would be prepared to take enforcement action whenever we have evidence of significant mis-selling. We have found *prime facie* evidence and have taken action against an overall enforcement programme which leads in total to less than 300 enforcement actions a year. That is quite an appreciable and very focused enforcement programme.

Q133 Angela Eagle: Do you think commission should be disclosed when Payment Protection Insurance is being sold? Some of the levels of commission are quite hair-raising, are they not? According to Citizens Advice and the OFT, commissions with PPI products can be 66% of the premium. So, for example, on a £5,000 loan, the insurance cost of taking out a PPI would about £1,162, of which £750 is undisclosed commission.
Sir Callum McCarthy: What I think we are more concerned about is to make sure that people recognise, first of all, that you do not have to take out PPI—you can get a loan without taking out the PPI—and, second, that people should check the terms. That should be both how much they are paying relative to a loan, because one of the things that is very alarming is the very high premiums for PPI versus the total capital sum of the loan. It is very important, also, in terms of the terms, that people should look at the exclusions very carefully. If you got people to recognise they did not have to take out PPI and got them to look at the terms I think we would have a huge improvement.

Q134 Angela Eagle: Again, does this not come back to the business model, where there is a lot of hidden stuff going on, and people who are selling these very dodgy products (I think you have to call them that in a lot of cases) are actually on huge commissions, which are hidden, to do so. They are basically ripping off customers, are they not?
Mr Tiner: I think the commissions in this area are much higher than many other products.

Q135 Angela Eagle: The prices are higher.
Mr Tiner: The prices are high.

Q136 Angela Eagle: Significantly higher. The commissions are higher and hidden. It is rip-off time, is it not?
Mr Tiner: I am not sure that disclosing the commissions to the customer, though, is the right remedy. I do not know whether the customer is going to know what to do with that information. I think probably the more important thing is that there needs to be competition brought into this market to drive commission rates down, and that is what the OFT are looking at. The customer benefits from that competition rather than (and we know levels of financial education and financial capability are not that high in this country) actually being able to detect what the commission is, even if it is

disclosed, and knowing what to do about it. I think the work of the OFT is critical here to try and create some competition in that market.

Q137 Angela Eagle: I know that the idea or the mantra is that the more competition there is the more prices will go down, but these are pretty dodgy products. They are very, very highly priced and they have a lot of exclusions that are hidden; many, many people take them out and find out that they cannot ever have claimed on them, and your answer is to have more of these products available.
Sir Callum McCarthy: No, I do not think that is the position, if I may say so. Can I just take one point, first? Payment Protection Insurance is not, in its nature, a "dodgy" product; it is a product which meets a real need. The challenge for us—

Q138 Angela Eagle: It could meet a real need.
Sir Callum McCarthy: It could meet a real need.

Q139 Angela Eagle: I am not sure it does at the moment.
Sir Callum McCarthy: I agree with that; not all Payment Protection Insurance meets a real need or does so on fair terms. That is why the real thrust of all our work here is to make sure that people treat their customers fairly. There are lots of examples of people not doing that, and that is why we are taking action against a number of firms; that is why we have agreed changes in actual processes and performance with a number of firms. Those are the things we are concentrating on.

Q140 Angela Eagle: Are you happy that the level of "rip-off", if I can put it that way, has gone down significantly in the year since you discovered the problem?
Sir Callum McCarthy: There are signs already of some improvement in a position that we regard as inadequate. We are determined to keep on pressing in that direction.

Q141 Chairman: Just to take Angela's point, I questioned the ABI on this. The question I asked them, and I will ask you, was: is it in line with treating customers fairly if, on the evidence we have before us, you have a £5,000 loan over three years and you are paying £750 in commission on it?
Sir Callum McCarthy: I do not think, Chairman, the thing that concerns us first is the level of the commission. The thing that concerns us is that people should understand that if they have a £5,000 loan—

Q142 Chairman: Sir Callum, I think that is a bit complacent. The reason I say that is this: I went for a loan from my bank, a major high street bank, and they sent PPI letters. They did not send me one, they sent me eight. Now, they overloaded me, as a consumer, with that. The impression given to a lot of people would be that this has to be a really important issue for you to take on. So you are getting pressured in that particular area. If you come before a Parliamentary Committee, to politicians, who receive constituents' issues and problems, I think the issue of commission is really important, because at the centre of it is treating customers fairly. If you do not look at it in that way I do not think you are looking at it in a proper way.
Sir Callum McCarthy: Chairman, it goes back to what John said a moment ago, which is: what is the information that customers will actually find most useful?

Q143 Chairman: I will ask you: if you were paying £750 commission on a £5,000 loan?
Sir Callum McCarthy: My concern, Chairman, is whether I am paying £1,000 for Payment Protection Insurance on a £5,000 loan. That seems to be a very bad deal for me. That is the first thing I want people to recognise.

Q144 Chairman: Would you publish tables on your website, then, of what the levels of these commissions and others are, so that the customer can understand what they are doing, as you have done with mortgages?
Sir Callum McCarthy: We are concerned to make sure that people understand how much they are paying, and we are concerned to make sure that people should understand that they can get a loan without paying for PPI.

Q145 Chairman: Would you put something on your website for us then?
Mr Tiner: Yes. I do not deny the points you are making at all. As I said last year, I think this is a market that does not work well and does not work in the consumer's interest. I agree with Sir Callum it is fundamentally not a bad product and a lot of people, when they lose their jobs, thank God they have got it because they can repay their loan. However, it has been, in my mind, over-sold, and it is because of the incentive structures and the cross-subsidisation between the underlying credit and the insurance. These are all issues which are right at the heart of the Competition Commission's referral, and I very much support their work, I must say.

Q146 Chairman: So will you do something on your website in terms of making this information available to consumers so that they can compare prices, as you have done with mortgages?
Mr Tiner: We will look at it.

Q147 Chairman: Will you write back to us within a month and tell us what you are going to do on this?
Mr Tiner: Yes, we will.[1]
Chairman: It is an issue we are going to keep pressing on.

Q148 Peter Viggers: In May, Mr Tiner, you told us that work to improve access to generic advice needed a real injection of effort. What additional work has been undertaken, please? Can you give us a progress report?

[1] Ev 77

Mr Tiner: Yes. I think I reported at the hearing on Financial Inclusion that I was a bit disappointed about that aspect of the financial capability work, and that seems to have stimulated some activity. What we have now done is to work with a whole range of agencies who are quite rapidly able to reach the sort of communities that we think are most in need of money advice, generic advice. So we are working with the Chartered Institute of Housing for people who are housing tenants, we are working with cancer charities, and with the national offenders' charities to help former prisoners; we are working with the Citizens Advice Bureau, Age Concern, Help the Aged, and so on. I think through providing them with very straightforward materials and content, and then using them as trusted advisers to the people they serve, we are able to get money advice quite rapidly into communities. The evidence so far, and it is only a few months since we spoke in May, is that that is beginning to take hold. I feel myself that that approach to getting money advice into the community is more likely to be successful on a cost effective basis and more quickly than setting up a central infrastructure to try and build something from scratch, as has been suggested by some. The evidence so far is that that is beginning to take root and is quite easily scaleable. If you take the housing association example, we gave £50,000 to a housing association called London and Quadrant. They have experimented with that, worked out how they could use the materials for their tenants, and then through the Chartered Institute of Housing they have launched that nationally, and it is beginning to take root. So I think we are on the journey now, whereas we were not in May. I think it has probably got a long way to go but all these things will only pay off over a period of, in my mind, 10 to 15 years.

Q149 Peter Viggers: The most general question of all relating to pensions: the means-tested benefits—now Pension Credit, Housing Benefit and Council Tax Benefit—are considerable, so that in retirement a rich person who has saved and has substantial funds is, of course, quite well off. Someone who has not saved at all is protected, but there are a large number of people in the middle who may perhaps not realise that unless they have saved something like £200,000 to £250,000 they are not going to be any better off by saving at all; all they are doing is providing their own resources rather than relying on the State. Do you accept some responsibility for trying to educate people in that area?
Mr Tiner: Part of this programme is to educate people better about the benefits system and how it will work for them right across the board. I think that is true for the sort of people in the gap you are identifying. It is not a specific item but, generally speaking, the benefits system is relatively complex and people need to know how to use it. For example, people who are thinking about releasing equity in their house perhaps ought to know whether they are getting the right level of benefit before they start releasing equity which may cause them difficulties when they get very aged. So, yes, I think that is all part of the broader picture.

Q150 Peter Viggers: Sir Callum, in your speech in Gleneagles you gave a graphic illustration from slavery, showing how the incentive to ensure that live slaves arriving in Australia meant a different rate of mortality amongst those being transported. How are you working in the field of commission to ensure that commissions are being paid to bodies who are providing and selling worthwhile insurance and pensions to those who need it, to ensure that the pensions are paid for those who are selling worthwhile long-term savings?
Sir Callum McCarthy: There are two ways we are trying to do this: one is, as part of the Treating Customers Fairly programme, to ensure that firms recognise the effect of their commission incentives—i.e. they do not, for example, offer commissions on sales which are irrespective of the value of those sales and the complaints associated with those sales. There are a number of issues that we are pressing on the firms. The second thing, which I think is particularly important, is that at the end of last month we published a paper on the relationship between providers and distributors. In the past, I think, there has been a very unattractive tendency of providers to set out their stall in a way which was quarantined from the mis-selling that often occurred as a result of the way in which they offered incentives to independent financial advisers, and we are keen to establish that that set of responsibilities cannot be cut off in that way. Those are the two main thrusts of activity.

Q151 Peter Viggers: The menu of fees and charges was intended to enable customers to make an informed choice. In 2003, Mr Tiner, you said: "Over time a menu may act as an encouragement to more people to pay a fee for truly independent advice." Is there any evidence that this is working?
Mr Tiner: I think there is what I might call anecdotal evidence that the number of people who are now paying a fee, as opposed to commission, has increased. Somebody mentioned to me the other day that it may be as high as 20%. I do not, I have to say, know where that number comes from and it sounds a bit high, but I think that there is a suggestion that more people are paying a fee. However, my hopes at the time I made that comment that more would have probably not been realised. I think what our mystery shopping in this area suggests is that not enough advisers are making it clear to their clients that they have an option to pay by fee, and we need to push that harder.

Q152 Peter Viggers: Moving to advertising, there is a disturbing amount of non-compliance—79% in general insurance promotion is one figure that has been put to us. The Advertising Standards Authority told us that their primary sanction for those who break the rules is adverse publicity. Does the FSA's work on financial promotions suffer from not having a similar sanction?

Mr Tiner: I do not think so. Our experience of financial promotions is that the standards have improved a lot in the last year. We have done some recent work which shows that there are still too many below standard, I have to say, but the number has roughly halved since the previous year. Out of the ones that are "below standard" only a very, very small number were high risk. I think it is important to distinguish in financial promotions between those that do not meet the requisite standard and those that actually present a higher risk to consumers. What we do where we see a really problematic advert or financial promotion is to ask the company to withdraw it, and that has happened on many occasions, and the company would then, at our request, write to their customers who have already taken up the offer, so to speak, and ask them if they would like their money back. That has happened on quite a number of occasions. That is how we deal with it. Of course, if we want to put it into enforcement, and we have had cases go into enforcement, then there is confidentiality up until the point at which the enforcement case is concluded, which can be some time later.

Q153 Peter Viggers: You have a hotline for the public and firms to report misleading advertisements for financial products. How many calls has this hotline taken, and do you think that more publicity in this general field would be helpful?
Mr Tiner: I am afraid I cannot tell you, offhand, how many hits the hotline has received, but I can find that out and write to the Committee.[2] Generally speaking, it has been overall relatively disappointing. We do not have a huge number of cases coming through the hotline. We have quadrupled the size of the financial promotions department in the last two years, and most of our work (I think we have looked at 4,500 promotions during the last two years) has more come through our own efforts rather than people tipping us off.

Q154 Ms Keeble: I wanted to ask some more questions about information, in particular for John. In May you said you thought the disclosure regime for information was too complex; there was too much jargon and so on. Now what you seem to be saying is that you are going to stick with the existing regime and improve the way that information is provided, in particular looking at extending best practice. That is quite a shift, actually, and I wondered, if that was intentional, why you had reached that conclusion and when you are going to make the improvements that you are proposing now under the new improved system that you seem to accept has taken place?
Mr Tiner: Yes. What we have, at the moment, and what we had when I spoke to the Committee in May, is up to something like 11 mandated documents appearing in front of a consumer who wants to buy an investment product, plus the marketing stuff that comes from the company. We are proposing that that comes down to five; that the documents that then are mandated are simplified and focus on what is really important and in as plain a language as is possible. So, yes, we do think that the sort of sense of "less is more" will work for the consumer. I think if you go back over the last ten years, where we have had terribly elaborate "key features" documents, where companies have gone to great lengths to explain every single risk in great detail, it has not served the consumer at all because they do not understand what they are reading, by and large, and is simply a way for the financial services industry to offload risk onto the consumer. I think we want to put that into reverse, or make the companies think much harder about what does the consumer of that particular product need to know, and how can they best get it across. So, yes, we are changing the emphasis quite a bit from a very prescriptive approach to putting the onus on the distributor and on the product provider to be very clear with the consumer in brief and simple terms what they need to know.
Sir Callum McCarthy: If I can just add one thing, we would also like to try and make a greater differentiation between those documents which are the essential, mandated documents, which we hope would have, as it were, an FSA kite mark on them, as distinct from all the other marketing information that firms should be allowed to send. That is what we are trying to do.

Q155 Ms Keeble: When is that going to happen? Also, how are you going to ensure that the documents produced are actually ones that will be acceptable to consumers? One of the problems with industry best practice is that it is often best practice the way the industry sees it, which might not be the best practice in the way the consumer sees it.
Mr Tiner: That is a fair point. We are coming up with the proposals in the next couple of weeks, with our quite significant reform of conduct of business regulation in relation to investment products, which coincides with the Markets in Financial Instruments Directive. So we are trying to do the two together because there is a lot of overlap. That will be implemented some time towards the end of next year. To the extent that the industry is now going to be developing best practice, we have said and will be saying (again in a paper we will publish in November) that we will be willing to provide some confirmation to those industry standards, but that if firms comply with those standards they may be seen to be meeting our requirements, which is quite a big step for us. However, we will have a set of criteria that we will think about before we give that kind of confirmation to those industry standards. One of them will clearly be: "What input have you taken from consumer bodies? What have they said and how are they going to ensure that these practices are not biased in favour of the industry against the consumer?" So we think that is built into that kind of process. Indeed, our own consumer panel will make itself available to provide advice on this.

Q156 Ms Keeble: The Consumer Council has written to us criticising the lack of specific targeted resources and activities for consumers in Northern Ireland,

[2] Ev 74

and also talks about raising concerns about the low level of public awareness of the FSA. I wonder what your comments are on those particular points—in particular the second because, in a sense, the public should be aware of you safeguarding the industry for them.

Sir Callum McCarthy: I think we are much more concerned that consumers of financial services know their rights. For example, if I go back to the PPI instance, I am much more interested in the fact that they should know that they do not have to take PPI than that they know what the letters FSA stand for. There is another interesting question which we are thinking about quite carefully, which is how we establish, for example, a kite mark on the mandatory documents, and that they understand that that kite mark means something. Those are the things we are concerned about, but it is not one of our objectives to have the ordinary man or woman in the street actually know what the FSA stands for.

Q157 Ms Keeble: People need to know that they have got some protections and some safeguards when the industry is so powerful and sophisticated, and when they are increasingly reliant on it for the protection of their financial security. I wonder if you are satisfied with whether the consumer actually feels that they have got some protection and knows what their rights are.

Sir Callum McCarthy: I absolutely agree. Those are the questions that we are concerned about: ie do people know their rights; and do they understand how they could apply to the Financial Ombudsman Service when something goes wrong? Those are the questions we are trying to look at just as we are trying to look in a very fundamental way at the question of financial capability as a whole. If I may make a rather narrow point, those, rather than name-recognition of the FSA, are the things that we are concentrating on.

Q158 Ms Keeble: There is an issue about the level of consumer faith (?) you have got. I have tried referring a particular constituency issue to yourselves and got bounced around all over the place and finally off to a completely different department. I think there is a real issue about information and the public ability to channel their concerns into you. Is there not?

Sir Callum McCarthy: In terms of the information we have developed, and put more resources into the information on, for example, MortgagesLaidBare and other campaigns like that. Again, the essence of what we are trying to do is to improve access to information so that people know where they can get it. Those are the things that we regard as important.

Q159 Ms Keeble: The Financial Services Practitioner Panel, as part of its Treating Customers Fairly, is talking about defining *caveat emptor* to be much clearer about what is expected of the consumer. "Much clearer" can imply extending the level of the responsibility that the customer should display. Where do you see that the balance lies between *caveat emptor* and information and protection for the consumer?

Sir Callum McCarthy: I think you have to distinguish between wholesale and retail markets. In the wholesale market the concept of *caveat emptor* is much stronger; in the retail market, for the reasons you set out a moment ago, I think there is a huge imbalance between the power of the provider and the knowledge of many consumers. That is why we have worked very hard (with, if I may say so, very successful work by John) in terms of financial capability, and it is also why we have been trying to make sure that people recognise that there are also responsibilities as well as rights that consumers have got. That, I think, is quite an important concept to get across.

Q160 Ms Keeble: Do you think the balance is right at the moment, or not?

Sir Callum McCarthy: No, I think the balance is clearly wrong because there is a huge information asymmetry between the strengthened power of the producers and the ability of many consumers, and that is something that we are trying to tackle in all sorts of ways.

Q161 Chairman: Sir Callum, on the issue of Northern Ireland, I was over there in the summer talking to many people on the issue of financial inclusion, which the Committee is interested in. The Consumer Council and others brought to my attention the fact that there is no office of the FSA in Northern Ireland and, furthermore, there is a lack of targeted resources and activities relating to specific financial issues for consumers in Northern Ireland. It is that area that they were focusing on. I think there is something the FSA could do to raise its profile there.

Sir Callum McCarthy: Could I take that away, Chairman? We will look into it.[3]

Q162 Mr Breed: Can we just turn briefly to an area of activity which causes me and, I think, some others concern, and that is hedge funds. Can I just draw your attention to Mr Tiner's report in the annual report, which says: "We have been careful to be proportionate in our regulation of hedge fund managers bearing in mind the highly mobile nature of their business and their ability to trade into the UK from overseas." Then turning to your memorandum that you sent to us, it says, amongst other things: "FSA authorised firms account for over three-quarters of the hedge fund assets managed by European based firms." The first question is: do you think that you have got the balance right if the regulation is such that it attracts three-quarters of the hedge funds, and are you happy that the existing regulatory regime is sufficient? Second: in the last part of your report in this respect you say: "We have set up a specialist hedge fund unit to carry forward our regulation of these firms". Can you perhaps give us some

[3] Ev 74

indication as to what that unit is doing and how you believe that regulation may be, perhaps, improved without disproportionately affecting the competitive nature of the UK?

Sir Callum McCarthy: Can I just say that we approach hedge funds on the same risk-based approach that we approach all our activities. There are a very large number of hedge fund managers in London, most of whom come and go because, like all hedge fund managers, their half-life is relatively short. The challenge for us is, first of all, we authorise all hedge fund managers to make sure that we have got a proper authorisation process, and then the question is: how do we actually exert our influence most productively. We have chosen to do it in two ways: one is we have a six-monthly survey of the prime broker dealers, which are the institutions which extend most of the credit and other facilities to the hedge fund managers, and that gives us a means of looking at the total exposure of hedge funds, which is important in terms of the prudential issues which are raised—i.e. the threat to financial stability. That we have done. We publish the results of that and discuss the results of that with the prime broker dealers, and we can talk about that. The other thing that we have done is to identify some 35 hedge fund managers who are responsible for sufficiently large chunks of activity for us to really supervise them in a way that is comparable to the way that we supervise other high impact firms. For those we discuss with them carefully their systems and controls and a whole range of other issues. Those are the essential features that we have done, and I think it fair to say that other regulators around the world are watching what we are doing with great interest because the regulation of hedge fund managers raises an interesting and quite difficult set of issues.

Mr Tiner: I think the success of London, if that is the right way to describe it, has not been because there is a weak regulatory system here. I think if you look at other international capital markets, the international credit markets, the international bond markets—certainly the international corn exchange markets—the sort of percentages that you quoted for hedge funds would apply there as well in the European context, with London being either number one or number two to New York in many of these markets. I think it just follows a pattern. Our worry would be that if we had a disproportionate effect on these companies that they would take their business offshore but they would still trade the markets in London, and so we would, in a way, lose touch and then lose the ability to actually intervene. I think that the regime we now have, which Callum has described, and the specialist team we have recruited are now looking quite critically at things like how the hedge funds are managing their conflicts of interest, because it is quite often that the hedge funds are taken in over the wall, so to speak, and when an investment bank is trying to put together a transaction or a convertible bond is being converted into equity, or whatever, the market is being tested. We are very keen to see at close hand how the hedge funds are handling that kind of risk so that they do not trade on that sort of inside information, for example. That specialist team is quite active particularly following the major 35 hedge funds which comprise a large part of the market. I think there is one thing which is slightly curious: whenever I go and meet the hedge fund managers as a group they all seem to be terribly keen to be regulated by us. I say to them: "I think you are a bit too keen", because I think there is some sense that we are a badge of respectability and we just have to be wary of that as well, I think.

Q163 Mr Breed: Is the unit going to be publishing any findings? Has it unearthed any concerns?

Mr Tiner: The unit will produce public reports when they do what we call thematic work; so when they look at particular themes. For example, they look at how hedge funds value their illiquid and complex positions; they look at conflicts of interest, and at the moment they are looking at side letters with major investors that we, in fact, talked about earlier this year. Yes, the results of that will be made public in a general sense.

Q164 Kerry McCarthy: With the move towards more of a principles-based regulation away from rules, what efforts have you made to ensure that the consumer does not lose out? You will be aware, I am sure, of criticism from *Which?* that you have not conducted any sort of cost-benefit analysis of the impact on the consumer. Do you think that is something that you should have done or should be doing?

Mr Tiner: I suspect it is not possible to do, is the truth of it, because you would have to make so many assumptions about actually how many more principles would be working in practice to determine whether the consumer is better off or not. It is our very strong belief that the highly prescriptive nature of the current regulations has meant that the companies have focused much more on the ticking of boxes than thinking about what do they actually need to do to treat their customers fairly. We are trying to turn the whole focus of the financial services industry to building Treating Customers Fairly, in all its component parts, into their business processes, and the way in which they motivate people, the way in which they reward people and, indeed, to try and see (and many companies are coming forward with very good ideas about this) how they can create shareholder value out of treating their customers fairly. So the regulation does not become something which they have to do in a very rigid way, which the research might suggest the consumer does not understand well enough, to one where the consumer is much more at the heart of their business. So that is somewhat an act of faith, I would accept.

Q165 Kerry McCarthy: Is not the problem that the vast majority of firms will be quite willing to go down the route but then you lose the power to more strictly control, maybe, the 5% or so that are not willing?

Sir Callum McCarthy: I think there is a danger in believing that our movement towards more principles-based regulation is, as it were, driven by a desire to impose lower costs on the producers and the firms. That is not the principal driving force. It may be—and I think will be—a good side benefit, but this is driven by a belief that this is a better way of actually achieving our statutory objectives, including that central statutory objective of appropriate consumer protection. I do not believe there is a tension between appropriate consumer protection and a more principles-based regulation.

Q166 Kerry McCarthy: As you move towards a principles-based approach there will be a need for guidance, presumably. How do you strike that balance so that the guidance does not, in effect, become another set of rules?
Mr Tiner: A very good question indeed. If you think about the paper that we have just published that Callum referred to a moment ago on distributor and product provider responsibilities, they are setting out our thinking about that aspect of treating customers fairly. We do not intend to turn that into formal guidance, which then has the degree of formality you are describing and becomes a sort of second set of rules. However, it is important the industry should know what is in our minds, and the industry can then work out how to interpret it. There is also a fear then, beyond that, about how can we take enforcement action where we do not have a precise rule to point to but we have a breach of a principle? We are quite satisfied that that will not curtail our enforcement activity. In fact, many of our enforcement cases, which is not a well known fact, have been based on principles already. I think the legal ground is well developed there.
Sir Callum McCarthy: Of the fines, which were among the largest fines that the FSA has ever imposed, at least two of them have been for breaches of principles: the Citigroup MTS trade fine was for a breach of a principle, and the recent Deutsche case was for a breach of principle. So I do not think that the movement towards more principles-based regulation is going to inhibit us or prevent us from actually taking enforcement action against, as you said, the 5%.

Q167 Kerry McCarthy: You think that firms can cope—particularly the smaller firms. Is there not a danger that they are going to adhere to the guidance just because they do not want that degree of uncertainty? You talk about them taking the guidance as guidance and making their own decisions as to how they operate, but there must be some firms that will think: "We do not want to run the risk of being deemed to be outside the principles".
Mr Tiner: I have heard it said that this is fine for large firms with very large legal departments, compliance departments and risk management departments, and very difficult for the sole trader. Actually, I am not sure about that. I think it may almost be the opposite. I think in the large companies these legal departments and compliance departments are saying to their senior management: "We like this very prescriptive approach because we can (a) do the job and (b) we know where we are on everything", which, frankly, I think reduces the sense of management responsibility at the top for doing the right thing. I think the small trader can look at it and say: "I can look at myself in the mirror and say: am I treating my customers fairly in this respect?" There is plenty of help around on that, on our website and other places, to help them to come to terms with it. I do not think they will need large departments and access to lots of consultants to do that.

Q168 Kerry McCarthy: Final question: in terms of the staff that you employ, has this caused an issue in that you are used to regulators that are there to apply rules and they are now to interpret principles and issue guidance? Have you had to make new appointments or re-jig things around?
Sir Callum McCarthy: The move that we are determined to make raises really big issues both for firms and for us as a regulatory organisation. We have, for example, recently had a major training exercise to train large numbers of people in terms of the new way that we do a central risk assessment called ARROW. We have a whole series of other changes that will be required as we roll this out over the years to come. It is a big cultural and managerial change in the FSA.

Q169 Mr Gauke: I would like to turn to the issue of MiFID. Last year Kerry asked you, Sir Callum, about whether the costs would outweigh the benefits. Your response was to the effect that it was really too early to say at that point. We are a year further on, and I know the process is not complete, but where do you think we stand at the moment?
Sir Callum McCarthy: I think the first thing I would say, Chairman, is that it is still a bit too early to tell—it is a bit like Mao Tse Tung and the French Revolution.
Mr Cousins: I think it was Zhou En Lai.
Sir Callum McCarthy: I am sure it would have been Mao Tse Tung as well! It just shows you should never go beyond your remit! If I can return more seriously to the question, we are required to do a cost-benefit analysis of all the rule changes that arise out of MiFID, and have done so. In addition, even though we are not required to do so, we have made an estimate of the total cost in the UK of implementing MiFID. We think that it will be between three-quarters and one billion sterling, and that is based on what we now know. We think that the implementation cost will be in that range. We will publish our work on that next month. The benefits are much more difficult to estimate but we think that they are likely to include continuing benefits of around £200 million a year and then there are wider benefits which could be very significant and which are, at the moment, almost totally unknown. If the cost of capital, either equity or debt, in Europe were to come down by one or two basis points that would have a quite fundamental effect, and we will just have to wait to see whether that

actually happens—if, after the event, it is possible to untangle it. I would just make one other point: as I said at the annual public meeting of the FSA last year, one of the things which I regard as deeply regrettable is that there has been this huge initiative, important and costly initiative, which was done without proper cost-benefit analysis within the Commission. We very strongly support Commissioner McCreevy in his determination to use impact assessment and cost benefit analysis, because it is not a good thing that at this very late stage we should not be able to answer the question you have raised.

Q170 Mr Gauke: Would it be fair to say that it is easier to quantify the costs at this stage than it is to quantify the benefits?
Sir Callum McCarthy: Yes.

Q171 Mr Gauke: Looking at the costs, can I ask to what extent you think the costs are going to be incurred because of the terms of the original Directive, if you like, and to what extent the costs are going to result as a consequence of implementation by the FSA? Perhaps, in answering that question, you could answer the concern that as a whole the FSA have, perhaps, been overly literal, or overly cautious in its implementation. I know best execution is one that is often mentioned, but how do you respond to those concerns?
Sir Callum McCarthy: Can I take the issue of gold-plating generally? Our general policy has been copy out, which is the most basic transmission that is possible. There are a very limited number of instances where we have thought it right to go beyond the Directive. Each of those will be justified by both an analysis of market failure and a cost-benefit analysis. For example, there are some reporting issues where we think there is a good case in terms of our ability to oppose market abuse. There are also one or two instances where we have existing requirements which we are, *pro tem* at least, going to maintain because we think they are useful (there are issues associated with the menu and IDD which fall into that category). Generally, we are taking a very cautious copy out approach.
Mr Tiner: May I add two points in addition to the points Callum has made about where we would go beyond. One is what we have done on soft commissions and the unbundling of research, which has been very widely welcomed—and strangely, in my mind, does not fit into MiFID. We have to make the case to keep that, but it is something that has worked very well for London in the two years since that market has been unbundled. The other area where I think there is quite a bit of misunderstanding and misconception, is that we have gone beyond on best execution, where we are publishing a paper about our proposals on best execution either later on this week or on Monday. It is clear to me that we are not and that the great advantages to London over many years of the dealer market, the principal-to-principal market, the very deep liquidity pools that exist in some markets, we can keep within the terms of the directive. The directive does raise significantly the expectations by institutional investors, fund managers, that if they ask for best execution they shall be given it. That is not a function of regulation; it is a function of the raising of the issue through the MiFID. But I am quite satisfied, as I said in my speech at the British Bankers' Association two weeks ago, that we do now have a solution to best execution, which has not been easy to arrive at—because it is written in very complex ways and all over the place within MiFID and to make sense of it in a real market sense has not been easy—but I think we have ended up in a good place.

Q172 Mr Gauke: You feel that the industry will be satisfied with the full details?
Mr Tiner: All the soundings I have taken suggest that will be the case, yes.

Q173 Mr Gauke: The logic of what you are saying—and best execution provides a good illustration—is that there are a lot of problems in the original MiFID text, if you like. Do you think it was wise for the Treasury to agree to the MiFID text as it currently stands? Did the Treasury have the grasp of the detailed issues and the industry contacts that the FSA clearly has when it was negotiating at a level 1 stage?
Sir Callum McCarthy: I think the answer, basically, to that is yes. They had that knowledge, partly because we helped them, in addition to their own contacts. Truthfully, the questions there must be on any negotiation of a directive are a whole series of tactical questions, on which I cannot comment at all because that depends on people who are immersed in the negotiation. In terms of, did they have access to an understanding of what the implications were: yes, and we helped give them that understanding and they then took the decisions.

Q174 Mr Gauke: From the FSA's point of view, given the very substantial costs that are going to be there—some uncertain benefits but substantial costs—do you feel there were too many compromises made? Was it a compromise that was in the UK's best interest?
Sir Callum McCarthy: I do not think that I am competent to make that judgment because it depends on a whole variety of other issues which are, in that great phrase, "above my pay level".
Mr Gauke: Mr Tiner, do you have anything to add?

Q175 Chairman: If it is above Sir Callum's, it is above yours, is it not?
Mr Tiner: Thank you, Chairman, for getting me out of that one!

Q176 Chairman: David mentioned market abuse and one area of market abuse that has been brought to our attention is insider trading. I know that your own statistics show a marked tendency for abnormal price movements to occur ahead of key corporate announcements. This is an area, as a Committee, we are thinking of looking at, but the ABI have written to us as well saying that they believe there are far too

many anticipatory share-price movements ahead of price-sensitive announcements. What are you doing about that?

Sir Callum McCarthy: First of all, we are trying to raise the awareness of this. That is why we published the research to which you have referred, Chairman. We are also investing very heavily in a new IT system which will enable us to look at the market and across the market and identify aberrations better. We are also, as John mentioned in relation to, for example, hedge fund managers, making sure that we pursue the importance of segregation of information and pursue those instances when there appears to be breaches of it. I would say that we have had at least one successful prosecution, which was the GLG and Mr Jabre enforcement action, where we took action against both a firm and an individual for the way in which they used information improperly.

Q177 Mr Love: Following up on that, could we say that Gordon Gekko has moved from the United States to the UK because of easier dealings in the London market?

Sir Callum McCarthy: I would basically say that there is no evidence for that at all! I am sorry, that was a slightly flip answer. I do believe that the question of market abuse and insider dealing is a real question. It is a question which in the UK and elsewhere it has been extraordinarily difficult to deal with and we are determined to deal with it in as focused a way as we can.

Q178 Mr Love: Do you think you are dealing with it as effectively as the United States?

Sir Callum McCarthy: If you look at the evidence in terms of what has been described as anticipatory market movements, I do not think there is any evidence that the US is a cleaner or fairer market than the UK.

Q179 Mr Love: In the year 2005 the FSA produced a report on offshore operations. In the light of the *Dispatches* report that appeared on television a couple of weeks ago—and I hope both of you are aware of that—about data protection in Indian call centres, do you have any plans to revisit this particular report?

Mr Tiner: I did not see the programme but I am aware of the programme and read about it. We said in that paper—and it is a core piece of our regulation as business models change and more outsourcing is embraced by the industry—that the responsibility for the outsourcing operation is the senior management of the company that we regulate. We have absolutely no intention of changing that. I think we have to look to the boardrooms of the big UK institutions who are outsourcing, whether it is to India or to other places, to satisfy themselves that data is protected, that fraud is reduced, that there are back-up systems if the systems collapse. They need to be aware of criminal gangs who try to infiltrate some of these organisations and so on.

Q180 Mr Love: Could I interrupt you there, because I want to investigate this balance between self-regulation and regulation itself. But let me ask you this first: there has been a lot of criticism of the report, that it was rather superficial. You visited five firms in three days in Mumbai and five firms in Bangalore in six days. Do you think that is adequate supervision for this type of report in the light of some of the concerns that have been expressed?

Mr Tiner: Yes, I do. That is not to sound complacent but our style of regulation is not to send armies of inspectors around to visit companies. That goes to the core of how we regulate. We have, in total, about eight people on HSBC and the Federal Reserve might have 50 people permanently on Citibank. It just shows you a difference in the way in which we regulate. We would expect that it is not us that spends a lot of time on site in Mumbai or elsewhere, Bangalore or wherever, but that the outsourcers, internal auditors, risk-management compliance people would do that and have a responsibility to report to their management.

Q181 Mr Love: Coming back to this issue, which I think is absolutely at the kernel of this problem about whether it is self-regulation or whether there should be greater regulation from the FSA, there is concern that you are accepting the assurances that are given to you by those companies which seek to outsource, yet there is increasing evidence of difficulties arising, and *Dispatches* is the latest in a series of exposés about this. Are you sure that there is not a greater role, a more direct role for the FSA, in regulating this sort of activity?

Sir Callum McCarthy: I think it is really important to understand both our legal powers and our policy. Our legal powers are in relation to regulated firms which are, for example, banks, a securities company, whatever it is, based in the UK, and we absolutely do that. For the reasons that John said, we make it clear to the senior management of those firms that there is no way that they can avoid their responsibilities by outsourcing, whether it is outsourcing somewhere in the UK or elsewhere. As part of that, we will test very hard the ways in which they control, initially set up, police any outsourced activities, so, in addition to the visits that you mentioned to Mumbai and Bangalore, there is all the effort that goes on in the UK looking at the systems that whichever is the bank in the UK has to control its outsourced activity.

Q182 Mr Love: I understand that. Let me quote briefly from the report. It says: "Most of the third party suppliers firms choose to use in India are BS7799 (British Standard for Information Security) certified." Is there not a terrible air of complacency about that; that you just simply accept this and that is the end of it?

Sir Callum McCarthy: I would go back to what John said. I hope there is not any complacency about it, because the whole issue of outsourcing raises important issues of control, prudential issues,

consumer-protection issues, which are absolutely essential to us. That was a statement which happens to be a true statement.

Q183 Mr Love: You suggest in the report that offshoring is not inherently more risky than outsourcing but you then go on to say "the main risk identified is the complexity of achieving suitable management oversight and control from a distance." "From a distance" suggests to me that there is a greater inherent risk in offshoring than there is in outsourcing. Would you agree with that?
Mr Tiner: I think there may be. I would agree. But I think it is a question of degree of risk. The important thing is that the responsibilities of the people that we regulate remain the same. I can see your point, clearly, that inherent risk when something is 4,000 miles away and subject to different types of regulation/different types of management is higher than if it is 20 miles down the road and you can pop down and make regular visits, but, from our point of view, the responsibilities of the board remain the same.

Q184 Mr Love: It says in the report, in paragraph 70, that "there is no evidence to suggest consumer data is at greater risk in India than in the UK". There has been the *Dispatches* programme; there was an exposé previously about fraud at Citibank. Whether that statement was true at the time the investigation was carried out, I would not seek to comment, but are you still convinced that statement is true today in the light of your recent experience?
Mr Tiner: We are not going to sit on our hands. When we have got more recent evidence that there may be problems then we will definitely follow it up. I cannot tell you today that that statement that we made when we published that paper remains the case, without further work, but I think what you are asking us to do is quite right. Given the increase in offshoring activity and the inherent risk to which you referred, it is fair that we should be looking again at that area to see whether there are new risks about data protection—and not just about data protection but about criminal activity that might go on within offshoring activities.

Q185 Mr Love: I think the FSA's primary concern here is consumer confidence, that their data is not being abused in the way that has been suggested. Let me ask you one final question. The Information Commission, as a result of the programme, has said they will be carrying out an investigation to discover the true facts behind all of this. Do you have any involvement with that? Are you in contact with them to ensure that your role is adequately represented in their final report?
Mr Tiner: I do not know. I need to establish that and write to you. I could not tell you at the minute.[4]

Q186 Chairman: Andy referred to consumer confidence and you referred to the business model changing, and Peter referred to your speech at Gleneagles, Sir Callum, and I was there listening to it, but at Gleneagles you said that the business model was based on commission incentives which produced "results which are unattractive to reputable providers, unattractive to their customers, and whose benefits to intermediaries are questionable." You also said that it is distinguished by a focus on business volume rather than quality; that persistency of policies is very low, with half of the customers who buy regular premium personal pensions no longer paying them after four years; and at the end of the day the sum picture is one that is incompatible with developing either the reputation of the industry as a whole or a brand reputation for individual companies. There is a persistency to commission in the industry, and, as one who has looked at it for quite a few years, I would see it very hard to change that model. What will be the triggers to change that eventually, in your optimistic opinion?
Sir Callum McCarthy: One of the things that is recognised in a growing way by the firms themselves is that the business model that they have is unattractive in the ways that I described. I think there is a business imperative for them to change—and, if they do not change, there will be new entrants who will emerge with different business models. That is one thing. In relation to what we can do: we are concerned very much to try, first of all, to identify this problem; second, we are doing a whole series of things in terms of treating customers fairly which are going to make it more difficult for people to use the traditional commission model without recognising the need they have to mitigate the risks that they are running by using that commission model. The other thing which I think is going to be important is the work we are doing on a survey of what is the distribution system. We want to identify a whole series of things, including where there may be regulation that is exacerbating the problem, because if there are places where there is excessive regulation, where it is not justified, we will want to change it.

Q187 Chairman: At the same conference, Ned Cazalet quoted figures for the industry, where he said that £56 billion has come in over the past five years but £31 billion of that is churning. There are people making quite a tidy sum for themselves in that area, but the consumer is losing out at the end of the day. In order to restore confidence in this industry, it seems crucial that this model is changed. Can it be done just by encouragement from the sidelines?
Sir Callum McCarthy: I do not think it can be done just by encouragement from the sidelines, no, but I think, first of all, that there is recognition among the firms that the position that you have described is deeply unattractive. There is the fact that we are going to make it more difficult for people simply to administer the commission model in the way that it has been administered in the past, without recognising their responsibilities, and I hope we will be able to bring pressure to bear on an industry which already recognises that the present position is

[4] Ev 74

in many ways unattractive, for them as for their customer. I think it is a significantly unattractive position we have got and we are trying to change it.
Chairman: Okay. The best of luck, Sir Callum, and we will be watching you, hopefully not from the sidelines.

Q188 Jim Cousins: May I pursue one aspect of the issues raised by my colleague Mr Love. If, in the offshoring process, the administrative functions and processing functions are handed over to the completely free-standing company that is contracted to perform those functions, does your regulatory reach still apply?
Sir Callum McCarthy: It is because of that that we make it clear to the firm that we regulate that the fact that they have taken a particular function and given it to somebody else does not in any way exclude them from their responsibilities. As part of that, we would want to have the same ability to test the way in which an outsourced company, whether in the UK or offshore, discharges its responsibilities for a regulated company as we would if that activity were taking place within the regulated company.

Q189 Jim Cousins: I am not here referring simply to geographical location but to a switch of responsibility from the company that is running the operations, that is interacting with the public, and the company that is responsible for the processing operations.
Sir Callum McCarthy: That, I think, brings us back to the paper that John referred to, which we published at the end of September, about the responsibilities of distributors versus producers. We are trying to ensure that it is not possible for a producer to escape from responsibilities that are properly theirs simply by having, as it were, a cut-off between their activities and the activities of the independent distributor.

Q190 Jim Cousins: What is your understanding of the legal position about that in terms of the Financial Services and Markets Act?
Sir Callum McCarthy: It depends on the circumstances, I am afraid is the answer, because it is possible to see some circumstances in which the producer reasonably has no responsibility and it is also possible to think of other circumstances where they clearly do have responsibilities. I am sorry to give you an answer of that nature, but if you look at the document that we published you will see that we teased out a series of circumstances where the responsibilities would be very different and it does depend essentially on the facts of the case.
Mr Tiner: It is very complicated, because in many cases there are two types of producers and one distributor. It may be that one of the big Wall Street investment banks may find a way of disaggregating a very complex product trading in the wholesale markets, which they would then arrange with a retail producer to package for the retail market, who would then go to distributors—and our paper reflects where the responsibilities lie in that chain—from very straightforward products, where there are clear contractual agreements between producer and distributor which would need to be complied with. It is not straightforward. More broadly, going to the question of outsourcing to companies that are not regulated, the important thing is that that is not a switch of responsibilities. The responsibilities lie squarely with the firm we regulate.

Q191 Jim Cousins: Turning to a slightly different topic, there has been a great deal of interest in the United States about the exercise of stock options. Is this something you have considered?
Mr Tiner: Yes, to some extent. The laws are different and the accounting is a little different in each country. You are allowed to issue in-the-money stock options here. It happens. There is a requirement to notify the market within five days if that is done and we have not discovered difficulties with that. Any issue of in-the-money stock options, I think, has to receive shareholder approval here as well. We are interested in this. We are reminding people, through the paper that we call *List* (which is the way we communicate with the public companies that we authorise through the UK listing authority) about this, but we have not found the same degree of backdating that they seem to have discovered in the US.

Q192 Jim Cousins: Have you discovered any degree of backdating?
Mr Tiner: No, we have not.

Q193 Jim Cousins: Will the transparency directive throw more light on these procedures?
Mr Tiner: I do not think it will.
Sir Callum McCarthy: I do not think so, but could we just check on that? I think the answer is no.[5]

Q194 Jim Cousins: I wonder if I could get you to turn your minds to the famous *Plumber* case—and I am here not referring to the Polish gentleman that the Governor of the Bank of England welcomes to our shores. Are these expenses, for which you will now be liable, known?
Sir Callum McCarthy: Not yet.

Q195 Jim Cousins: Are they likely to be substantial?
Sir Callum McCarthy: I cannot tell you because we have no idea of what claim Mr Davidson and Mr Tatham will make.

Q196 Jim Cousins: Your 2005–06 annual report shows a situation of expenditure on enforcement of £33 million roughly, roughly half of which is covered by penalties. Will the outcome of the *Plumber* force a re-write of those figures?
Sir Callum McCarthy: They will not cause a re-write of those figures, because I think we will treat them as a cost in the present year, not in relation to past years, but we will recover whatever the costs are eventually agreed by the tribunal in the only way we

[5] Ev 74

can recover; that is, by spreading it across the fees that we charge to the firms and individuals we regulate.

Mr Tiner: I think it is important to point out that the money that we raise from fines does not go to abating our costs. That was very clear at the time the Bill was going through Parliament.

Q197 Jim Cousins: That is clearly set out.

Mr Tiner: Is that clear? I thought that was part of the implication. The £33 million of enforcement last year stands on its own, irrespective of the fines we recovered. Obviously, otherwise, we have the wrong sort of incentives ourselves.

Q198 Jim Cousins: In your annual report you set out some risk-assessment procedures to inform board members of the work of the FSA. Will your own internal procedures before taking enforcement actions be one of those issues that you will bring to board members under those risk assessment arrangements?

Sir Callum McCarthy: Last year, in the light of the *L&G* case, we set up a committee of the board to review the whole way in which we approached our enforcement cases and made a whole series of significant changes to them—which, incidentally, in the decision on the costs in the case of Mr Davidson and Mr Tatham, the tribunal recognised would have, in their view, resulted in a different set of decisions being taken by the FSA in relation to those cases. The answer is: yes, the FSA board is integrally involved in the risk assessment of our enforcement process, and has been, and I expect them to continue to be.

Q199 Jim Cousins: That is an interesting point. You have already indicated that both the *Legal & General* case and later on the *Plumber* case are going to lead to changes in the pattern of your enforcement action. How much less enforcement action is there going to be?

Sir Callum McCarthy: I do not think it will necessarily result in a reduction in our enforcement action, because we will take enforcement on the same basis that we do at the moment.

Q200 Jim Cousins: Do forgive me, you have just said something entirely different. You have just said that it would change the way you take enforcement action, and that the actions, both in the *Legal & General* case and the *Plumber* case, would not have been taken if these new risk assessment procedures had been in force.

Sir Callum McCarthy: No. With respect, I said—and for the avoidance of doubt, let it be clear—that we would not have proceeded in exactly the way that we did proceed in either of those cases. I am not sure whether we would have taken either of those cases forward, but, irrespective of that—

Q201 Jim Cousins: You have now told the Committee three different things. You have said that the review of enforcement procedures would not have led to those two cases being brought; that they would have led to those two cases being brought; and that they might not have led to those two cases being brought.

Sir Callum McCarthy: May I be clear: we have made a series of changes—

Q202 Jim Cousins: Which of those is it?

Sir Callum McCarthy: I am about to explain, if I may have an opportunity. We have made a series of changes already to the enforcement procedures. Second, because we now have a definition from the tribunal of what they regard as reasonableness on behalf of the FSA, we will of course take account of that in the way that we adopt our procedures going forward. Overall, I do not expect us to have either an increase or a decrease in the number of enforcement activities or the emphasis that we place upon enforcement, as a result of either of those changes.

Q203 Jim Cousins: Do any of these enforcement actions involve board approval?

Sir Callum McCarthy: Very rarely, I think is the answer.

Q204 Jim Cousins: We have talked about the culture in the insurance industry earlier in our discussion. Is not the enforcement culture of the FSA going to be changed by the outcome of these two cases?

Sir Callum McCarthy: I am not sure what you mean by enforcement culture.

Q205 Jim Cousins: The issues to which you have just been drawing the attention of the Committee.

Sir Callum McCarthy: One of the things that we have made clear is that we will not adopt a policy of only pursuing enforcement cases of which we have 100% probability of succeeding, and that will not change.

Q206 Jim Cousins: What probability of success are you going to use?

Sir Callum McCarthy: It is a balance, on any case, and it is not based on a simple arithmetic: "We will do it if it is 98 but not if it is 96." I am sorry, but it is more judgmental set of issues.

Q207 Jim Cousins: It is quite normal for enforcement authorities to have an internal assessment of the likelihood of success before bringing a case. That is perfectly normal; no one is going to be surprised by that. You have told the Committee that it is not going to be 100% success. That leaves us, if you will forgive me for saying so, really nowhere. What are the internal guidelines you are using to test whether an enforcement action will be brought?

Sir Callum McCarthy: I would say that, broadly, they are the requirements that we have under the law in relation to criminal cases: a balance of probability—which is the same in those criminal cases. In other cases, it involves a series of judgments. But the only point I am making is that I believe it would be wrong for the FSA to confine its enforcement actions to those where we are

completely sure that we will succeed, because, if we were to do that, I think it would be necessarily and improperly lax.

Q208 Jim Cousins: In your annual report you somewhere say that there were 166 suspicious trading reports that you received. In how many of those was there enforcement action?
Sir Callum McCarthy: I am sorry . . .
Mr Tiner: I do not know.

Q209 Jim Cousins: You have told the Committee that there was one successful action for insider dealing. The Committee heard earlier that one of your own directors said that 28.9% takeover announcements resulted in a potentially significant sign that there was use of insider information. You have told us of one successful prosecution. What is the baseline? What is 28.9% of the takeover announcement? What is that figure?
Sir Callum McCarthy: The 28.9% are the instances where there is a public announcement in advance of which there is a significant share-price movement.

Q210 Jim Cousins: How many cases are we talking about? How many cases are represented by that 28.9%?
Sir Callum McCarthy: I am sorry, I cannot remember what the number is. I will give you a note telling you that.[6]

Q211 Jim Cousins: But the successful prosecutions out of that number were one.
Sir Callum McCarthy: No.

Q212 Jim Cousins: Successful actions.
Sir Callum McCarthy: No, there was more than one instance, but, as I said earlier in evidence, one of the continuing problems that exists in this country and other countries is bringing successful prosecutions against the standard of evidence that we have to bring for insider dealing. That is a real problem which we are determined to attack.

Q213 Jim Cousins: Have you made representations about that to the Government?
Sir Callum McCarthy: No, is the answer.

Q214 Chairman: I will tell you what, Sir Callum, because we have to move on, why do you not write us a nice letter to explain all that stuff to us so that we can try to pursue it here.
Sir Callum McCarthy: I would be delighted to do so.

Q215 Jim Cousins: Let us be clear about it: there is a problem here and you have not drawn it to the attention of the Government.
Sir Callum McCarthy: No, I would not say that.

Q216 Jim Cousins: You just have.
Sir Callum McCarthy: It is a problem that we had discussed with government—

Chairman: We are happy that you are going to write to us, Sir Callum.

Q217 Mr Newmark: My question is for John and it is to do with these split capital trust schemes, which, with certain people, is unfortunately still a running sore, so perhaps I can be very specific in my question. I appreciate this was covered last year but unfortunately I was not on the Committee. I have seen the answers and I also appreciate a letter I received from your head of department of litigation and legal review, which was a very thorough letter on this issue. A particular phrase that was written in the letter, which was how the settlement was reached, was, "As we said in our statement of 24 December 2004, our decision to settle on the basis we did was driven by a view that this settlement was in the best interests of investors." It does not say some investors; it says investors—which I am assuming was supposed to cover all investors. It goes on: "Our main aims were to seek to achieve a settlement which would obtain a reasonable amount of compensation for retail investors"—and, again, it does not say some retail investors; it says retail—so I am assuming there was some process of trying to be equitable to all people who were involved in these schemes. I have had a considerable amount of correspondence from a Mr Roland Fernsby and others who were ordinary income shareholders. From the information I have read, it seems that, while the zeros were compensated, unfortunately the ordinary income shareholders were not at all, so it looks like there was a complete bias to one group of shareholders. I would like to ask John as to why this decision was equitable and fair, and if he would explain to me in very simple language why the ordinary income shareholders really received nothing.
Mr Tiner: There was a limited pool of money as a result of the settlement on Christmas Eve 2004. We felt that the class of investors who were most deserving of that money were the people who went into it expecting that they had the lowest degree of risk. The nature of split capital investment trusts was that the zeros were the lowest risk category; the income shareholders were next; and then there were the capital investors, who were really taking a bit of a punt. There are a couple of points that differentiated the income shareholders and the zeros. Up to that point—in fact, up to any point but maturity—the zeros got nothing. They were getting no income at all—all of their pay-back of capital and any subsequent income was in the capital repaid on maturity—whereas the income shareholders had received dividends during the course, and in some cases quite reasonable dividends—so they had already received something which the zeros had not. That, combined with the fact that the zeros had been led to believe (in a way which I think income shareholders had not) that they were kind of putting their money into a deposit account—there were some adverts that compared them to building society deposits—whereas income shareholders went in more on the basis that they were buying sort of ordinary shares in a company, led us to believe

[6] Ev 76

that this limited pot of money should be divided among the zeros alone. There was also, of course, a backstop then for the income shareholders—and, indeed, for the zero shareholders that did not want to take the settlement—which was the Ombudsman. If they felt that they had been misled into the sale, there was always the compensation system of the Ombudsman waiting to help them if that was necessary. That was the rationale.

Q218 Mr Newmark: And that is sort of what I have read. This is what surprised me with the way the pot was divvied up: there were clearly a lot of people who were in the zeros but a much smaller group in the ordinaries and income in terms of amount that was at risk. Those sort of people, it is my understanding—and please correct me if I am wrong on this—were people who did not want to sort of wadge away zeros hoping that they would get the capital at the end of the bag; they were more the widows and orphans, if you will, or the pensioners, who wanted to get the income from the income shares. In many ways they were perhaps some of the more vulnerable investors, who relied on that income, and the reason why they feel aggrieved is because when they were sold to go into the income shares, as opposed to the zeros, it was because probably a lot of them were older and were sold on the idea that they were going to get some sort of steady stream of income. I think that is why a lot of that sort of investor feels hurt and aggrieved. Is that a fair analysis?
Mr Tiner: I am quite sure there are a number of ordinary shareholders who are in that category, but, if they were advised to take those and they feel as though they were inappropriately advised, by taking the case to the Ombudsman and succeeding with the Ombudsman they would get a much higher payout than if they received a part of the settlement, which would then have to be divided by a larger population, and they would get—because this is the Ombudsman's normal way—interest on the capital settlement as well. That has always been available to them. We just felt that in terms of the actual settlement, given that for all the investors this was a full and final settlement—you could not take the money and then go to the Ombudsman—we were better keeping it to the zeros, to let those people who were genuinely badly treated in the income shareholder category to take their case to the Ombudsman.

Q219 Mr Newmark: You do not think, given the relatively small size of the income category and who they were, that, in having a settlement, there should have been any consideration for those income people? I still do not understand why, in a settlement, you only settle with one group of investors. This is a question I have been asked to push you a bit with. Why, in trying to come to a settlement in a case which involves a series of classes of investments, did only one group get anything out of it?
Mr Tiner: From the settlement?

Q220 Mr Newmark: Yes. You are saying: "For all you guys, you have to go to the Ombudsman." In settling things normally, you settle with all people. You do not say, "We are just going to settle with one group and for the rest of you there is a different route and you have go there." That seems inequitable to me.
Mr Tiner: I do not think it is inequitable, given that they are, by their very character, different classes of shares. They were different levels of risk, different levels of income distribution, and I think that persuaded us that we should, through the settlement, distribute that to those who came in on this deal thinking basically that they had a copper-bottomed capital guarantee. They did not, and they never did, but many of them came in on that basis. I think, therefore, we felt they were the most deserving cause.
Mr Newmark: Thank you.

Q221 Mr Todd: Could we turn to general insurance and your role. You have a goal of ensuring that there is clear, simple and understandable information available for and used by consumers. Have you researched what information consumers find most useful and use in determining product choice?
Mr Tiner: In the general insurance market we have. In fact, we did that at the time the policies were written, when the insurance mediation directive was being implemented throughout the European Union. I made comments earlier, with respect to what I regard as relatively low-risk insurance products where the market works pretty well—market household and so on. My feeling is that many of the requirements, because they are built in, are over-elaborate. With 18 months' experience, I hope we will be able to trim back quite a bit of that.

Q222 Mr Todd: What did consumers tell you they found most valuable in terms of information in making a product choice?
Mr Tiner: I think they want to know what they are getting, what the exclusions are, what the price is, what the claims arrangements are and whether they are getting advice or not getting advice, whether they are on their own or whether they have resource to complain if they feel they have been misadvised. It is those sorts of things that customers said they wanted to know.

Q223 Mr Todd: As you have said, the documentation they currently receive is often extraordinarily lengthy, with vast quantities of small print which leaves consumers at the very least confused and potentially concerned, as well, that they may not have understood fully the product they have purchased.
Mr Tiner: Yes. We have seen some very good examples from some firms who have worked very hard to create some clarity around the policy, what it covers, what it does not cover, what it costs, how to make the claim and those sorts of things, and there are others who have taken a very legalistic approach which is not for the benefit of consumers. I think we have understood now that, in those lower

risk markets, if the Government were able to create a cut-down regime which is still directive compliant then that will make a lot of sense.

Q224 Mr Todd: This would be focused on the simpler products that we are talking about.
Mr Tiner: Yes.

Q225 Mr Todd: The industry itself has some concerns about the FSA being over-prescriptive in this field, but I think it is also fair to say that they have an anxiety that if something is not listed then they may be caught out at some stage in the future. So you are hung, whichever way!
Mr Tiner: Yes. It is the job of the regulator.

Q226 Mr Todd: How do you resolve that dilemma?
Mr Tiner: That is the tension between having a very prescriptive rules-based system and having a more principle-based system. I think the industry and the FSA need to accept a level of ambiguity, what the firms might regard as vulnerability—I do not think they should, but they might regard it as that—actually for the good of the market. A massive level of prescription in some markets does not help the consumer being informed and well protected, but there has to be, I would accept, probably an increasing level of trust then between the regulator and the firm/the firm and the regulator to do that.

Q227 Mr Todd: I am not entirely clear whether they want more regulation or not in this field.
Mr Tiner: I do not think they want more, but, whenever we try to take rules away, we get complaints because we seem to be taking away some trade association's favourite rule. But we are fairly determined to challenge and to press on with this approach because we think ultimately it will be good for business.

Q228 Mr Todd: There are surely some core items of information—and you listed some of them at the start—which any sensible consumer would wish to know about any product.
Mr Tiner: Yes.

Q229 Mr Todd: And which should be obligatory and printed in a very clear format so that people can understand it.
Mr Tiner: Yes.

Q230 Mr Todd: Then there is a range of other things which could legitimately be covered by principles.
Mr Tiner: I think so. I will give you one example: if you phone up for a motor quote I think you get a 25–30 second spiel on something and a lot of people put the phone down during that period. They have gone in 20 seconds. The question is: does that add anything or could you do it on a more sensible basis?

Q231 Mr Todd: I was going to ask you about telephone sales, which is the way in which a lot of these products are now sold.
Mr Tiner: Yes.

Mr Todd: I was going to ask you about telephone sales, which is the way in which a lot of these products now are sold. The rules that we have seem singularly ill-adapted to a normal telephone conversation. The caller receives a lengthy monologue before they can say anything at all, and, as you say, we cannot really make legitimate comparisons.
Chairman: We have one example here where there is a 200-word introduction.

Q232 Mr Todd: We have received some evidence from John Howard on this, on the interaction between regulations from you, from Companies House, the Information Commissioner, the Motor Insurance Bureau, a whole series of different bodies with different recommendations, often overlapping, as to how you communicate effectively with the customer. Is there some way in which one can bring some of these practices together so that the consumer gets a clearer explanation and a shorter one?
Mr Tiner: I do not know. At the moment, I do not know of any central facility where all those things will come together. All the separate bodies that you mention there just have to work very hard to keep things simple for the consumer.

Q233 Mr Todd: Do you not have an ownership overall over that task?
Mr Tiner: I am not sure.

Q234 Mr Todd: You are right, they are all separate bodies with slightly different agendas, but your responsibility is clearly to serve the consumer in this matter and to ensure that they are properly informed.
Sir Callum McCarthy: I think it goes back to those things that we are concerned to try to get real attention paid to as the core information, because, irrespective of whatever we mandate, it would be completely improper, we believe, for us also to say to firms, "You cannot give this particular advertising material." We are trying to get the core information that John described and get it described clearly, unambiguously, and get that requirement observed, because there is still a problem of observation of this.

Q235 Peter Viggers: On a previous occasion, I raised with you, Mr Tiner, I remember, the issue that some insurance institutions, notably Lloyd's, were trading on the basis that they would enter into insurance with the contract details to be written later. I recall that you shared my incredulity that any organisation could operate in that way. Are you able to give us a progress report on any manner in which you have been able to encourage an improved practice of having contractual terms clear at the time?
Mr Tiner: Absolutely. This is the challenge to the wholesale insurance market, to create some contract certainty by December this year. At the last count, which I think was at the end of June, something like 80% of contracts in the Lloyd's and London market insurance market were being issued within 30 days of the cover being agreed. The operating models

around how slips were signed in Lloyd's and how they translated into policies—which is the old problem—have been significantly re-engineered to allow these policies to emerge. I think we have seen a sea change in that. What is interesting is that this is a problem that exists around the world but it is not something that other regulators and other markets seem to be addressing. It has just become a malaise in the insurance industry globally that they allow this sort of thing to happen. London will gain competitive advantage from providing much more contract and more legal certainty in relation to the policy than other centres ultimately.

Peter Viggers: Chairman, that is reassuring. Perhaps I should have declared an interest as a residual underwriting name of Lloyd's through Equitas and as Chairman of the Lloyd's Pension Fund.

Q236 Ms Keeble: In 2005 you found there were problems with the sale of equity release products and you were going to do some follow up. I wonder if you find the practice there has improved, particularly referring to what was found to be the habit of some advisors of advising people to release more equity than they needed and then invest in other products and getting dual commission. So first, in general, and then specifically about that point on which questions were raised.

Mr Tiner: Yes, we followed that up in June this year with visits to 23 firms who sell and advise on equity release mortgages. We found a generally much better picture than we did the previous year and specifically we found that consumers were not being encouraged to over-borrow and then to invest on the other side and commission gets paid twice. We found very significant improvement there.

Q237 Ms Keeble: Are you satisfied with the position or do you feel there is still room for further improvement, and, if so, in which areas?

Mr Tiner: We think there have been improvements. I think further improvements can be made. I mentioned earlier that particularly for people who are being approached who are relatively young for this sort of product, if I may put it that way, in the 55–65 category, they should be aware of other sources of household income that they could create other than releasing equity in the mortgage. For example, are they maximising from the benefits system, as I mentioned. I think we want firms to be clearer that equity release is the right product for them, having considered all other options. So there are two or three things, we have said to the industry, that we think they can improve, but, overall, we have found standards much better.

Sir Callum McCarthy: One of the things that makes this an area of particular concern is that, clearly, if you move away from the 55–65 year olds, up the age groups, there is the prospect of dealing with people who are less acute and who need a degree of protection. That is why we keep coming back to this area.

Q238 Chairman: There are some financial institutions yet who are a bit nervous about selling this because it is a risky product. Given the undoubted increasing market there will be for this in future years, is there not improvement yet for ensuring that it is sold in a totally responsible, fair-minded way?

Mr Tiner: I think releasing equity in a person's house is going to be an important source of income for many families for a long time to come. This is a product which is important to society for probably decades. It seems to me that we want to see a product which is well designed, carefully put into the hands of distributors, with all the right incentive structures to sell it responsibly. I think there are real opportunities there for some of the larger brands. Our concern, as Sir Callum has said, is that you are dealing very often with a very vulnerable consumer at the end and we want to see the industry respect that and behave properly.

Q239 Chairman: On LSE regulation the financial secretary came out with his proposals a couple of weeks ago. Are you satisfied with that and that it will secure the position of London in the FSE in regulatory matters and that there will no be any outside interference?

Sir Callum McCarthy: I think it was a very useful step to make sure that there is not a risk of extraterritoriality associated with the foreign ownership of the London Stock Exchange, if that were to occur.

Q240 Chairman: In terms of financial promotions, there is still a bit the FSA could learn from the Advertising Standards Authority. As we mentioned earlier, we will write to you on that and try to get your views in that particular area. My last question has a constituency element. I have been contacted by a number of constituents, and I presume other Members of Parliament have been contacted, with regard to the collapse of Farepak savings scheme. Only this morning I had an email from a constituent, which said: "Myself and a number of my workmates have been robbed in broad daylight by Farepak. Since January all the girls within our workplace have been saving for Christmas. We have scraped together the weekly payments only to be informed now, when we have fully paid up our purchases in advance, that our hard savings are gone." They are obviously asking me and others to see what we can do about it. I do note from a newspaper report that Ian McCartney, the Consumer Affairs Minister, will meet the Financial Services Authority and the Office of Fair Trading to discuss tighter regulation for the savings club market following the collapse of Farepak nine days ago. There are 100,000 customers thought to have lost savings up to £15 million due to that demise. Do you have any comments on that or any information you can give us in terms of a meeting with Ian McCartney?

Sir Callum McCarthy: I would say two things. One is that I have huge sympathy for the people who have lost money in this way and the second is that the FSA

has no responsibility whatsoever at the moment, as the law is drafted, for this sort of scheme. It would require a change of law to give us responsibilities.

Q241 Chairman: We are not asking for a change of law, but again we are talking about restoring confidence in long-term savings. Here is an issue where people at the modest end of the market are putting their savings aside and they are blown before Christmas.

Sir Callum McCarthy: In so far as I understand the facts, I think this is a dreadful occasion and I have great sympathy for the people. We will sit down and explore with Mr McCartney or anybody else who wants to talk to us about it and explain the responsibilities.

Q242 Chairman: Do you think it is worthy of exploration and that the FSA can contribute to that debate?

Sir Callum McCarthy: I do not know enough about this sort of savings market to know, in terms of a policy initiative and in terms of public policy, which is the best bit of the government machine or the quasi-government machine as a whole to deal with it. That is the thing that would have to be explored.

Q243 Chairman: Yes. But when you have people's individual savings going up in smoke, just like that, there is a public policy issue here, and you, like others, can contribute to that.

Sir Callum McCarthy: Yes.

Chairman: I think we have covered a lot this morning. Thank you for your attendance. We look forward to a continuing contact with you. Thank you very much.

Written evidence

Memorandum submitted by the Association of British Insurers (ABI)

Summary

1. The insurance industry aims to serve customers well and to grow the market for savings and protection insurance. Companies respond to changing customer needs within a fast-developing social and economic environment and have to reflect these in the products and services that they offer. The industry recognises that further work is needed to build public confidence and its own reputation.

2. To achieve this, we need a constructive relationship with our regulator, and a framework of regulation that sustains high levels of public confidence in financial services, financial strength in the industry, and a competitive and innovative marketplace.

3. In recent years the FSA has made significant progress and this is recorded in its most recent Annual Report. The FSA has introduced important reforms of the financial regulation of insurance companies, improved processes of supervision and enforcement, its Better Regulation Action Plan, and has a strong commitment to move towards more principles-and risk-based regulation. The ABI supports the FSA's work in these areas.

4. We have also welcomed the large number of FSA reviews that are now underway, including of distribution issues, the Conduct of Business rules for investment and savings products, and the regulation of the sale of general insurance, as well as the continuing work on Treating Customers Fairly.

5. The challenge now facing us and the FSA is to ensure that this work is fully integrated, and that each project fits comfortably within an over-arching strategy based on a set of regulatory outcomes that command the widest possible support, within the industry and outside.

6. This paper responds to the three issues specifically raised by the Committee.

The Responsiveness of the FSA to the Needs of the Consumer

7. The FSA has a responsibility to protect retail consumers of financial services. The test for its regulation is therefore the extent to which it reflects the real needs of those consumers.

8. One important area in which this is currently being achieved is the prudential (capital adequacy) regulation of insurance companies.

9. The FSA has worked closely with the industry to develop the UK's new insurance capital adequacy regime. A recent Consultation Paper (September 2006) sets out a series of progressive reforms aimed at establishing a more effective, principles-based regime. A number of these reforms were proposed by the ABI. New FSA rules will be complemented by industry guidance to achieve a more proportionate and risk-based approach to capital assessment.

10. The FSA has also engaged in extensive dialogue and consultation with the industry on the forthcoming EU-level framework for capital adequacy regulation—Solvency 2. For example, the FSA's Insurance Standing Group provides a forum for debate with the industry and for reporting on discussions with the other European supervisors involved in developing advice on the draft Directive.

11. The FSA's work on capital adequacy regulation helps reassure customers that insurance companies are financially sound and well-managed. And, through the increasing use of risk-based regulation, it enables companies to keep prices down.

12. Whilst not wishing to see the FSA being overstretched, the ABI also supports the forthcoming regulation of the sale of all equity release products. Many customers are potentially vulnerable, and a coherent regulatory framework is essential to build confidence in this market. We recognise the need for high-level rules to prevent misleading advertising or the mis-selling of high-risk products.

13. The industry also has a key role to play in responding to the needs of consumers. It is working closely with the FSA to help deliver the FSA's Treating Customers Fairly objectives in areas such as financial promotions and complaints-handling. We also believe that industry initiatives can play an important role in complementing principles-based regulation. Such initiatives can be more flexible than statutory rules and can raise standards quickly. For instance, the ABI has worked with the FSA and consumer groups to address criticisms about Payment Protection Insurance (PPI). We are developing a Customer Guide with Citizens Advice.

14. Earlier this year, the ABI launched the Customer Impact scheme. This is designed to improve customers' experiences of the life, pensions and protection insurance industry. The Boards of participating member companies must submit annual reports to explain their progress against a set of customer commitments, and join in an annual benchmarking survey of the industry's customers. The ABI is also issuing guides for firms on key customer issues such as clear language and claims-handling. The launch of Customer Impact has been welcomed by consumer groups and the FSA.

15. It is important, however, to guard against unintended consequences of regulation that are not in the consumer interest. For instance, the regulatory costs of providing financial advice can make it unprofitable for insurers to offer core savings products to the mass market. And the rules governing generic advertising can make it difficult to persuade people of the need to save. Regulation should make it easier for people on low and middle incomes to access simple savings products.

16. Equally, the time taken to comply with disclosure requirements during a telephone enquiry about general insurance products can deter customers from shopping around.

17. Our concern is therefore that in some cases, the current approach of trying to prevent any customer buying any product other than the best possible, can result in consumers not purchasing any product at all, so missing out on the protection that they need. Consumers can therefore become the victims of a well-intended but costly approach, leading—for example—to lower than desirable savings rates and all the resulting consequences.

18. The insurance industry welcomes the recognition, both by the Government and the FSA, that more needs to be done to improve the public's understanding and capability on financial topics. The Financial Capability Baseline Survey gives the National Strategy for Financial Capability an evidence-base, and allows progress to be monitored.

19. The ABI is a longstanding supporter of the Personal Finance Education Group (pfeg) which promotes financial education in schools. The industry is delighted that the FSA is supporting the expansion of pfeg so it can help more schools to introduce financial education in the curriculum. The industry also welcomes the FSA's workplace education scheme, under which companies provide staff to help plan and deliver workplace presentations.

The Better Regulation Action Plan

20. We welcome the FSA's contribution to the Government's broader Better Regulation agenda. The FSA has recently published two very useful updates on its work in this area and we propose that they do so annually in future.

21. Better regulation delivers benefits for customers and the industry alike: a reduction in compliance costs; innovation in products and distribution models; and wider access to core insurance products for consumers on low and middle incomes.

22. The FSA's Conduct of Business Simplification project is a core plank of its Better Regulation work and the ABI is working closely with the FSA as it develops specific proposals.

23. As part of this initiative, the FSA is considering applying some of the regulations in the EU Markets in Financial Instruments Directive (MiFID) to insurance. The European Commission did not conduct an impact assessment on MiFID, and we do not believe that a cost-benefit case can be made for extending its scope in some areas. However, where the approach taken under MiFID is more high-level than the current FSA rules (eg as regards complaints-handling), we agree it would make sense for the FSA to use MiFID to move further in the direction of principles-based regulation.

24. The level of prescription in the current FSA Rulebook has sometimes led to a compliance culture in the industry, in which it becomes more important to observe the rule than to serve the customer. The shift to principles-based regulation will be a major challenge for regulated firms, as much as for the FSA.

25. Some firms had initial anxieties about the perceived loss of certainty associated with a reduction in detailed rules. It must, for instance, be possible to predict with reasonable certainty when behaviour will be in breach of the relevant principles and thus subject to enforcement action. As John Tiner noted recently, there is work to be done in building trust between the regulator and the regulated. But the industry is clear that the move towards principles and away from detailed rules is the right direction of travel.

26. For example, the FSA's recently published study on the cost of regulation found that compliance remains a significant burden for financial services firms. The retail advice sector was found to have the most significant costs—not least because of the current sales regulation regime. Overall, the FSA's study provided clear evidence of the need to move towards a more principles-based regime. Such a shift should enable firms to tailor compliance to their individual business models—improving the outcomes of regulation and reducing the costs.

27. We have recommended to the FSA that we should work together to develop clear criteria that will help decide where in the market principles are likely to work, and where more detailed rules are always likely to be required. The role of the Financial Ombudsman Service will be crucial here. We also believe that FSA needs to think more about "what good looks like" in terms of the market and regulation. Better regulation is more than just reducing rules on an *ad hoc* basis.

28. The ABI sometimes issues guidance to its members to help them to improve outcomes for customers. However, our capacity to do this has on occasions been inhibited, not only by competition law but also by uncertainty about the status of such guidance in relation to FSA rules.

29. The ABI therefore welcomes the FSA's recent positive engagement with the industry on this subject. We hope the FSA's forthcoming discussion paper will propose a clear process enabling the FSA to respond positively to industry guidance in future.

30. The FSA must also continue to develop the tools it uses to assess its regulations. It is especially important that the FSA periodically revisits old regulations to put them to a cost-benefit test. This will help to keep regulations up-to-date with the market, and ensure they deliver genuine benefits to consumers.

The FSA's Regulation of the Sale of General Insurance

31. FSA regulation of general insurance implements EU directives. HM Treasury decided that customers should be treated the same way, regardless of how they bought insurance products. There was some industry support for this. However, the result is that the Directives' requirements for intermediaries have been applied to direct sales as well, so "gold-plating" the original text. And the new rules do not sufficiently distinguish between the different needs of customers who buy insurance in different ways. Giving customers the same level of protection is not the same as applying the same set of rules.

32. The ABI's recent research (*General Insurance One Year On—March 2006*) found that for core mass-market products (motor, household) the costs of regulation for customers exceeded the benefits, but that there were benefits from better sales processes for the more complex protection products. We have therefore welcomed the FSA's recognition, in launching their review of the effectiveness of the general insurance sales regime, that different market segments should be distinguished.

September 2006

Supplementary memorandum submitted by the Association of British Insurers (ABI)

I am writing to follow up on the ABI's session last week and, in particular, to respond to your e-mail seeking further information.

As we made clear at the hearing last week, payment protection insurance is a valuable product for many consumers who would be seriously exposed in taking out loans without it. This has been recognised by both the FSA and the OFT.

The Committee raised questions about how well it is sold. This is an area on which we and other trade associations have been working. This work has led to:

- the production of a consumer guide on PPI which is subject to consultation with all interested parties until the end of November;
- a commitment to pay refunds when the insurance is surrendered early. We have proposed model wording for sales or policy documents on premium refunds to make it easier for customers to understand how the refund will be calculated and how much they can expect to receive;
- commitments to improve training standards;
- improved sharing of information between insurers and providers, for example, so that people are not pursued for bad debt while a claim under PPI is being handled; and
- improved guidance for consistent claims handling for use by insurers—this was published in June this year.

You asked for further information on several issues surrounding the provision of PPI, including PPI issues for secondary loans, refunds on single premium PPI and, finally, our comments on companies not allowing a PPI policy to be cancelled unless the relevant loan had been repaid in full.

Secondary Loans and Mortgages

It is important that customers are aware that, when they increase their borrowing, they must review their PPI policy in order to match their cover with their repayment commitments. It is therefore appropriate that customers are able to take out PPI at the same time as they take out a secondary loan.

Refunds when the PPI is Cancelled and the Loan is Settled Early

As noted above and confirmed in a press release published today, the FSA welcomed the initiative agreed in March 2006 by ABI members, that a refund on a single premium policy will be offered if the loan or credit agreement is repaid early and no claim has been made. We have recently checked with all our members who write PPI, and they have confirmed that they are operating this policy.

Refunds When the PPI is Cancelled but the Loan is Not Settled

ABI members have also confirmed that they will offer a refund to customers who cancel their PPI policy, regardless of the reason for the cancellation, unless a claim has been paid.

Most PPI policies are sold through lenders or other intermediaries. We are, therefore, pleased that the British Bankers Association has made the same commitment. We are not aware of companies that refuse to cancel a PPI policy unless the loan has been repaid in full. It should be noted, however, that some lenders insist that the refund is used to reduce the outstanding loan and that under Consumer Credit Act regulations, it may be necessary to re-negotiate terms of the loan.

Finally, we are of course aware that the OFT has today signalled its provisional intention to refer the UK PPI market to the Competition Commission, as well as publishing its analysis of the market for consultation. We are pleased to see that the OFT recognises that there is competitive pressure in the upstream market, ie between insurers competing for contracts with distributors.

We look forward to now working with the Commission, OFT and FSA on this issue, in order to achieve the best results for consumers.

October 2006

Supplementary memorandum submitted by ABI

I am writing following the FSA's oral evidence session to the Treasury Select Committee, held on 24 October, during which the issue of Payment Protection Insurance refunds was raised.

As you know, the ABI agreed with our members earlier this year that all customers should receive appropriate refunds whenever they cancel their PPI policy, whatever the reason.

We have recently double-checked with our member companies and they all confirm that they support and will implement this policy. Many have already done so.

This insurance is, in large part, distributed by lenders, and premium is normally funded as part of the loan. Some lenders need to undertake significant systems or procedural changes to implement this change, for example to avoid penalty charges or the loss of other benefits attached to the loan. Some of these changes are required by the Consumer Credit Act. Product literature and website information also has to be revised to ensure clarity for customers.

I fully understand the Committee's concern about this issue and can assure you that member companies are proceeding as quickly as possible.

November 2006

Memorandum submitted by Alan Lakey, Highclere Financial Services

1. The Responsiveness of the FSA to the Needs of the Retail Financial Services Consumer

1(a) The FSA is charged with a number of duties. Protecting the consumer and maintaining market confidence are two of these. Clearly this is a difficult task especially when these two Statutory Objectives often cancel each other out.

1(b) It is apparent that the FSA believes that the publicity resulting from its public shaming and fining of firms serves to show that it is on the ball and batting on behalf of the consumer. However a trawl through the financial newspapers will highlight the fact that whilst dubious compliance practices and ineffective management controls are eagerly stamped on the far more worrying financial criminals preying on UK consumers appear to operate without constraint.

1(c) I attach a copy of a recent Tony Hetherington column in the *Financial Mail On Sunday*.[1] This is an example of continuing FSA ineffectiveness, something regularly highlighted within its pages.

1(d) I would also argue that highlighting rule breaches or principle breaches, as they will shortly become, engenders a negative effect, even an antipathy towards the financial services sector.

1(e) The UK population is woefully under-insured and under-pensioned. It also has the highest level of personal debt in the world. These matters are not unrelated as they indicate a failure of another Statutory Objective, the need to promote public understanding of the financial services system. It is partly a matter of education and partly one of persuasion.

---

[1] Not printed.

An example is the distrust of pensions. Partly due to the Maxwell and Equitable Life scandals, partly due to the Governments dismissal of the Parliamentary Ombudsman's ruling in respect of wound up pension funds and partly due to the stockmarket crash of 2000–03.

1(f) There is another reason and this is the Governments decision to introduce Stakeholder pensions which ticked every conceivable box yet purposely failed to accommodate a profit margin for the providers and, more importantly, the distributors. In my own practice pension planning has fallen from around 60% of my business in 1999 to around 10% over the past few years.

1(g) Advisers no longer seek out clients to assist in retirement planning because it is simply not economic. It is far better to concentrate on other more profitable areas because, like insurers, we are businesses and not charities. As an example, Legal & General no longer pays introductory commission on Stakeholder pensions where the monthly contribution is less than £200. Stakeholder pensions were designed for the £10,000 pa—£25,000 pa earnings group—a group typically unable and unwilling to contribute 10%–25% of their gross incomes.

1(h) The Government and the FSA seem keen on the view that fee-based advice is the way of the future. The theory is that consumers will pay either an hourly or an agreed fee to take advice from pension specialists (normally independent financial advisers). The theory is sound for high net worth individuals but it does not work for the Stakeholder target income bracket. The result is that this large sector of the public has effectively been disenfranchised.

1(j) A further point is that high net worth individuals are usually self-aware of the need to plan for their retirement. They rarely require chiding or persuading. The disenfranchised majority do need persuading. They hold other more short-term obsessions and therefore need persuading and educating. The ultimate irony is that at retirement they will likely receive means-tested benefits which are funded by the rest of us.

1(k) In summation, the FSA is the organ of the Treasury and whilst it has Statutory Objectives these are often in conflict with the short-term needs of the Government. This divergence serves to work against the consumer. Where the effect of regulations impedes the ability of the consumer to save, insure or prepare for retirement the regulation must be revised.

2. Progress in Relation to the FSA's Better Regulation Action Plan, Including Recent Studies of the Cost and Benefits of Regulation

2(a) There is great concern within the industry regarding the move from rule-based to principle-based regulation. The fear is that such a concept allows great leeway for the FSA to determine a breach. In other words, it can choose which firms to punish. This is a realistic fear as a small firm is unlikely to have the capital backing to pursue the FSA through the appropriate channels and courts.

2(b) The balance of costs v benefits is one close to the heart of every firm. Annual fees have risen massively as has the annual levy for the Financial Services Compensation Scheme (FSCS). In assessing costs the Committee should be aware that the FSA has chosen to spend over £300,000 on works of art to adorn its Canary Wharf offices, over £1,700,000 on foreign travel and £1,000s on taxi fares for its staff. The industry has right to expect its regulator to apportion expenditure in a disciplined and prudent manner. I attach a comment from September 23rd edition of *The Scotsman*.[2]

2(c) The FSA's December 2005 Better Regulation Action Plan confirmed that in dealings the regulated firms "*information we require from firms will be kept to a minimum*". This is not borne out by the introduction of the Retail Mediation Activities Return (RMAR). Twice yearly firms are required to submit data online. The nature of this data ranges from the obviously essential such as complaints and professional indemnity insurance details to the less meaningful such as The area of most concern is the requirement to provide precise half-yearly financial information relating to capital adequacy, profitability and breakdowns of types of business. Such information can only be arrived at by using the firms accountants to trawl through part-year figures and arrive at an "estimate" of gross and net profits and capital account details. Such information may well be essential for large corporate bodies and indeed it is these bodies that have the infrastructure to provide such information. The matter effectively returns us to the cost/benefits argument.

2(d) The FSA has stepped up it "thematic work". Typically this involves a third-party company in mystery-shopping firms. The resulting data is used in press releases and used to shape policy, This would be acceptable if the base information was robust however in recent months we have seen mystery-shopping exercises involving less than 60 firms. Additionally, the firms were divided between "independent", "multi-tied" and "tied". No competent scientific laboratory would use such scant information as the basis for a paper let alone a system of regulation. The FSA needs to consider the basis under which it obtains and receives such information. In addition there is a substantial question mark regarding the artifice of pretending to be a potential client when actually obtaining data for the regulator.

[2] Not printed.

2(e) By way of summation, the FSA is seen as an unfriendly organisation waving a big stick in the form of fines and naming and shaming. It maps out a course of action, often based on inaccurate or potentially misleading data. Whilst advocating financial prudence to the consumer it has a far more reckless view when spending funds received by way of fees and fines from its stakeholder firms. Like many quango's it appears beholden to nobody, accountable to the Treasury yet left to its own devices. Regulating by fear is not an option in the 21st century.

September 2006

Memorandum submitted by the Financial Services Practitioner Panel and the Smaller Businesses Practitioner Panel

Introduction

1. In the Treasury Committee's consideration of the FSA's 2005–06 Annual Report, the Practitioner Panel and Smaller Businesses Practitioner Panel would like to draw the Committee members' attention to a number of high-priority issues for regulated firms, which might merit greater scrutiny during the oral evidence sessions. These include:

- The FSA's principle of Treating Customers Fairly.
- The principle of *caveat emptor*, as included in the Financial Services and Markets Act 2000 (FiSMA).
- The move by the FSA towards a more principles-based regime.
- The cost of regulation, especially for smaller firms.
- The implementation of EU directives and the FSA's international work.

2. The aforementioned points will be explored more deeply later in this memorandum, following a quick introduction of the two Panels and their work.

About Us

Practitioner Panel

3. The Practitioner Panel was established in November 1998, comprising senior figures from a cross-section of the financial services industry, to provide a high-level body available for consultation on policy by the FSA and to communicate to the FSA views and concerns of the regulated industries. It has a statutory basis under Section 9 of FiSMA. The Panel sees its main role as that of a "constructive critic" of the FSA. To help the Panel monitor the FSA's effectiveness, it conducts a comprehensive biennial survey of regulated firms, the latest of which is currently ongoing and will be published by the end of this year.

4. Further information on the role and work of the Panel and its current composition can be found on its website: www.fs-pp.org.uk.

Smaller Businesses Practitioner Panel

5. The Smaller Businesses Practitioner Panel (SBPP) was set up by the FSA in 1999 to represent the views and interests of smaller regulated firms. It is composed of independent industry practitioners from a variety of smaller firms, covering the major sectors of financial services activity. Even though the SBPP does not have statutory status, the FSA has committed to treating it in the same way as the Practitioner Panel, and the SBPP Chairman also serves as an *ex officio* member of the statutorily independent Practitioner Panel. This helps to ensure that smaller firms are properly represented at the very highest level within the FiSMA framework.

6. Further information on the role and work of the SBPP and its current composition can be found on its website: www.sbpp.org.uk.

7. *Both Panels meet formally on a monthly basis to discuss current and future issues of relevance to regulated firms—some of which are driven by the FSA's priorities and some of which are raised proactively by the Panels themselves. In addition, both Panels convene smaller sub groups on specific matters to engage with the FSA in greater detail.*

HIGH-PRIORITY ISSUES

The move by the FSA towards a more principles-based regime

8. Both Panels are supportive of principles-based regulation, which they considers the appropriate approach towards a modern, proportionate and effective risk-based regulatory framework in the UK. However, if this is to succeed, they have urged the FSA to properly consider the implications of this new approach to its work in a number of areas, including supervision and enforcement. The Panels recognise that principles-based regulation is a new and largely untested concept, and that a clear-cut, definitive approach might be an unrealistic expectation at this point.

9. In a recent letter to John Tiner, Practitioner Panel Chairman Roy Leighton conveyed some commonly held concerns by practitioners to senior FSA management. As the SBPP has pointed out repeatedly, smaller firms, in particular, appear to struggle with some aspects of principles-based regulation *(please see reference item 6 for further detail)*.

The FSA's principle of Treating Customers Fairly (TCF)

10. One of the major principles that the FSA has introduced as part of its evolving principles-based framework is TCF. While both Panels have been supportive of the TCF concept generally, they share many of the industry's concerns regarding its implementation, supervision and enforcement. Consistency of approach will be crucial to ensure that TCF is applied fairly across the industry. At present, a lack of clarity persists, especially among smaller firms, over the regulator's expectations regarding firms' embedding of TCF, and evidencing thereof.

11. Anecdotal evidence has reinforced the fear that FSA supervisors' application of TCF in practice might sometimes be too detail-oriented and meticulous, signalling a disconcerting departure from the FSA's commitment to high-level principles. Moreover, it also appears to hint at a possible disconnect between senior FSA managers' public stance on principles-based regulation and the day-to-day application of this concept throughout the organisation. The Panels appreciate that this will be one of the regulator's major challenges going forward *(please see reference items 2–5 for further detail)*.

The principle of Consumer Responsibility, as included in FiSMA

12. The Practitioner Panel dedicated considerable time over the past year to developing a practical articulation of "consumer responsibility" (or *Caveat Emptor*) and engaged in a series of discussions with members of its counterpart, the Financial Services Consumer Panel, and the FSA. The original aim of those discussions was to define what exactly was meant by "the general principle that consumers should take responsibility for their decisions," as outlined in section 5(2)(d) of FiSMA. FSA Chairman Callum McCarthy's speech to the Financial Services Forum in February 2006 was helpful in highlighting the principle of consumer responsibility and stimulating further debate.

13. As a balance to the principle of TCF it is important not only to focus on the obligations of firms during the retail sales process—which already are prescribed in great detail in the regulatory regime—but also on what could reasonably be expected from the consumer; "fairness," after all, is a concept that usually is not applied in a unilateral manner. Both Panels maintain that the lack of a clear definition of the principle of consumer responsibility is one of the main drivers of high regulatory costs in the retail sector, as firms in search of legal certainty often incur additional costs in being extra careful in complying with existing rules and regulations; these costs eventually getting passed down to the consumer *(please see reference items 2–5 for further detail)*.

The cost of regulation, especially for smaller firms

14. The Practitioner Panel in partnership with the FSA has conducted a Cost of Regulation study which focused on regulatory costs across three chosen sectors—corporate finance, institutional fund management and investment and pension advice—with the objective of identifying specific rules from the FSA Handbook where incremental costs may not be justified by the benefits they aim to secure. The Panels will use the results of this exercise to engage in a constructive dialogue with the FSA about the burdens of regulation—in particular, on the retail side—and how these might best be relieved.

15. The SBPP has long held the view that the costs and burdens of regulation are not only too high, but that smaller firms feel their impact in a disproportionate way—a view that was reinforced by the findings of the Cost Survey. It continuously urges the FSA more generally to be rigorous in its drive for Better Regulation and deregulatory measures; without that, there is a real prospect of smaller firms being forced out of business *(please see reference items 2–5 for further detail)*.

The implementation of EU directives and the FSA's international work

16. The Panels strongly support the trade associations' view that EU and international regulatory measures must be implemented in a pragmatic manner that avoids superequivalence (the implementation of EU Directives beyond their immediate requirements), unless there is a compelling case for it—and FSA senior executives, including CEO John Tiner, have publicly embraced such an approach. The implementation of the Markets in Financial Instruments Directive (MiDIF) will prove to be an interesting test case for the FSA's commitment in this regard, and the Panels will closely follow developments in this area.

17. The UK financial services industry pays approximately one third of all Corporation Tax paid in the whole of the UK and 11% of PAYE and NHI. Much of this is export led. The UK has the highest contribution to its trade balance of any nation in the world from financial exports provided by firms located here. Consequently, the Practitioner Panel feels that the UK financial regulatory system needs to be internationally competitive and attractive and encourages the FSA to maintain a high profile in world regulatory fora on a bilateral basis, especially with key overseas developing markets (eg China, India, The Gulf, etc) Much good work is being done by the FSA on international issues and should this be maintained *(please see reference items 2–5 for further detail)*.

September 2006

Memorandum submitted by TRS Independent Financial Advisers

1. Executive Summary

1.1 This submission concerns "The responsiveness of the FSA to the needs of the retail financial services consumer."

1.2 The FSA is failing to address an ongoing issue that arises partly from the actions of a number of life assurance companies and partly from the previous regulator. It is causing unnecessary financial loss to those retail financial consumers who purchased Unit Linked low cost endowment policies between April 1988 and December 1994.

1.3 From April 1988 until December 1994 insurance providers had to use standardised charges (LAUTRO) specified by the then regulator when producing policy illustrations and quotes. These standard charges were considerably lower than the provider's actual charges. Thus retail consumers were often being misled by the illustrations provided by the Life Insurance Companies. From January 1995 following the intervention of the Office of Fair Trading they were able to use to use their own charges again.

1.4 Since that time a number of insurance companies have voluntarily compensated those consumers who suffered as a result of this policy. However a number of providers have not.

1.5 Those companies that are compensating are using different methods. Some compensate monthly by enhancing the premium others intend to make an adjustment at maturity.

1.6 Even those who are compensating are not advising their clients regularly of the positive effect of the enhancement on their plans. As a result many financial retail consumers unaware of the "hidden" benefits of their plans have been cash surrendering their Unit Linked Low cost endowment policies to their considerable detriment.

1.7 The FSA is aware of the problem and has taken no action to regularise the situation.

1.8 *The FSA should not wash its hands of legacy issues by claiming that it was before they were instituted. This is an ongoing problem and is causing financial loss to consumers today. Many of the FSA executives were employed by the previous regulator and have a duty to resolve this issue.*

2. Background

2.1 *LAUTRO*

In April 1988 the Regulatory predecessor of the FSA introduced standardised charges (LAUTRO assumed charges) for all illustrations and quotations for life assurance and pension policies, including low cost endowment policies. The use of these charges in producing illustrations and quotes was mandatory. Many in the industry believed this to be a result of muddled thinking because it meant that all policy illustrations and quotations produced were misleading. This was because the actual charges on policies were higher than the standardised charges assumed in the illustrations. Thus even if the rate of investment returns over the term of the policy had been consistent with those shown on the illustration, the actual returns to the policyholder would have been less than illustrated due to the much higher charges actually deducted from the policy over its term. The then regulators were warned consistently of the problem during this period.

2.2 *Unit linked low cost endowment policies*

Some Life Assurance companies used the LAUTRO assumed charges to calculate premiums for their unit linked low cost endowments and thus compounded the problem identified in para 2.1 above. This meant that any policy affected could not possibly attain the illustrated maturity benefits as the companies used their own actual charges and these were much higher than the LAUTRO assumed charges. This was especially unfortunate for low cost endowment policyholders who would be relying on the proceeds of their policies to repay mortgage loans.

2.3 *Abandonment*

In December 1994 the Lautro projections were abandoned. This action followed an unfavourable regulatory report.

> "The requirement to use standard charges prevented life offices from producing illustrations which demonstrated the relative merits of their products thus restricting their ability to compete with others in the market . . . the requirement to use standard charges in illustrations was likely to restrict and distort competition among life offices"

The regulatory body that came to this conclusion was the Office of Fair Trading and regrettably not the predecessor of the FSA.

2.4 *Post December 1994*

Since January 1995 companies have been able to present their illustrations using their own charges. Since 1997–98 a number of life offices have compensated their unit linked low cost endowment policy holders who were adversely affected by the misrepresentation and breech of contractual warranty identified in 2.2 above. The compensation has been provided by a variety of means. However, there are still companies who are not compensating.

2.5 *Problem Awareness*

As previously stated not all companies are compensating their clients and those that are, are using different methodologies. For example some companies increase the premium invested monthly by adding substantial amounts to the premiums that the policyholder pays. The value of the redress can be as high as 60% of the premium being paid by the policyholder. This means the benefit of the policy cannot be equalled by any other investment or financial arrangement. Other Life Assurance companies however intend to make the redress adjustment to policies at maturity. Few of the companies advise their clients on a regular basis of the nature and value of the redress. Finance professionals and, to our certain knowledge, some retail consumers have made the FSA aware of the potential for clients to suffer financially through lack of such relevant and appropriate information from the insurance companies. Failure to keep the client informed is clearly in breach of the Principle 7 in "The Principles of Business" in the FSA Handbook as well as a Breach of the COB requirements. Thus many unit linked low cost endowment policyholders have been and are cash surrendering their policies unaware of the valuable additional benefit that they are losing. The FSA have remarked that a relatively high proportion of endowment policyholders cash surrender their policies. Given the publicity that mortgage endowment policies (low cost endowment policies) have attracted in recent years it is likely that the tendency to cash surrender has been high. In the case of unit linked low cost endowment policies which are subject to compensatory payment every month, it can easily be seen that the Life Assurance companies gain handsomely but illicitly when such plans are surrendered by their clients through ignorance of the compensatory benefit. Keeping this issue as low profile as possible could be construed as a deliberate ploy on their part to reduce future compensation payments every month to the detriment of the consumer.

3. Action Required

The FSA should:

- List all the Life Assurance Companies who are providing compensation.
- Encourage (using moral suasion if necessary) all those Life Assurers who are not compensating to do so as soon as possible.
- Insist that Insurance providers remind their clients of the redress at each and every plan update.
- Instruct providers to revisit all surrendered unit linked low cost endowment policies to determine if the client was given adequate warning of the redress being lost.
- Devise a standard method for calculating recompense that all providers should use.

4. Action Taken by FSA

None.

5. Conclusion

5.1 The subject and associated issues of this submission demonstrate that the FSA is consistently failing to provide many consumers with the appropriate protection from misrepresentation that they should reasonably expect. In addition this submission illustrates that:

5.2 The FSA is consistently failing to acknowledge and give proper consideration to valuable information, issues and intelligence provided from industry sources, especially when these sources are small businesses and that when pressed.

5.3 The FSA consistently fails to recognise issues and actions that are extremely likely to cause consumers loss even though it might reasonably be expected to do so.

5.4 The FSA fails to take timely and appropriate action to protect consumers thereby creating both unnecessary losses and potential losses for consumers.

5.5 As a consequence, confidence in the UK Financial system has been destroyed for many consumers and investors who no longer trust the abundant and compliant documentation produced by authorised financial companies choose not to save or invest.

September 2006

Memorandum submitted by the Financial Services Consumer Panel

Executive Summary

FSA Responsiveness

For the first time, in this year's annual report, the Consumer Panel assessed how effective it felt the FSA had been on behalf of consumers. The Panel looked at a number of aspects of FSA operation and awarded scores ranging from very strong to weak. Overall it was felt the FSA had responded reasonably well to the needs of consumers but there are a number of areas where the Panel is looking for improvement.

Better Regulation

Progress in relation to the FSA's Better Regulation Action Plan, including recent studies of the costs and benefits of regulation has included a number of initiatives, not least of which is a move to a more principles-based regulatory regime. The Panel supports the FSA's plan to scrap many of its detailed rules and rely instead on high level principles. However the Panel is concerned that this may result in industry developing its own guidance and codes. There seems little benefit in doing away with many rules only to replace them with even more guidance and codes controlled largely by industry bodies with little or no real consumer input. The effect could be to replace publicly scrutinised rules with codes and guidance which have not been scrutinised in public.

The Panel welcomed the joint FSA/Practitioner Panel initiative to ascertain the costs of regulation and noted that these costs proved to be lower than many commentators expected. The Panel is however, not yet convinced that proper account is being taken of the benefits of regulation. The Panel feels the work undertaken by Oxera concentrated on a methodology which may have only limited application.

General Insurance

The initial experience of FSA regulation of the general insurance industry has been mixed. The Panel was pleased the FSA undertook early thematic work in the general insurance sector, the results of which were disappointing. Also disappointing were the results from the Panel's own research into compliance levels for financial promotions appearing in the national press on one particular day in February. The results for general insurance promotions were the worst of the three regulated sectors with only one in five of promotions reviewed found to be compliant. The Panel remains concerned that the FSA ignores what the regulator sees as technical breaches of the rules.

Responsiveness of the FSA to the Needs of Retail Financial Services Consumers

1. In its 2005–06 Annual Report, the Consumer Panel focussed its attention on the outcome for consumers of FSA performance in particular areas. The Panel gave the FSA performance a rating, ranging from very strong to weak. These ratings were based on the opinion of the Panel, which is comprised of a more informed group of consumers. In arriving at these ratings, the Panel did not make a judgement about the resources available to the FSA. It discussed overall priorities in the FSA work programme with FSA staff, but recognises that a range of factors, some of them outside the Panel's remit, need to be considered by the regulator when allocating resources.

2. The Panel addressed 23 key areas of the FSA's work covering the period April 2005 to March 2006. The Panel rated FSA performance as very strong; strong; acceptable; and weak, with no very weak rating being awarded. These ratings are outlined below:

3. Very strong:

— Bundled brokerage and soft commissions for retail investment funds;
— Financial capability;
— Communications with consumers;
— European issues.

Strong:

— Treating customers fairly (TCF);
— Mortgage endowments;
— Disclosure of information;
— Mystery shopping.

Acceptable:

— RU64—advising on the most suitable pension;
— Payment protection insurance;
— Financial promotions;
— Home reversion schemes;
— Islamic home finance schemes;
— Unfair contract terms;
— Enforcement action;
— Regulation of small firms;
— Mortgages;
— General insurance.

Weak:

— Self-certification mortgages;
— Consumer access to a wider range of investment funds;
— With-profits funds;
— FOS and FSCS payment limits;
— Generic advice.

4. The rest of this paper picks out a few of these issues to highlight why the Consumer Panel has awarded a particular rating and focussing on areas of concern that have arisen since the Panel published its annual report.

Protecting Consumers

5. *RU64*. The Panel challenged the FSA on its proposal to remove the rule (known as RU64) which requires advisers to explain why any recommended personal pension is at least as suitable as a stakeholder pension. The Panel believes removal of this rule will not be in the best interests of consumers as this could lead to mis-selling on a significant scale. The Panel was therefore pleased the FSA delayed its decision on the removal of RU64 until transitional arrangements for the NPSS are announced later this year. The Panel rated the FSA performance on this issue as acceptable, but will be monitoring the situation closely in the coming months.

6. *Home reversion plans*. The announcement by the government to regulate the home reversion and Islamic home finance markets was welcomed by the Panel. The equity release market is generally one which the Panel has a keen interest in, and it has therefore monitored the development of the FSA policy with great interest.

7. The Panel rating of the FSA as acceptable in this area was given before it had considered the FSA draft rules outlined in CP06/8. These proposals gave rise to several areas of concern. The Panel remains alarmed that consumers will be able to purchase a home reversion plan in the new regulated environment, without advice. The industry currently largely operates under a voluntary code which requires that product providers may only sell these products where advice has been given. The FSA does not intend to replicate this requirement which the Panel sees as a retrograde step and one which could give rise to serious consumer detriment.

8. The Panel recently undertook some research in the equity release market, obtaining an analysis of the value for money the products provide. Initial findings from this research highlight the need to ensure these consumers are properly advised before deciding to purchase any equity release products—not simply home reversion plans.

9. In addition, the Panel's concerns over the extent to which a valuation can be guaranteed to be independent have still to be allayed. This is again a subject which the Panel will be closely monitoring over the next few months.

10. *Financial promotions.* The FSA's approach to the regulation of financial promotions continues to be the subject of much debate between the Panel and the FSA. Whilst the Panel is pleased there has been an increase in resources made available for this aspect of regulation, the Panel remains concerned the industry will constantly push at the boundaries unless the debate on what is acceptable practice takes place more in the public domain. Research we undertook recently showed 57% of financial advertisements published in national newspapers on one day did not meet FSA requirements.

11. The Panel therefore continues to press the FSA to consider naming firms—following the example of the Advertising Standards Authority—where action has been necessary to remove unacceptable financial promotions, but where such action falls short of formal enforcement procedures.

12. Compliance levels across investment, mortgage and general insurance markets remain low, and the Panel will shortly be repeating its research project, to take a snapshot view of the number of financial promotions appearing in the national press which comply with the rules, and the extent to which non-compliant promotions present a medium or high risk to consumers.

13. *Self-certification mortgages.* The Panel was very concerned at the results of thematic work the FSA carried out in the self-certification mortgage sector. The Panel gave the FSA a weak rating for this largely because it believes the FSA did not appreciate the *potential* risks for consumers which were apparent from the results of this work. The Panel challenged the conclusions drawn; the FSA stated there was no evidence of widespread abuse or systemic problem in this market. What was apparent was that very poor record keeping continues to be an issue, and the Panel believes that this could mask a much bigger problem in this sector of the market than is immediately apparent. The Panel believes further, higher priority work is necessary.

14. *Interest Only Mortgages.* The Panel was also worried by statistics produced by the FSA for the number of interest only mortgages for which there was no evidence of the consumer having a repayment vehicle in place. This was raised with the FSA and it is now undertaking research into why this is and whether consumers understand the risks they are taking.

15. *Closed funds and orphan assets.* The Panel has continued to monitor the management of closed with-profits funds and orphan assets, as it believes these continue to be a major risk for consumers. The Panel attached a weak rating to this area of the FSA's work. Whilst the FSA has introduced new rules on orphan assets, it remains to be seen if these will have enough impact. There has been a recent rise in the number of closed funds being sold by their original owner to consolidation companies who specialise in this area. The Panel believes the actions of these companies must be closely watched and that the implications of the changes and options available should be communicated to affected policyholders. However, the Panel remains worried about the quality of information available to consumers and consumers' ability to influence the behaviour of these companies.

Promoting Consumer Understanding

16. *Financial capability.* The Panel believes the FSA's work on financial capability has been very strong recently. The FSA has successfully brought together government, industry, educational and not-for-profit groups in an effective partnership. The FSA's financial capability baseline survey gave a comprehensive picture of people's attitude and behaviour in relation to their personal finances. The Panel is pleased this work was coupled with the publication of a new plan of action to improve financial capability. The Panel welcomed the targeting of specific groups including schools, young adults and the workplace, although it was disappointed that older consumers were not seen as an early priority. That said, the Panel is pleased that the FSA is exploring the possibility of using intermediary organisations to reach particularly vulnerable groups, including the elderly, single parents and those in social housing. The Panel has also been pleased at other initiatives including the Innovation Fund which supported 12 projects where activities covered, for example, a money awareness pack for cancer carers and a financial awareness and support service for prisoners and ex-offenders.

17. *Consumer communications.* Also given a very strong rating was the FSA's work on its strategy for communication with consumers. The Panel was very pleased to see the development of the "mortgages laid bare" and "money laid bare" campaigns. The FSA has put in place a sustained and co-ordinated programme of consumer campaigns aimed at highlighting regulatory/policy issues and improving financial capability. The Panel hopes the FSA will set realistic and achievable evaluation measures for future communication activity in the next few months.

18. *Mortgage disclosure.* The FSA did some good research on the information firms were required to give to consumers looking for a mortgage. Whilst the results of this work were disappointing, the FSA warned the industry that improvements were needed. Of particular concern were the results on the quality of advice in the lifetime mortgage sector. The Panel was particularly disappointed that the FSA did not act to require firms to remove advisers from the sales force who were found to be weak. However, it is reassured that further work is being planned in this area. The Panel awarded the FSA a strong rating for this work.

19. *Generic advice.* More disappointing was the painfully slow development of work on the provision of generic advice and as a result the Panel judged the FSA work in this area as weak. The Panel sees this as one of the most important aspects of the FSA's work on financial capability and would like to have seen the FSA "champion" generic advice more. New avenues are being explored by the Resolution Foundation to look into the business case for providing generic financial advice, although it is disappointing that as a result the FSA has appeared to relinquish its leadership role. The Panel would like to see the FSA step more into the forefront on this subject. The main hurdle appears to be funding and the Panel is hopeful that the proposed Social Investment Bank, which might use unclaimed assets, could provide the resources needed.

Developing the Right Regulatory Framework

20. *Mystery shopping.* The Panel believes the FSA's performance in relation to the use of mystery shopping has been strong. For some time the Panel has been urging the FSA to make greater use of a range of regulatory tools—to rely less on information provided by the industry—and to check with the consumer or receiver end by using mystery shopping. The FSA has undertaken several projects during the year where mystery shopping has been an integral part of the project.

21. The use of this means of checking industry performance has sadly uncovered problems in several areas—for example, equity release, the sale of payment protection insurance, mortgage disclosure, self-certification mortgages and with the new depolarisation rules. The Panel hopes the FSA will continue to use mystery shopping as an important means of checking whether regulation is working correctly at the level of the individual consumer experience.

22. *General insurance regulation.* The Panel judged the FSA's performance in relation to general insurance regulation as acceptable. There has been some early thematic work, the results of which have been disappointing. The Panel expects to be briefed on the results of the FSA's general insurance effectiveness review towards the end of 2006, which will judge the effectiveness of the regime itself, and whether it is delivering policy objectives to consumers.

23. Also disappointing were the results from the Panel's small research project covering financial promotions. In the general insurance sector, the research found that a staggering 79% of promotions failed to comply with the relevant rules, and of these 17% were judged not to comply with the requirement to be clear, fair and not misleading. These results are very worrying. Whilst general insurance promotions were judged to pose a low risk to consumers, these results demonstrate that more must be done in this field to ensure that rules are adhered to.

24. As mentioned previously the Panel is critical of the FSA's risk based approach to the regulation of financial promotions rules. It feels that firms will simply copy other examples of non-compliant promotions which are seen to provide a competitive advantage and where no action appears to have been taken by the regulator. The Panel has written to the FSA calling for the FSA to review its policy on the regulation of financial promotions.

25. *Principles-based regulation.* The FSA has stated its intention to radically change its regime by scrapping many detailed rules and relying instead on high level principles such as Treating Customers Fairly. The Panel stated in its annual report that it supported the FSA's review of current regulatory requirements but countered this with a comment that better regulation does not necessarily mean deregulation. The Panel is concerned that the driver for the move to a more principles-based regime is one of deregulation, and feels strongly that this should not be the case, but that rather, it should be driven by a desire for better customer outcomes as a result of a closer match between firms' working culture and the requirements of the regulatory environment.

26. The Panel has been briefed by the FSA on its proposals to simplify the Conduct of Business regime for investment business, although as yet it has not seen the detailed proposals this entails—this could be an early indicator of what is to come. The Panel supports a more principles-based regime in the wholesale market where there is likely to be a fair balance of knowledge and expertise between parties. The Panel is happy to support such a move in the retail market, provided the resulting regulatory structure delivers what is needed for consumers and is robustly enforced.

27. However, the Panel does have a number of concerns with this developing policy. With a reliance on high level principles comes a greater emphasis on senior management responsibilities within a firm and on the ability of FSA supervisors to make judgements about adherence to principles rather than detailed rules.

28. Of particular concern to the Panel is the temptation for the industry, seeking certainty under a principles based regime, to write its own guidance and codes and then seek FSA endorsement for these. Currently FSA rule changes are subject to public consultation and scrutiny. If the industry writes and controls its own guidance and codes, dictating policy on much of the interaction between consumer and firm, the worry is that any consultation process will not be as open as it is now. Open and effective consultation with consumers at large must be seen to operate effectively to ensure consumer concerns are adequately dealt with.

29. Also of concern is the importance of ensuring consumers are aware of the limitations of such codes and that apparent compliance with an industry written code does not preclude a complaint being made to the Ombudsman who may well see things differently.

30. The Panel also believes that the extent to which the Ombudsman and possibly the FSA's Regulatory Decisions Committee will take industry codes into account needs much greater clarity—the independent standing of both will be of particular importance under the new regime. The Panel will be keeping a close eye on this significant development in FSA policy.

31. *Costs and benefits of regulation.* The Panel was very interested to read the report of the costs of regulation work jointly commissioned by the FSA and the Financial Services Practitioner Panel. The incremental costs of regulation appear to be lower in each sector than some had feared. Whilst senior management in firms seem to understand the importance of regulation, there is still a problem on the high street where consumers continue to face poor advice and information which the regulator must do more to improve. The figures in this report seem to counter the argument that strong regulation will undermine business.

32. The Panel is not yet convinced that proper account is being taken of the benefits of regulation. It appears that the necessary assessment of benefits is falling behind work on the costs of regulation. The Panel is also of the view that the work on the benefits undertaken by Oxera has focussed on the methodology alone and in any event may have only limited application. The FSA needs to take a broader approach to this issue. An immensely important benefit of regulation is the fact that consumers who have confidence in a strong regulatory system will be more willing to invest, and an effective and efficient regulator appears to be an international asset, drawing more firms to the UK and also increasing the country's lead in financial services.

33. *Commission.* The Panel has taken a keen interest in the continuing debate on how financial advice should be paid for, and like the Treasury Committee, remains concerned about the potential for commission payments to cause adviser bias towards certain products or providers.

34. The Industry has been reluctant to accept that commission is causing biased advice. But whether it does or not, consumers clearly believe it does and this perception has a significant effect on consumer confidence in financial services generally.

35. The Panel welcomes the comments in a recent speech by Sir Callum McCarthy in which he recognised that the current distribution model focuses on business volume as opposed to quality, and that this system serves neither the consumer nor producer of financial services, nor arguably the financial intermediary.

36. The Panel has recently discussed what alternatives there are to a commission-based sales regime that would serve industry and consumers better and has pledged to encourage wider debate on this point. It will be closely following the FSA's project which will be examining the current distribution model in the retail investment market.

Role of the Consumer Panel

The main purpose of the Panel is to provide advice to the FSA. Consequently the emphasis of the Panel's work is on activities that are regulated by the FSA. The Panel is also responsible for assessing and commenting on the FSA's effectiveness. The Panel also looks at the impact on consumers of activities outside but related to the FSA's remit. Examples include European issues and policy proposals by HM Treasury and others. The Panel has regard to the interests of all groups of consumers, including those who are particularly disadvantaged in the context of financial services. The Panel can also advise the Government on the scope of financial services regulation; and consider other matters that assist it in carrying out its primary functions.

How the Panel operates

The full Panel meets about 10 times per year. In addition, smaller "working groups" meet monthly to deal with specific issues in more detail and to consider the Panel's formal responses to FSA and other consultations. FSA staff and other third parties are invited to these meetings and participate in discussions.

The Panel also holds meetings outside the FSA's offices (most recently in Glasgow) with members of the financial services industry, as well as with consumer representatives. The Panel also commissions research to obtain a better understanding of consumers' views and to identify areas of concern. A monthly report of the Panel's work and concerns is provided for the FSA Board.

Accountability

The Panel publishes an annual report on its activities. Annual Reports, responses to consultations, research reports and other information is available on the Panel's website at www.fs-cp.org.uk. The website contains the Panel's e-mail address, but makes it clear that the Panel is not in a position to pursue individual or specific complaints from the public about financial services. The Panel does however consider carefully the wider implications of any complaints or other information provided by consumers and others who contact the Panel.

Membership

Panel members are appointed by the FSA Board following an open recruitment process based on the Nolan principles; the appointment of the Chairman must have the formal approval of the Treasury. John Howard became Chairman of the Consumer Panel with effect from 1 October 2005, having been a Panel member since October 2000. Adam Phillips, who joined the Panel in March 2004, was appointed Vice Chair with effect from 1 November 2005.

Members of the Panel have a wide range of relevant experience such as consumer advice and advocacy, front-line advice, legal expertise, market research, consumer policy and the media.

October 2006

Memorandum submitted by Which?

1. Executive Summary

1.1 We welcomed the creation of the FSA that brought together the activities of the 10 previous regulatory organisations under one umbrella. However, we want to see some changes to the governance, operation and structure to ensure that the regulator better ensures that consumer interest is at the heart of its work. We are not calling for more regulation. Our goal is to promote more effective, proportionate regulation. We want a system of deterrents and incentives which can be applied to the retail financial system so that the interests of consumers, providers and shareholders are better aligned.

1.2 We believe that if the FSA is to be a more effective regulator, it needs to become better at identifying detrimental practices in the first place—and then become a more aggressive enforcer.

1.3 We welcome the FSA's recent announcement that it is to start looking more carefully at root causes of consumer detriment, and we share its analysis about the problems caused by the prevailing remuneration model. It is now vital that the FSA follow through on this analysis and take tough action to address these problems. The forthcoming FSA Retail Distribution Review, will be an important opportunity.

1.4 We do not object to the move to principles based regulation/Treating Customers Fairly. However, we have concerns that the FSA is in effect devolving more responsibility to directors of firms without first ensuring that robust discipline and enforcement measures are in place to provide a deterrent against firms exploiting less intrusive regulation. In addition, Which? believes that any change to principles-based regulation should be accompanied by a cost-benefit analysis of potential detriment.

1.5 A key current issue is regulatory costs and benefits. No one supports unnecessary regulation that adds no value. However, it is our view that allegations of overregulation and unnecessary costs are overstated. The industry lobbies have been able to portray standard business costs as new or additional costs of regulation. When cost sources are examined objectively, firms that were following good business practice would still incur most of those costs.

1.6 In many respects, the FSA's General Insurance Conduct of Business regime has led to benefits for consumers. However, we have concerns that the protection that this regime offers is insufficient for some of the higher-risk products, notably the pure protection products.

1.7 The Chief Executive of Which?, Peter Vicary-Smith, will be giving oral evidence on the work of the Retail Financial Services Group in conjunction with other colleagues from the group, including the previous chairman, Richard Lambert. We are aware that written evidence by the committee is being provided to the committee directly by the group.

2. Introduction

2.1 We saw the creation of a single retail regulator in the form of the FSA as being a significant success and milestone in our efforts to make retail financial services markets work in the interests of consumers and wider society. However, we are of the view that the structure and culture of the FSA is in need of reform if it is to meet the future needs of society.

2.2 At present, we are concerned that the FSA puts its relationships with firms and issues of market confidence ahead of the interests of consumers. We would like to see the consumer interest be given equivalence to other more powerful interests within the financial system. We are not calling for more intrusive or expensive regulation. Indeed, we recognise that the cost of regulation will ultimately be borne by the consumer. Instead, our goal is to promote more effective, proportionate regulation. We want to see a system of deterrents and incentives which can be applied to the retail financial system so that the interests of consumers, providers and shareholders are better aligned.

2.3 This response focuses on the three questions set out in the call for evidence. However, we would also like to bring particular attention to a number of key issues that the FSA highlight in their annual report.

2.4 The problems with financial advice that the FSA depolarisation post-implementation research has identified are of particular concern. Which? is concerned that depolarisation has meant that consumers are increasingly confused about the advice that they are being given. In September 2006, we published the results of an in-depth study of 57 financial advisors and found that less than a third reached our benchmarks for good advice[3] (This study is provided as a separate attachment). Tied advisers, who mainly work for high street banks and building societies, were the worst—just 16% passed all the standards. Almost half of the tied advisers Which? visited led researchers to believe they offer more choice than they do. While independent financial advisers (IFAs) came out better, they still fell short of the mark; less than half those visited passed all the benchmarks for good advice. These findings are of great concern and will require considerable attention.

2.5 Which? has long highlighted the problems in the Payment Protection Insurance market.[4] Problems relating to poor selling practices and a lack of compliance in this market have been highlighted this year by the FSA in their thematic work in this area. The emerging thinking document published by the OFT in August, as part of their study of the effectiveness of competition in this market, has also been very critical of this market. Some tough action is needed to correct the clear problems that exist in this market. The problems that the FSA highlight with the sale of Critical Illness insurance are also of notable concern.

2.6 A number of outstanding problems in the mortgage markets also need addressing. The serious problems that the FSA has identified in the equity release market will need to be tackled as will the widespread deficiencies that the FSA have identified with mortgage disclosure documentation.

3. Responsiveness of the FSA to the Needs of the Retail Financial Services Consumer

3.1 Which? has a number of strategic aims for the retail financial services industry:

- Introducing strong market forces which lead to effective competition from the consumer perspective and "normalising" good behaviour and responsible practices.
- Putting power in the hands of consumers and ensuring firms are held accountable by aligning the interests of shareholders/producers with those of consumers and society.
- A high degree of consumer protection, reducing the risk of mis-selling and other reckless behaviour by firms.
- Restoring confidence in the financial services industry, which at a time when the UK faces a pensions crisis, must be in the national economic interest.

3.2 Our strategy for making retail financial markets work is based on a three-pronged approach.

- Better regulation: that is more robust, targeted regulation which addresses causes rather than symptoms of market failure;
- Better governance, accountability and consumer representation: to balance the explicit duties directors have to shareholders under UK company law (including self-regulation); and
- Making market forces work better so that competition has a chance to work effectively.

3.3 Reform is needed in each of these three areas. Our major initiative "*Time for A Change*" (TFAC)[5] proposes a set of standards designed to promote better governance and leverage market forces to complement effective regulation.

3.4 The FSA has a major role to play in achieving these strategic aims. Rather than solely chase after detriment, we believe that if the FSA is to be a more effective regulator, it needs to become better at identifying detrimental practices in the first place—and then also become a more aggressive enforcer.

---

[3] http://www.which.co.uk/press/press_topics/product_news/which_magazine/financial_advisers_571_94442.jsp

[4] Which? "*Protecting your income*", March 2005.

[5] Which?, "*Time for a Change: Discussion Paper*", Which? 2005.

Retail Distribution

3.5 We welcome the FSA's recent announcement that it is to start looking more carefully at root causes of consumer detriment. The FSA has recently said that the current distribution system for financial services to retail customers "*serves neither the producer of the services nor the consumer of the services*".[6] In their opinion, the prevailing remuneration model is leading to product bias, provider bias and churn, with the consequence of significant potential consumer detriment. Training deficiencies have also been highlighted as another important problem. Which? has long argued that problems of remuneration and training are key sources of detriment in the financial sector and this development is therefore timely.

3.6 It is now vital that the FSA follow through on this analysis and take tough action to address these problems. The forthcoming FSA Retail Distribution Review, will be a very important opportunity to do this.

Principles—based regulation

3.7 The FSA is changing the way it regulates the industry trying to move from a rules based approach to one based on high level principles. Which? does not object to high level principles/TCF per se. It is a worthy aim that we share with the FSA. However, we have concerns about this approach:

- The FSA is in effect devolving more responsibility to senior management/directors of firms without first ensuring that robust discipline and enforcement measures are in place to provide a deterrent against firms exploiting less intrusive regulation.
- The FSA is not publishing data on individual firms' compliance with TCF. This means that consumers will not be in a position to assess the risks and benefits involved in entering a commercial relationship with a firm. This undermines the consumer protection and competition aims of the FSA.
- The necessary market forces to provide incentives to good corporate behaviour are not in place.
- Which? believes that any change towards principles-based regulation should be accompanied by a cost-benefit analysis of potential detriment. We are not aware that the FSA has conducted an impact assessment on the potential consumer detriment by replacing rules with high level principles. We believe an impact assessment is vitally important. In light of the better regulation environment, we would have expected the FSA to justify any changes to legislation with a cost/benefit analysis, including looking at potential impact on consumers. It is surprising that this has not been done.

3.8 If the FSA is to ensure that firms do treat customers fairly, then a system of deterrents and incentives need to be created along with intelligent application of regulatory tools to the root causes of detriment.

Enforcement

3.9 Senior management have to be clear that failing to treat customers fairly will result in serious consequences for the individuals responsible, the financial position of the firm and therefore its shareholders. Firms need to fear the FSA. They need to be certain that behaviour which is detrimental to the consumer and public interest is likely to attract the attention of the FSA and result in penalties which hit their bottom line. Only then do we think that shareholders will be incentivised to put pressure on directors of firms to put consumers at the heart of business.

3.10 To provide this necessary regulatory, corporate and individual director level accountability we advocate a number of reforms connected to the enforcement process. These include:

- A more transparent enforcement process. We argue for a reform of the disclosure regime so that firms are required to publish information which would affect consumers' decisions to engage in a relationship with a firm (similar to the rights of access afforded shareholders under the Listings Regime). This could include complaints information or regulatory breaches.
- A clear, tough fines tariff.

4. Progress in Relation to the FSA's Better Regulation Action Plan

4.1 One of the key issues exercising the business community, regulators and government is regulatory costs and benefits. Which? believes in a common sense approach to regulation. No one supports unnecessary regulation that adds no value. However, it is our view that these allegations of overregulation and unnecessary costs are overstated. Industry lobbies have been able to portray standard business costs as new or additional costs of regulation.

[6] Speech by Callum McCarthy, Chairman, FSA, Gleneagles Savings & Pensions Industry Leaders' Summit.

4.2 Costs "attributed" to FSMA regulation arise from a number of sources and the existence of FSMA and FSA does involve real additional regulatory costs for firms. However, when cost sources are examined objectively, firms that were following good business practice, which would naturally include things like information disclosure, would still incur most of those costs regardless.

4.3 The most objective way to measure regulatory impact is to identify costs over and above those costs which firms would incur anyway as part of operating in the market and providing a decent service to consumers.

Deloitte "Cost of Regulation" Report

4.4 We believe that the Deloitte report into the cost of regulation reinforces much of our assessment. One of the main conclusions from the report was that "much of what regulation requires is, in fact, regarded by firms as good business practice".[7]

4.5 The study concluded that incremental costs in the wholesale sectors covered were relatively low. In contrast, the incremental costs in the retail sector covered were higher. Deloitte explain this contrast by arguing that a more detailed regulatory regime was established in the retail market because of the clear evidence of significant market failure.

4.6 Which? would dispute whether Deloitte's study supports the idea that there are significantly greater incremental costs in the retail sector. There is no question that there has been significant market failure in the retail pensions and investment sector. However, it does not necessarily follow that incremental costs are directly correlated with the level of detriment. Firms who were behaving fairly and transparently towards retail consumers should already be undertaking the same steps and performing the same checks and balances required by regulation.

4.7 Regulation serves to codify what should be good business practice and acts as a proxy for effective market forces. In other words, consumer focused firms ought to be "self-regulating" their behaviour throughout the retail supply chain[8] so as not to exploit the advantage they have over retail consumers. If incremental costs are defined as costs over and above those associated with the normal course of business or good business practice, then a functioning consumer focused retail market would not be burdened with significant additional costs. It is possible that firms reporting higher incremental costs may have a more "reckless" attitude to conflicts of interest and risks throughout the retail supply chain.

Real Assurance Risk Management Study—"Estimation of FSA Admisistrative Burdens"

4.8 The Real Assurance Risk Management study, conducted for the FSA, estimates that total costs of reporting to the FSA for the financial services sector are around £600 million a year (approximately 0.5% of industry costs). The study identified the top 20 rules which individually account for 1% or more of total administrative costs.[9] Looking at the top 20 rules, it is interesting that rules relating to money laundering are the single biggest component—over 40% of total estimated costs. It can be inferred from this that the so called burden associated with conduct of business rules is quite low.

5. The Initial Experience of FSA Regulation of the General Insurance Industry

5.1 In many respects, the FSA's General Insurance Conduct of Business (ICOB) regime has led to benefits for consumers, especially in terms of product disclosure and redress. However, we still have some concerns about the regime.

5.2 Our key concern is that we don't believe that the same regulatory regime is appropriate for all general insurance products. The ICOB regime means consumers can be sold insurance products on a non-advised route, without the consumer knowing whether or not they have been advised until the end of a sale. This may be appropriate for lower-risk products such as home and contents cover, or car insurance, but higher risk products, especially the pure protection products such as Income Protection or Critical Illness, should have been given a higher standard of protection with stricter advice requirements unless the consumer specifically asks for a non-advised sale.

5.3 In a Which? report, published in June 2004, we highlighted the problems that consumers faced when trying to purchase insurance to protect themselves in the eventuality that they could not work. This research explained that because of the complex and high-risk nature of these products regulation should not treat them in the same way as other general insurance products. The situation research into financial advice that Which? published in September 2006 clearly highlights that, even with the protections given under the new ICOB regime, the scope for consumer detriment that is being caused by inappropriate sales of protection

[7] Deloitte, "*The Cost of Regulation Study*", p 1.

[8] Much of the detriment which occurs in retail financial services we attribute to the conflicts of interest which can be identified along the supply/distribution chain.

[9] See Table 1: Top Twenty Administrative Burdens, FSA Briefing note BN022/ 06, 28 June 2006.

products still exists. In our study, 76% of advisers visited for protection advice failed to advise researchers of the risks associated with income protection should their income fall.[10] (Both these articles are provided as separate attachments.)

5.4 As a result of the considerable scope for detriment surrounding protection products, we continue to argue that the FSA should treat protection products with a higher importance than other general insurance products.

September 2006

Memorandum submitted by the Retail Financial Services Group

Update to Treasury Select Committee—July 2006

INITIAL RECOMMENDATION AND FORMATION OF THE GROUP

1. The Retail Financial Services Group is an independent, voluntary and collective effort, on the part of major UK financial services companies, consumer groups and trade associations, to pursue one of the Treasury Select Committee's (2003–04) recommendations in its report on long-term savings, published in July 2004. The Committee commented that:

> "We are surprised that the industry currently fails to engage in serious dialogue on a regular basis with consumer bodies and other interested parties on issues such as pension reform, access for the less affluent or, indeed, general consumer confidence. This may well partly explain why the industry in recent years has seemed to limp from crisis to crisis. There is a need for the industry, the regulator and consumers to establish a collective, forward-looking joint agenda. This should particularly focus on how the industry can better serve its customers. We recommend the establishment of a broad ranging forum, including representatives from all parts of the industry, consumer groups, the FSA and Government. This should meet regularly with the aim of agreeing priorities, monitoring progress, giving early warning of problems that might be arising and putting pressure on laggards in the industry to catch up with best practice."
>
> *Restoring confidence in long-term savings, Treasury Select Committee (paragraph 115)*

2. Initial exploratory steps to establish such a forum or group, broadly following the remit outlined in the Treasury Committee recommendation, began in late 2004 and gathered momentum in 2005. At this stage, discussions with potential participants were brokered directly by the Committee chair, John McFall.

MEMBERSHIP, CHAIRING, STRUCTURE AND RESOURCES

3. From the outset, it was envisaged that the Group should be an independent effort to bring together senior executives from the long-term savings industry and their counterparts from consumer groups—the key stakeholders involved would be the industry and consumer organisations, with the support of Government, the regulatory authorities and the Financial Ombudsman Service.

4. Potential participants from industry agreed that the membership should primarily consist of chief or senior executives from some of the relevant companies and organisations, as opposed to trade association representatives or officials. This was intended to allow a more open or wide-ranging debate, and give consumer groups greater direct access to the views of market practitioners. However, participants also recognised that the trade associations should have a central and direct role to play in establishing and providing support to the group, as well as contributing to its developing work-streams and discussions. In practice, these connections are reinforced as all the senior practitioners are members of the relevant associations, and, in many cases, are also current or former trade association board members or chairs.

5. Participants agreed that the membership would need to represent the broad spectrum of the financial services industry involved in the long-term savings market—the life insurance sector, retail banking and other product providers/distributors, investment fund management and independent financial advice. This field of interests also suggested the core involvement of the following trade associations at a working level: the Association of British Insurers (ABI), the British Bankers' Association (BBA), and the Investment Management Association (IMA).

6. The Group would need to bring together the major consumer groups and advocacy organisations with a strong interest in saving and investment. These include the Financial Services Consumer Panel, the National Consumer Council, the National Association of Citizen Advice Bureaux and Which?

---

[10] http://www.which.co.uk/press/press_topics/product_news/which_magazine/financial_advisers_571_94442.jsp

7. Finally, in order to fully reflect the key stakeholders involved in the industry, it was agreed that it would be essential for the Group to receive both the broad support of, and some level of participation from, the Government and the appropriate regulatory authorities. Therefore the Financial Services Authority, the Financial Ombudsman Service, the Financial Services Practitioner Panel and HM Treasury are also represented at the Group's meetings. HM Treasury has also provided the secretariat support for the Group.

8. It should be stressed that the Group is not a policy-making body for any of its members or any form of public agency. Rather, the Group is an informal forum that encourages a frank, open and sustained discussion between individual senior figures, who are able to speak with both independence and authority. As the Group develops, it hopes to seek out and promote areas of consensus or joint positions, and it may also aim to develop a more significant media profile. Although the Government is keen to support and facilitate the work of the Group, it should be stressed that the Group's own agreed positions will not always reflect the views of Government or the regulator—in fact several of the Group's initial outputs have involved direct requests to Government. Neither is the Group's own output binding on the organisations from which its members are drawn.

9. The Group participants asked Richard Lambert to become its first chairman in Spring 2005. All participants recognised that the chair of the Group would need to be a senior impartial and independent figure, combining a broad experience of financial and wider commercial world with a wide-ranging interest in, and understanding of, economics and consumer affairs. At the time of appointment, Richard Lambert was an external member of the Bank of England's Monetary Policy Committee. He was previously Editor of the Financial Times between 1991 and 2001. Mr Lambert also conducted independent reviews on behalf of the Government (the Lambert review of Business-University Collaboration in 2003, and a review of *BBC News 24* for the Department of Culture Media and Sport in 2002). The Group chair is a voluntary unpaid role.

10. Richard Lambert has envisaged the role of chair as providing, first and foremost, an impartial facilitating role between the members of the Group at its main meetings. He has sought to propose an agenda based upon consultations with the membership and information provided by the secretariat. The Chair tries to establish consensus positions on the issues discussed as well as identifying and communicating the major points of disagreement or problem areas. Richard has also tried to propose areas of further Group work, joint papers or signed letters, and has begun the process of establishing an independent "voice" for the Group that tries to reflect its discussions and concerns more widely.

11. The full membership, at its first official meeting in June 2005 was as follows:

Richard Lambert—Chair

Paul Myners—Deputy Chair

David Budd—Chief Operating Officer, HSBC

Sir James Crosby—then Chief Executive, HBOS

Simon Davies—Chief Executive, Threadneedle Asset Management

Ann Foster—then Chair, Financial Services Consumer Panel

Patrick Gale—Chief Executive Officer, Sesame

David Harker—Chief Executive, Citizens Advice Bureau

Richard Harvey—Chief Executive, Aviva

Roy Leighton—Financial Services Practitioner Panel

Stephen Locke—Board Member, National Consumer Council

Keith Satchell—Chief Executive, Friends Provident

Mark Tucker—Chief Executive, Prudential

Peter Vicary-Smith—Chief Executive, Which?

Walter Merricks—Chief Ombudsman, Financial Ombudsman Service

Clive Briault—Managing Director Retail Markets, Financial Services Authority

Clive Maxwell—Director of Financial services, HM Treasury

12. Since that time there have been a handful of changes. Ann Foster has stepped down as chair of the Consumer Panel, the panel's present chair, John Howard, has taken her place. Teresa Perchard, Director of Policy at Citizens Advice has attended a majority of the meetings in place of David Harker, and Sir James Crosby has stepped down as Chief executive of HBOS. Mike Fairey, Deputy Group Chief Executive of Lloyds TSB has taken up this place from September 2006. Paul Myners resigned from the Group in February due to other commitments.

13. Members of the Group agreed a suitable level of dedicated resource to support its discussions in its first year. Participants agreed to secure funding for the Group via its members and trade associations, with all making a significant contribution. Funds of £100,000 were pledged in total from the following members, the Financial Services Authority (£25,000), the Association of British Insurers (£25,000), the British Bankers' Association (£25,000), the Investment Management Association (£15,000) and Which? (£10,000).

14. These funds were primarily used to cover the secondment of an official from HM Treasury to act as independent secretary to the Group and provide briefing support to the Chair. Which? also complemented their financial contribution with the generous offer of dedicated office and meeting room space, along with IT and functional support for the secretariat.

15. The Group was established as an "Unincorporated Association", with a brief constitution outlined and agreed at its June 2005 meeting (attached at annex A). This form was chosen to minimise the legal and administrative aspects of the Group in this early stage of its existence and reflect its informal nature, allowing a quick establishment with minimal bureaucracy. An unincorporated association is not a legal entity, and cannot enter into contracts, but it allows the Group to establish its own Bank Account, with the chair or appointed members as signatories.

16. The Group agreed that its minutes and most associated papers should be distributed to members and made publicly available. Minutes and associated papers are posted on a dedicated website for the Group (www.rfsgroup.co.uk).

Group Meetings 2005–06: Discussions, Updates, Themes and Outputs

17. The group has held six full meetings since its formation in 2005: June and October 2005, February, April, June and September 2006. The agenda for each meeting has sought to develop a range of specific interests or interconnected themes for the Group, with the aim of developing the Group's discussion. At its first full meeting in June 2005, the Group agreed a mission statement drafted to reflect both the concerns expressed by the Treasury Select Committee in its original recommendation, and the objectives proposed by the membership.

Mission Statement

The Group aims to encourage a thriving savings culture and a competitive retail financial services environment in the UK by building consumer confidence in personal savings and investment. It will be a place for frank, open and constructive dialogue between all players. The Group will:

- provide an early warning mechanism to highlight emerging problems;
- have an input into policy stances and individual initiatives at an early stage; and
- and promote best practice.

The goal is to promote an industry that serves its customers better.

18. A continual challenge for the Group is to identify and focus on areas where an open discussion between practitioners and consumer groups may be of particular value, acknowledging the fact that there are already clear sites of responsibility or work programmes on financial services, led by the regulatory authorities, trade associations and influenced by direct consumer group consultation.

19. Members of the Group stressed that discussions would need to complement existing initiatives in order to add value, whilst avoiding duplication. At the same time the Group should seek to identify specific under-exposed topics that may emerge as threats to consumer confidence in the future. The Group also noted that while establishing consensus positions between industry and consumer groups would be desirable wherever practical, there would also be value in the general process of providing an informed debate.

20. The Group has pursued these objectives through a mixture of discussions focused on specific topics, along with update discussions from members on key initiatives and work-streams. A broad summary of these discussions is included below.

General themes—promoting consumer confidence

21. The Group has held several discussions focused on developing the general theme of consumer confidence. The chair wrote to members in January 2006 to propose that this theme, at the heart of the Group's mission statement, is articulated through the Group's future discussion on individual issues.

22. Group members have discussed the range of initiatives focused on consumer confidence underway at present, including work from industry trade associations, consumer groups and the FSA. Members discussed whether the Group could establish a role in setting out the common ground or overlap between those initiatives. For example, the Group could receive updates from the industry on consumer-focused initiatives—setting out what was delivered and how this has helped to increase justified consumer confidence. There would be a subsequent role for consumer representatives in the Group to comment on the progress made and highlight where further work may be required or what more could be done.

Work-stream discussions and outputs

23. *Equity Release work-stream:* The Group commissioned an initial piece of work on Equity Release schemes at the June 2005 meeting. This followed on from the publication of the FSA's thematic research and mystery shopping on the sale of "Lifetime Mortgage" products in May last year. The secretariat coordinated the production of an "Equity Release and consumer confidence" discussion paper for the October 2005 meeting of the Group. The Chair commissioned written contributions from members and the secretariat established an informal working group on Equity Release, holding two meetings (September 2005 and January 2006) to inform discussion.

24. The group discussed the Equity Release paper at its October 2005 meeting. The paper includes an overview of recent market developments, the introduction of FSA regulation for Lifetime Mortgage products and the enhanced advice and sales rules of the Mortgage Conduct of Business (MCOB) sourcebook. The paper focuses on the variety and complexity of the issues facing potential customers when considering Equity Release and the difficulties for the consumer in accessing and evaluating advice.

25. The Group's discussion primarily focused on the nature of any "Advice Gap" in the market. For example, members stressed that the need for a broad range of adviser expertise (mortgage, retirement planning, debt, tax and benefit status) meant that it was likely that only a very limited number of advisers would provide a full service on Lifetime Mortgage products. Other members stressed the need for high quality generic advice in order to build consumer understanding, though it was also acknowledged that significant sources of quality literature are now available but that this could only achieve a minimal amount without further measures, such as the promotion of "best practice" working methods in the advice market.

26. The group agreed to explore the provision of best practice advice for Equity Release products. The Chair and secretary received further briefings on the work being conducted by industry groups to raise advice standards in response to the FSA's mystery shopping results (including Safe Home Income Plans, the Council of Mortgage Lenders and Age Concern Enterprises). Most of these Groups are also engaged directly with the FSA's own Equity Release forum.

27. The Group produced an updated commentary or "report card" for its February meeting on Equity Release. This summarised the steps being taken by various industry groups, as well as outlining the response from consumer groups to the latest market developments and data—this included the Financial Services Consumer Panel/FSA correspondence on Equity Release in December 2005 and the Which? market update published in January 2006. The FSA has recently published further research and mystery shopping results on the advice and sale of Equity Release. The Group may therefore return to this topic at a later meeting.

28. *Pensions Tax Simplification:* At the outset of the Group's meetings, members noted that the approach of the "A Day" (6 April 2006) pensions taxation reforms legislated in Finance Act 2004 represented a fundamental simplification of the pensions tax regime that could result in significant product innovation and the need for existing savers to review their arrangements or seek advice.

29. Industry and regulatory members felt that in general preparations for the implementation of A Day were well advanced, although there were some concerns on the relatively late finalisation of regulations and other changes. Industry and consumer group comment, as well as press attention in 2005 had focused on the apparent generosity and flexibility of the new rules in relation to self-directed pension investment in residential property. The steps taken in the 2005 Pre-Budget Report mitigated risks in this area.

30. However, the Group produced an initial discussion paper on tax simplification and consumer opportunities/risks for consideration at its April 2006 meeting, just after A-Day. Members noted that it was too soon to assess any general effects on the market, and stressed that the reforms would have the greatest immediate or "transitional" impact on the affluent or financially sophisticated who would need to review existing arrangements.

31. Anecdotal evidence suggested a rise in sales and advice activity in the run-up to A-Day. Members argued that any "churning" activity would not be readily identifiable simply from a rise in sales, as we would expect a significant amount of activity to take place as existing customers rationalised their portfolios.

32. *Claims Management Companies and the Compensation Bill:* The Group discussed claims management services and compensation at its February 2006 meeting, as the Government's compensation bill received scrutiny in the House of Lords. All the Group's members welcomed the Government's move to introduce a regulatory regime for claims management companies and discussed the particular relevance in relation to consumers' knowledge and use of the existing redress mechanism via the Financial Ombudsman Service.

33. The Group agreed to send an ABI briefing paper, along with a letter from the Chair outlining this broad consensus to the Department of Constitutional Affair's Compensation bill team.

34. *Personal Pensions and Contracting-Out:* The Group decided to defer discussion of most pension issues until after the publication of the Government's White paper on pension reform, responding to Pension Commission proposals of November 2005.

35. However, discussions with members identified a particular area of the pensions debate where there was a good argument for a more pressing debate. The Group discussed the provision of financial advice on contracting out of the state second pension into personal pension schemes, and the different approaches taken by firms in response to the level of rebates currently available. This was an area where there is a recognised difficulty in assessing likely future benefits and providing clear advice. The Group wrote to the Department of Work and Pensions to ensure that the White Paper provided clarity on the future of contracting out for defined contribution personal pensions and the policy intention supporting the present rebates.

36. The White Paper subsequently confirmed the Pensions Commission recommendation in this area. Contracted out rebates to Defined Contribution personal pensions will be abolished at the same time as the other major reforms are introduced, such as the introduction of auto-enrolled Personal Accounts (2012 or by the end of the next Parliament in any event).

Update discussions

37. *ABI work on commission and financial advice:* In October 2005 the Group received an update paper from the ABI on its "paying for financial advice" work programme. Members noted the objectives, including the elimination of bias and/or the perception of bias arising from remuneration structures, an increase in the transparency of charging structures and the need to ensure a sustainable capital base for the advice industry. The ABI hoped to identify and address continuing concerns. Members disagreed on whether the commission-based advice model resulted in significant sales bias or potential consumer detriment and the sustainability/appeal of alternative remuneration models, including upfront fees.

38. Since this date the FSA has also published the findings from mystery shopping and desk-based research on the provision of new Initial Disclosure Documents or "menus" by advisers, with "disappointing" results in terms of compliance with the disclosure regime and accurate document formatting.[11] The FSA provided further feedback on this area in its Treating Customers Fairly update published in July 2006.

39. *FSA paper on risk ratings and product disclosure:* The FSA presented a paper to the Group in October 2005, reporting on the meetings of its taskforce exploring the feasibility of risk ratings, as part of its review and consultation on potential reform of product disclosure rules. The Group discussed the FSA's decision not to pursue a risk rating or "traffic light" system as part of the disclosure review, in light of the potential problems in defining and categorising different forms and levels of risk as well as the potential for "moral hazard" or perverse outcomes.

40. Whilst members recognised these issues, there was also recognition that more independent work on risk measurement and communication would be desirable in its own right, could help to inform or standardise the approach to risk ratings taken by different firms, and may also inform the future development of the formal disclosure regime. The Chair encouraged members, via trade associations, to pursue initiatives to this end and the Group is taking a keen interest in potential work by both the ABI and the IMA in this area.

41. The FSA has also pushed back its intended consultation on investment product disclosure, citing adverse results of its analysis of the costs and benefits of introducing a new "Quick Guide" regime, as well as uncertainty on the implications on the implications of the delayed Markets in Financial Instruments Directive (MiFID) for product disclosure.

42. *Industry and consumer group initiatives:* The Group has had several discussions on the efforts of both industry and consumer groups to take new initiatives to promote best practice and consumer confidence. In October 2005, the Group received an update briefing from Which? on its consultation with the industry on a proposed code of practice and potential corporate governance reforms, entitled, *"Time for a change: Restoring and maintaining consumer confidence in the financial services industry"*.

43. At the Group's April 2006 meeting the Group discussed the ABI's new initiative for the improving consumer confidence in the life industry "Customer Impact". The Group received a detailed presentation of the Customer Impact initial survey results and discussed the development of the Scheme, including suggestions from many consumer group members for the extension of the scheme and the publication of individual company survey results. The Group has also received an update from the FSA on the progress of its Treating Customers Fairly programme and the National strategy on Financial Capability. At its most recent meeting (29 September 2006), the group discussed the Treating Customers Fairly (TCF) programme in greater detail, in particular the risks to delivery of TCF going forward and a general discussion on the nature of principles-based regulation in the retail market. The Group agreed to investigate further discussion on measuring the outcomes/success.

[11] FSA "Dear CEO letter": Results of our review of retail investment disclosure documentation, 24 March 2006. Full research available at www.fsa.gov.uk/pages/Library/Communication/PR/2006/031.shtml

FUTURE DEVELOPMENT OF THE GROUP

44. In March 2006 Richard Lambert was appointed Director-General Designate of the Confederation of British Industry and stepped down from the Monetary Policy Committee. Richard became Director-General on 3 July and due to his new commitments he is no longer be able to chair the Group.

45. In the Spring, the Group began the process of inviting a new independent chair to join, working through an "appointments committee" drawn from the Group's membership. Subsequently the Group announced in June that Ron Sandler has agreed to become its second chair. Ron is Chairman of a number of companies, including Computacenter plc and Paternoster. He was previously Chief Operating Officer of NatWest and before that, Chief Executive of Lloyd's of London. In July 2002 Ron published Medium and Long-Term Retail Savings in the UK, an independent review commissioned by HM Treasury. He is Chairman of the personal finance educational charity *pfeg* and a member of the FSA's Financial Capability Steering Group. Ron chaired his first meeting in September.

46. The change in Chair marks a useful opportunity to take initial stock of the Group's progress. Members agreed that the Group had met its initial objectives and there was unanimous and unqualified support from members for the Group to continue meeting. A forward timetable of meetings in late 2006 and 2007 has been agreed.

47. The Group has been successful in creating a frank, open and continual dialogue focused on general consumer confidence, detached from most "day-to-day" lobbying or reactive commentary, between market practitioners and consumer groups. As far as the Group is aware, no other forum brings together such a diverse range of stakeholders at such a senior level to discuss high-level issues. Participants have also noted the increasing quality and openness of discussion over the last year.

48. There has also been a good balance of broad "consensus issues" and candid discussions where there are clear differences of opinion between industry and consumer advocacy members. The Group's ability to promote consensus outputs on some specific issues, such as the letter to the Department of Constitutional Affairs endorsing the Compensation Bill, provides a useful template for possible future engagement and agreements between the members.

49. However, the Group also recognises that, by its very nature, it is difficult to fully align the interests and opinions of its membership, making the pursuit of "consensus" projects or initiatives challenging. The Group has also had a limited media profile in its first year.

50. In order to add value, the Group will have to identify further areas for both consensus-building discussion and subjects where conflicting opinions should be usefully debated. A definitive outline cannot be decided until the new chair is established. Furthermore, the Group must remain to some extent "reactive", rather than prescriptive, if it is to pick up issues of immediate concern to members.

51. However the Group has highlighted specific areas where further work from members, trade associations and the regulator could be discussed. These include:

Product disclosure and risk ratings: As outlined above, the Group will return to the research conducted by trade associations exploring the role of risk ratings in prompting greater customer engagement. The Group will also look to follow the FSAs next steps in consulting on its product disclosure regime more generally.

Pensions White Paper: With the Paper published, the Group held a full discussion of the proposals, and reflected this in an extended minute submitted to the Department of Work and Pensions discussions over the summer. However, as the debate develops, and further announcements are made by the Government over the coming year, the Group is likely to return to the reform debate, with a particular focus on the question of building consumer confidence in any new system and thinking about the transitional stages.

"Treating Customers Fairly" and principles-based regulation: As detailed above, the Group's most recent meeting discussed Treating Customers Fairly and the practical issues surrounding principles-based regulation. The Group intends to return to this area to discuss key questions relating to the measurement of success and helping to build a common understanding of what it means for firms to treat their customers fairly.

Annex A

RETAIL FINANCIAL SERVICES GROUP

CONSTITUTION

1. *The Name*

The name of the organisation is The Retail Financial Services Group.

2. *The Objects*

The Group aims to encourage a thriving savings culture and a competitive retail financial services environment in the UK by building consumer confidence in personal savings and investment. It will be a place for frank, open and constructive dialogue between all players. The Group will:

— provide an early warning mechanism to highlight emerging problems;

— have an input into policy stances and individual initiatives at an early stage; and

— promote best practice.

The goal is to promote an industry that serves its customers better.

3. *Group Membership*

(a) Officers

There shall be a Chair, Deputy Chair and Secretary.

(b) Members

The Group is comprised of senior (usually chief) executives encompassing a broad range of the retail financial services industry including retail banks, insurers, the investment management industry and financial advisors; senior executives from both independent and statutory consumer/advisory groups and representatives of the Financial Services Authority, the Financial Ombudsman Service and HM Treasury.

Representatives were put forward by the industry trade associations and the consumer groups, specifically the Association of British Insurers, the British Bankers' Association, the Investment Management Association, the National Consumer Council, the Financial Services Consumer Panel, the Financial Services Practitioner Panel and Which?. A selection of these bodies, along with the Financial Services Authority, also provides funding for the Group.

4. *Meetings*

The Group will meet quarterly. Minutes are to be taken at each meeting and retained by the Secretary.

5. *Dissolution*

In the event of the organisation dissolving—after paying or making provisions for all debts and liabilities of the Group, any remaining assets shall be repaid to the contributing members of the Group.

October 2006

Memorandum submitted by the Advertising Standards Authority

1. Introduction

1.1 The Advertising Standards Authority (ASA) is the UK self-regulatory body responsible for ensuring that all ads, wherever they appear, are legal, decent, honest and truthful.

1.2 The ASA is grateful for the opportunity to provide written evidence to this inquiry. Although the call for evidence does not specifically relate to advertising, we thought that the Committee might find it useful to receive some background information on the ASA regulatory system given the Financial Services Consumer Panel's recent survey of financial advertising and their comment, "It is a quirk of the set up that financial advertising is not covered by the ASA, and so consumers seem to get a worse deal, with the FSA offering no public scrutiny and pressure to make sure that advertisers keep to the rules in an area where it is all too easy to blind the consumer with seeming good news headlines. We would like this part of the FSA's work at least to open up with public naming and shaming of the worst offenders in breaking the advertising rules."[12]

1.3 This submission aims to:

— provide a brief outline of the ASA system of advertising self- and co-regulation; and

— explain the ASA's role in regulating financial advertising and how it works with the Financial Services Authority (FSA).

1.4 Further information about the ASA and the work that we do can be found at www.asa.org.uk

[12] Press release available at: http://www.fs-cp.org.uk/press/ct_pr77.html

2. Advertising Self- and Co-regulation

2.1 The ASA has been responsible for regulating non-broadcast (eg print, outdoor) advertising since 1962. The ASA is recognised by the Government and the Office of Fair Trading (OFT) as the "established means" for enforcing the Control of Misleading Advertisements Regulation (1988) (as amended). The OFT acts as the ASA's legal backstop regulator for the purposes of these Regulations, which means that the ASA is able to refer those advertisers who are unable or unwilling to comply with the ASA to the OFT for statutory action against misleading non-broadcast ads.

2.2 The success of advertising self-regulation was recognised in 2004 when Ofcom contracted-out the regulation of broadcast (TV and radio) advertising to the ASA system. Ofcom is the ASA's backstop regulator for TV and radio advertising.

2.3 This contracting-out arrangement created a "one-stop shop" for advertising content standards in the UK. There are effectively two systems operating behind a single shop front: a self-regulatory system for non-broadcast advertising and a co-regulatory system for broadcast advertising.

2.4 The ASA is responsible for policing three Advertising Codes. These are owned by the Committee of Advertising Practice (CAP), which owns and updates the British Code of Advertising, Sales Promotion and Direct Marketing (the CAP Code), and the Broadcast Committee of Advertising Practice (BCAP) which owns and updates the TV and Radio Advertising Standards Codes (the BCAP Codes). The three Advertising Codes can be accessed at www.cap.org.uk/cap/codes.

2.5 Membership of CAP comprises trade associations that represent advertisers, media owners and advertising agencies. Membership of BCAP comprises broadcasters and trade associations representing advertisers and advertising agencies.[13]

2.6 The system is based on a concordat between advertisers, agencies and the media that each will act in support of the highest standards in advertising. It is not a voluntary system.

2.7 Having a single front-line regulator for advertising brings great benefits to consumers and business, which now only have to deal with one complaint handling body. It has also led to harmonised decision making in cross media cases (eg campaigns that run on TV, in the press and on billboards).

2.8 The entire system is funded by the industry, not the tax payer, via a 0.1% levy on the cost of advertising space. The money is collected by two arms-length bodies, the Advertising Standards Board of Finance (Asbof) and the Broadcast Advertising Standards Board of Finance (Basbof).

2.9 The ASA investigates complaints from both the public and industry about ads that appear to break the Advertising Codes.

2.10 Complaints are investigated free of charge. The ASA accepts complaints by telephone, email, via the website or in writing. The results of the ASA's formal investigations are published weekly on www.asa.org.uk.

2.11 Where possible the ASA will try to resolve complaints informally with advertisers, for example to correct obvious breaches or minor mistakes.

2.12 In 2005, 2,241 ads were changed or withdrawn as a result of ASA action.

Sanctions

2.13 The ASA's primary sanction is adverse publicity for those advertisers that break the Codes. The ASA publishes its rulings on a weekly basis and its adjudications receive a substantial amount of media coverage. Adverse publicity is damaging to most marketers and serves to warn the public.

2.14 Other sanctions include: media owners and broadcasters refusing to run ads that break the Codes; removal of trading privileges, such as the Royal Mail bulk mailing discount if advertisers persistently flout the Codes, and as a final sanction advertisers who continue to breach the Code can be referred to the OFT for misleading non-broadcast ads. The ASA is able to refer broadcast licensees to Ofcom (under any aspect of the BCAP Codes) for regulatory action where necessary. Ofcom is able to levy fines and revoke licenses.

The effectiveness of the system

2.15 The advertising self-regulatory system seeks to achieve compliance through a number of mechanisms:

(i) First of all, most broadcast advertisements are pre-cleared by the Broadcast Advertising Clearance Centre (BACC) and the Radio Advertising Clearance Centre (RACC).[14] Pre-clearance does not prevent the ASA from investigating a compliant about an ad.

[13] Membership of CAP can be accessed at www.cap.org.uk

[14] Further information can be found at: http://www.bacc.org.uk and www.racc.co.uk

(ii) CAP provides free pre-publication copy advice for non-broadcast advertisements in order to promote compliance with the Code. The Copy Advice team also provides up-to-date guidance through online help notes.

(iii) CAP and BCAP undertake monitoring and compliance work. Ads that are considered to breach the Codes may be investigated and brought before the ASA Council. Sector surveys may prompt sector-wide compliance work.

2.16 The effectiveness of the system is illustrated by the high compliance with the rules. A survey of the national press in 2004 showed that 99.3% of ads complied.[15]

2.17 The effectiveness of the system is further evidenced by the fact that very few advertisers have to be referred to the ASA's legal backstops for further enforcement action. For example, since 2000 the ASA has had to refer fewer than thirty advertisers to the OFT.

2.18 Furthermore, the ASA, CAP and BCAP conduct research into advertising issues to ensure that the Codes and ASA decisions remain up to date and relevant to business and consumers.

2.19 Finally, the aim of the system is to be transparent and to promote the highest standards in advertising by compliance with the Advertising Codes. The fact that ASA decisions are published and covered in the general consumer press and the trade press creates a greater awareness of the rules and means that the industry is better able to learn from ASA decisions.

3. The ASA's Relationship with the Financial Services Authority (FSA)

Non-broadcast Advertising

3.1 Since the FSA assumed its full powers and responsibilities under the Financial Services and Markets Act 2000 (FSMA), the ASA has referred to the FSA complaints about financial claims in non-broadcast marketing communications where the complainants allege that claims about specific elements or characteristics of investment business, mortgages, general insurance and pure protection policies (eg term assurance) are misleading (including that they are unclear, unfair or misrepresentative) or make impermissible comparisons.

3.2 All non-technical elements of non-broadcast financial marketing communications are, however, still subject to the CAP Code eg serious or widespread offence, social responsibility and the truthfulness of claims that do not relate to specific characteristics of financial products.

Broadcast advertising

3.3 When the ASA became responsible for broadcast advertising on 1 November 2004, it acquired a general statutory obligation to consider all complaints about broadcast advertisements (TV and radio). This means that the ASA considers all complaints about financial broadcast advertisements, even when they concern technical matters of financial promotion that would usually fall within the FSA's remit (ie those claims that the ASA would refer to the FSA in non-broadcast marketing communications).

3.4 The BCAP Codes contain various prohibitions for financial products. These include investments not regulated by the FSA (including tangible investments) and some forms of investment that amount to betting. The relevant Code clauses are attached at Annex 1.

Multimedia advertising campaigns

3.5 In the case of multimedia campaigns, the ASA has agreed with the FSA that where it receives a complaint about a technical aspect of such a campaign that it will investigate all aspects of the campaign, ie both non-broadcast and broadcast advertisements.

3.6 When the ASA investigates technical aspects of a broadcast or non-broadcast financial advertisement, it is able to seek assistance from the FSA.

Conclusion

We understand that the FSA plans to move towards principles-based regulation, in line with Hampton recommendations on better regulation. In the light of this, we would be interested to know what will become of those advertising breaches in non-broadcast media that are likely to be considered too small for FSA action.

[15] http://www.asa.org.uk/NR/rdonlyres/441DCCD4-9219-485C-BD63-3379401F941B/0/ASA_National_Press_Survey_2004.pdf

I hope that this provides a succinct overview of how financial advertisements are regulated by the ASA. If you have any questions about this submission or require any further information on the work of the advertising self-regulatory system, then please do not hesitate to contact me.

Annex 1

THE BCAP TV CODE

Section 9: Finance and Investments

Background:

(1) *The rules in this Section largely draw attention to statutory regulation with which all advertising must comply. However, selecting the most appropriate financial products or services normally requires consumers to consider many factors and television advertising is not well suited to communicating large amounts of detail. It is not, therefore, an appropriate medium for advertising some particularly high risk or specialist investments or any financial products or services that are not regulated or otherwise permitted in the UK under FSMA.*

(2) *The Financial Services and Markets Act 2000 (FSMA) unifies much of the structure of financial regulation in the UK by replacing previous legislation and merging existing regulators into the Financial Services Authority (FSA).*

(3) *The FSA is the regulator for the financial services industry and regulates conduct of business, including advertising, for investment products. It also regulates the advertising of insurance, including the activities of insurance intermediaries (eg motor, home and travel insurers).*

(4) *The FSA is responsible for the regulation of most first charge mortgage lending and selling. Mortgages that are not regulated are those secured on non-UK land, business premises with less than 40% residential occupation, and second charge mortgages. The FSA's Financial promotion rules set out in Mortgage Conduct of Business Chapter 3 (MCOB 3) in the FSA Handbook apply to qualifying credit promotions as defined under the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO) and the FSA Handbook glossary.*

(5) *Unsecured lending, other forms of secured lending and some other credit activities continue to be regulated by the Consumer Credit Act 1974 (as amended) and the Consumer Credit (Advertisements) Regulations 2004.*

(6) *In this Section, unless otherwise stated, the terms "financial promotion", "authorised person" and "qualifying credit promotion" have the same meanings as in the FSMA and the FPO. Please note that the definition of a financial promotion is broad and includes, for example, advertising for deposits and insurance products.*

(7) *Advertisements for Spread Betting are unacceptable under 3.1(c) (Betting and gaming).*

9.1 Non-UK Advertising

Advertisements for financial services which:

(a) are broadcast on Ofcom-licensed services that are aimed exclusively at audiences in EU Member States other than the UK and

(b) are not subject to the financial promotion rules of the FSA

need not comply with Section 9. Instead they must comply with the laws and regulations of the relevant Member States.

9.2 Legal Responsibility

Financial promotions must comply with all legal and regulatory requirements

Notes:

(1) *To quote the FSMA, a Financial Promotion is "an inducement or invitation to engage in investment activity, which is communicated in the course of business". It is, however, important also to refer to the FSA Handbook, in particular to the rules in Conduct of Business Chapter 3 (COB 3), MCOB 3 and Investment Conduct of Business Chapter 3 (ICOB 3).*

(2) *Legal advice, or general advice from the FSA, may be required concerning compliance with FSMA requirements. Please note that the FSA does not pre-vet promotions.*

9.3 Misleading Advertising

Background:

The ASA and BCAP will apply their usual standards to prevent misleading advertising (see sections 5) and require any significant exceptions and qualifications to be made clear (see rule 5.2.3). In addition, Financial Promotions must be "clear, fair and not misleading" as required by the FSA Handbook. Where appropriate, the ASA and BCAP will seek advice from other regulators when investigating possible breaches of the rules in Section 9.

Unless advertisements subject to Section 9 are clearly addressed to a specialist audience and shown either on specialised financial channels or in breaks within appropriate financial programming, they must be considered to be addressing non-specialist audiences.

Note:

No specialist knowledge should normally be required for a clear understanding of claims or references. For example, exceptions, conditions or expressions which would be understood by finance specialists must be avoided or explained if they would be unfamiliar to many viewers.

9.4 Direct Remittance

Financial promotions must not invite the direct remittance of money

Notes:

(1) *It must not be possible to buy "off the screen" without further formality. There must always be an intermediate stage in which further information is supplied.*

(2) *See the BCAP Code for Text Services for exceptions to the rule for Ofcom-regulated text services.*

9.5 Unacceptable Categories

(a) Except on specialised financial channels, the following categories of advertising are not acceptable:

  (1) advertisements for the issue of shares or debentures. Exceptions are made for advertisements announcing the publication of listing particulars or a prospectus in connection with an offer of shares or debentures to be listed on the London Stock Exchange or prospectuses approved for the purposes of the Prospectus Directive 2003/71/EC and permitted under FSMA.

  (2) advertisements recommending the acquisition or disposal of an investment in any specific company other than an investment trust company listed on the London Stock Exchange.

(b) Nothing may be advertised as an investment unless it is regulated or otherwise permitted under FSMA.

Notes to 9.5:

(1) *Advertisements for Spread Betting are unacceptable under 3.1(c) (Betting and gaming). Please also note rule 3.2 (Indirect promotion) which prohibits advertising if a significant effect would be to promote a product or service that cannot be advertised in its own right.*

(2) *Advertisements for Contracts for Differences (except Spread Betting) are acceptable on specialist financial channels provided the products are available only to clients who have demonstrated through appropriate pre-vetting procedure that they have relevant financial trading experience. (For this purpose, a "specialised financial channel" is an Ofcom licensed channel whose programmes, with few exceptions, are likely to be of particular interest only to business people or finance professionals.)*

(3) *In this Code, "Spread Betting" and "Contract for Differences" have the same meanings as in the current glossary to the FSA Handbook.*

Note to 9.5(b):

Any advertising which implies that, for example, a collectors' item or some other unregulated product or service could have investment potential would normally be unacceptable. ("Investment" is used in its colloquial sense in this note.)

9.6 Financial Promotions

Subject to 9.5(a), financial promotions are acceptable if:

(a) they have been approved by an "authorised person" as defined in the FSMA or

(b) they are exempt as set out in COB 3.2.5R, MCOB 3.2.5R and ICOB 3.3.6R

Note to 9.6:

Advertising by a general insurance intermediary need not be approved by an authorised person if it is a generic promotion under the FPO. (This is usually where the advertising does not identify any particular insurer, insurance intermediary or product, so it will usually apply where the financial promotion refers generally to product types).

9.7 Savings and Deposits

(a) References to interest on savings must be accurate at the time of transmission and the advertising must be modified immediately if the rate changes.

(b) Calculations of interest must not be based on significant unstated factors.

Note to 9.7(b):

It may be necessary to refer to factors such as a minimum deposit, minimum deposit period or minimum period of notice for withdrawal.

(c) Advertisements must make clear whether interest is gross or net of tax.

(d) Where the interest rate is variable, this must be stated.

(e) Where the investment returns of savings products are compared (eg a unit trust is compared with a bank deposit) any significant differences between the products must be explained.

(f) Advertisements subject to Section 9 must comply with Code of Conduct on the Advertising of Interest Bearing Accounts which is published jointly by the Building Societies Association and the British Bankers' Association.

9.8 Lending and Credit

The advertising of most credit or hire services is acceptable only where the advertiser complies with the Consumer Credit (Advertisements) Regulations 2004 and the Consumer Credit Act 1974 (as amended). The advertising of mortgages regulated by the FSA and secured loans of FSA regulated lenders is only acceptable where the advertiser complies with the FSMA and the FSA Handbook.

Notes:

(1) *Credit advertisements that are not qualifying credit promotions must comply with Section 46 of the Consumer Credit Act and Regulations made under it. Where there is doubt about their applicability or interpretation, advice should be sought from the appropriate Trading Standards Department. Such advertisements that involve distance marketing must also comply with the Financial Services (Distance Marketing) Regulations 2004. Other financial advertisements that are distance marketed will be covered by the FSA Handbook.*

(2) *Please note the Guidance for Debt Management Companies and other guidance issued by the Director General of Fair Trading.*

9.9 Financial Publications

Advertisements for publications (whether electronic or on paper) must make no recommendations about specific investments.

October 2006

Memorandum submitted by the Financial Services Authority

A. Introduction

1. This memorandum is submitted in advance of the FSA's appearance before the Committee on 24 October. We look forward to elaborating on it in oral evidence.

2. In our Annual Report for 2005–06, published in June, we reported on our work during the past year under three headings:

- helping retail customers get a fair deal;
- promoting efficient, orderly and fair markets, both retail and wholesale; and
- improving our business capability and effectiveness.

3. This memorandum summarises our approach to regulation and our work during the past year and highlights some recent developments, including on the topics signalled in the Committee's press notice of 12 September.

B. Our Approach to Regulation

4. We want to promote effective working of markets to deliver benefits for firms and consumers. So we aim to work with the grain of the market. We introduce new rules, where we have discretion, only where this is justified by market failure and cost-benefit analysis. In practice this is where we judge that market forces will not rectify the problem, and where it is likely that the benefits of regulatory intervention will outweigh the costs. We look for opportunities to challenge the market to find its own solutions to market failure, using regulatory intervention only as a backstop. A recent successful example of this approach is our challenge to the market to establish contract certainty in the wholesale and commercial general insurance market, where it appears that the market is on track to find its own solution.

5. We operate a risk-based approach, which enables us to focus our resources and activities on the most significant risks to our objectives. Importantly, this approach accepts that some failure neither can nor should be avoided. Our approach is proportionate and is therefore more interventionist in retail than in wholesale markets.

6. We are also moving towards a more principles-based approach to regulation. This means fewer detailed rules and less regulatory prescription, and more flexibility and discretion for firms' senior management on how best to run their businesses in compliance with our regulatory requirements. This is illustrated by our new money laundering regime, which came into effect on 1 September. High-level provisions replaced the detailed rules in our Handbook, giving firms greater flexibility over how they identify and manage their money laundering risks. A further example is our Treating Customers Fairly work, where we are challenging firms' senior management to satisfy themselves and us that they are delivering the fair treatment of customers at different stages in the life cycle of a product.

7. We recognise the challenges this regulatory approach poses for our staff, in that it requires them to exercise greater judgement and to make decisions based on the outcomes the FSA is trying to achieve in financial markets, rather than focusing on monitoring compliance with detailed rules. We are now delivering a comprehensive training and development programme to equip them with the relevant knowledge, skills and behaviours.

8. In discharging our statutory responsibilities we are committed to striking the right balance between the costs of regulation and the benefits. In June, we published two reports on the costs to firms of complying with our requirements. Many of the rules which give rise to the greatest costs are being reviewed in work already under way. For example, we are combining the requirement to implement the Markets in Financial Instruments Directive (MiFID) with an exercise to simplify the rule book and make it more principles-based. We will consult on the new regime at the end of October.

9. We also recently published a report by Oxera on how to assess the benefits arising from the regulation of financial services. We are asking consultants to use Oxera's methodology to review the benefits of certain aspects of our retail conduct of business rules. We will report our findings in the second quarter of 2007. Like other independent regulators and Government departments, in November we will publish our Simplification Plan outlining the progress we have made in cutting back unjustified regulations.

10. Looking forward, a significant number of areas are under review. By 2008 we will have reviewed activities which in total account for more than 80% of the administrative cost incurred by firms as a result of our rules. We will remove rules that are no longer effective or proportionate in correcting market failures and generally move towards a more principles-based rulebook. We will continue to introduce improvements to make it easier for firms and consumers to do business with us.

C. Helping Retail Consumers Get a Fair Deal

11. In helping retail consumers get a fair deal, we focus our efforts on what we consider to be the four main elements of an effective retail market, and develop our retail initiatives with these in mind:

- capable and confident consumers;
- clear, simple and understandable information from the industry and the FSA, available for, and used by, consumers;
- responsible firms who treat their customers fairly and are soundly managed and adequately capitalised; and
- risk-based regulation, through firm-specific and thematic supervision and policy.

We highlight below particular aspects of our retail markets work programme.

Financial capability

12. We published the results of our Baseline Survey in March this year. As the Committee will recall from our earlier evidence, this survey was the largest of its kind in the world and enabled us to create a comprehensive picture of the extent to which people in the UK are able to: make ends meet; keep track of their finances; plan ahead; choose financial products; and stay informed about financial matters.

13. The headline results were:

- large numbers of people, from all sections of society, are failing to plan ahead for their retirement or for a rainy day;
- over-indebtedness is very severe for some and there are many more people who are currently just coping and so are vulnerable to an economic downturn or to a change in their personal circumstances;
- many people are taking financial risks without realising it because they struggle to choose products in a way that truly meets their needs; and
- the under 40s are, on average, less capable than their elders but carry much more personal responsibility than their parents' generation.

14. Building on the findings from the Survey, together with our partners we have launched a seven-point programme which aims to raise financial capability across the UK. The programme focuses on: improving financial capability among children in schools and young adults in further and higher education; providing employees with ready access to information in their place of work; helping new parents; and the provision of relevant, user-friendly and accessible tools and information, particularly to help with planning ahead and with choosing products. We anticipate that these initiatives will reach more than 10 million people in the period to 2010–11.

15. The programme covers those who have limited involvement with the financial system, and so contributes directly to greater financial inclusion. An example of this is our work with young adults not in education, employment or training.

16. On money advice, we believe that the FSA can best add value by targeting further specific groups of consumers who are in priority need of relatively simple and straightforward advice (including the elderly, lone parents and those in social housing) and working through the existing intermediaries they know and trust. By leveraging existing networks and resources and building on the replicability and sustainability of the Innovation Fund projects, we are expanding the range of partners with whom we work to provide these groups with the help they need. This offers the prospect of reaching millions more consumers in our target groups. We are also discussing with other partners how the provision of money advice could be expanded further.

17. We welcome the announcement made by the Economic Secretary to the Treasury of a 10-year Government strategy on financial capability. We are working closely with the Treasury as that strategy is developed.

Information for consumers

18. Clear, simple and understandable information for consumers is crucial in helping them to make sound financial decisions. We approach the provision of information in two main ways: by making FSA information available direct to consumers; and by specifying the information which firms must give their customers at particular stages in the selling and advice process.

19. Our main direct channels of communication with consumers are our website, hard-copy booklets and factsheets and our Consumer Contact Centre. In the last financial year:

- our consumer website received two million visits;
- we received orders for 11 million hard-copy publications; and
- our Consumer Contact Centre handled 230,000 inquiries.

20. Earlier this year we ran three promotional campaigns: MortgagesLaidBare; Pensions Made Clear; and MoneyLaidBare. They generated over 600,000 visits to our campaign websites and extensive media coverage. Further campaigns will be undertaken in 2007 to promote the availability of our resources to consumers. We have also developed two on-line tools—the Financial Healthcheck and Debt Test—both aimed at helping consumers to understand their financial position and to take action. We worked with a range of organisations to make this available to consumers, including the BBC, The Pensions Service, Directgov, Citizens Advice and the Royal Bank of Scotland. Over 1.3 million consumers have now taken the Financial Healthcheck or the Debt Test.

21. We know that there is more we can do to make our information appealing, engaging, and appropriate for our audience. A new consumer website will go live before the end of the year and our booklets and factsheets will be revised by the end of the second quarter of 2007.

22. In addition, we have carried out a review of the information provided to consumers at the point of sale for investment products. We propose a radical simplification of our rules, which aims to provide greater flexibility for firms, reduce the amount of material provided to consumers and improve the content and prominence of key information.

23. In particular, we have considered a proposal to replace the current "*Key Features Document*" with a "*Quick Guide*" (a two page document setting out the answers to 10 key questions that consumers want, or need, to know at the point of sale). However, our research suggests that implementing the Quick Guide would involve significant costs for firms, yet very similar results in consumer understanding and behaviour can be achieved through good practice under the current regime. Recent testing has also shown that standards have generally risen since the review started, with many firms embracing similar concepts to those used in the Quick Guide, such as the use of simple layout, clear headings, a Q&A format and improved standout. We have therefore decided that the most proportionate action is to focus our efforts on making further improvements under the current regime. To support this we are developing a package of measures to promote good practice and reduce poor practice. We will consult on our proposals later in October as part of our plans to simplify our Conduct of Business regime.

The fair treatment of customers

24. The aim of our Treating Customers Fairly initiative is to achieve fairer outcomes for consumers. This continues to be a priority for us. As we indicated in our paper of July 2006, "*TCF: towards fairer outcomes for consumers*", we have conducted further work to assess firms' progress in implementing TCF and in developing TCF Management Information. This work also focused on the TCF aspects of the quality of investment advice.

25. We identified and reported on some TCF issues of specific relevance to the mortgage and general insurance sectors. These issues are applicable more generally. For example in both sectors we have suggested that firms need to focus their efforts on treating customers fairly when designing new products and ensuring that literature provided to consumers is clear and understandable. In the mortgage sector we have also encouraged the industry to design remuneration strategies for mortgage advisers which reflect the TCF principle. In the general insurance sector we have encouraged firms to make progress in the production and use of management information to support the implementation of TCF.

26. We recently published a Discussion Paper (28/09) on the responsibilities of product providers and distributors for the fair treatment of customers. We encourage providers to design their products with greater care, to provide higher quality information, to monitor distribution channels more effectively, and to undertake better post-sale analysis of the performance of products. We also encourage distributors to scrutinise more closely information they receive from product providers to ensure that specific products are suitable for particular consumers.

27. We have built TCF into our training for our supervisors and have developed training for firms to enable them to improve and implement their TCF strategies. We work closely with the industry to encourage them to embed TCF in their business cultures and we have indicated that we hold senior management responsible for achieving this. During the year we have also worked with small firms to help them identify and tackle any gaps in their ability to treat their customers fairly, which has included launching a self-assessment tool.

28. Although much remains to be done, we have seen firms make progress. We have set a deadline of the end of March 2007 for firms to reach the implementation stage of their TCF work in a substantial part of their business, and we will measure the progress of firms against the six high-level outcomes for consumers which we have identified in this area.

Retail Distribution Review

29. Many of the issues we are addressing in the retail market are symptoms of more fundamental problems in the distribution of retail financial products. For this reason, we have announced a review of retail distribution.

30. In his speech at the Gleneagles Summit, Callum McCarthy set out some early thoughts on the areas for reform in the distribution of retail investment products, to be addressed by this review. These relate to the current business model, incentives including commission structures, professionalism of those distributing products and customer access to financial products. It is clear to us that there is appetite in the industry for major reform and we will work with the industry to help it find solutions. We also know that there are some areas where our existing rules and regulatory approach may need to change if we are to improve the efficiency of this market and deliver better outcomes for consumers.

31. In early November we will announce the scope and priorities of this review. In the second quarter of 2007 we plan to publish a Discussion Paper which will recommend solutions, whether regulatory or market-led.

Our risk-based approach to the retail market

32. We identify risks by monitoring information from a number of sources, including data from the market and our discussions with firms.

Mortgage and general insurance regulation

33. Over the past year we have used thematic work to review a number of issues, in particular how firms have met the requirements of our mortgage and general insurance regimes. Specific examples include our review of disclosure documentation, financial promotions and controls over appointed representatives in both regimes. Where we identified concerns, we have worked with the industry to improve standards.

34. Last November, we concluded a market review which found poor selling practices and a lack of proper compliance controls in firms selling Payment Protection Insurance (PPI). We found firms selling policies to customers who were not eligible to claim on them, as well as evidence of firms not explaining either the price or the main exclusions and limitations of the policy. In cases where we identified serious concerns we took action with the relevant firms and informed firms more generally about our findings. We are also engaging with trade associations to address these concerns and are working closely with the Office of Fair Trading on its study of competition in the PPI market. We will publish shortly the outcome of further work we have undertaken to assess to what extent practices have improved.

35. We are currently reviewing our general insurance conduct of business rules and plan to report on our findings in the first quarter of 2007. In June this year, following feedback from the industry, we announced that we were widening the scope of this review to actively look for deregulation opportunities. We are considering the feasibility of a differentiated regime with a lighter touch for simple GI products, where there is little or no evidence of consumer detriment (eg motor and household insurance), compared to personal products (eg critical illness and payment protection insurance) where there is more scope for consumer detriment. To inform our thinking we have commissioned three pieces of consumer research to establish what use consumers make of point of sale disclosure documents. We will work closely with consumer bodies as well as the industry. We intend to consult on any rule changes that arise from the review in the second quarter of 2007, and make rule changes in the fourth quarter of 2007.

Pensions reform

36. In the light of the Pension Commission's second report in November last year, and the Government's White Paper in May, we have been working with the Government and The Pensions Regulator to assess the potential regulatory implications of the options for a national pension scheme. As we said to the Committee in May, the nature of the regulatory regime will depend on the Government's decisions on the design of the model. We have outlined some of the regulatory implications of the different design options in our response to the White Paper (which we published). Our main message remains that the simpler the design of Personal Accounts and the simpler the choices consumers have to make, the fewer the risks to consumer protection, consumer understanding and market confidence.

D. Promoting Efficient, Orderly and Fair Markets

37. We aim to promote efficient, orderly and fair markets, and to ensure that UK markets are internationally attractive and sustainable. The UK is the most international capital market centre in the world; FSA-authorised firms account for over three-quarters of the hedge fund assets managed by European-based firms, the London market is the largest for internationally traded insurance and reinsurance, and the UK banking industry has the third largest volume of assets and deposits in the world and the largest in Europe.

38. Our approach to regulation is driven by the need to achieve our statutory objectives in a way which is proportionate and consistent with innovation and competition in the financial sector. This approach is an important and positive contributor the UK's position as a leading global financial centre. A Corporation of London survey of the City, published in November 2005, found that London and New York have moved further ahead of Europe as the only genuine international financial centres, and London is marginally ahead of New York. The survey identified the quality of the UK's regulatory environment as one of the main factors which makes London so competitive. 25% of respondents to a London Stock Exchange survey of December 2005 said the UK's standard of regulation and corporate governance were the most important factors in the decision to float on the Exchange's markets.

Europe

39. As we have explained to the Committee on other occasions, a significant proportion of our policy formulation is driven by initiatives originating in the European Union. We are bound to implement European legislation and the FSA and HMT (as the principal UK negotiator) aim to exert maximum influence at the development stage. In implementing EU legislation through our rules, our approach is not to impose obligations beyond what is required by directives unless this is necessary to achieve our statutory objectives and can be justified by cost-benefit analysis.

40. Now we are nearing the end of the process of implementing the Capital Requirements Directive, the most significant measure on which we are currently working is the Markets in Financial Instruments Directive (MiFID), due to be implemented by November 2007. This will have a major impact on a wide range of firms in the UK. We have been working closely with the industry to develop a proportionate approach to implementation. As mentioned above, we will consult shortly on our proposals for a fundamental reform of our conduct of business rules, which will include the relevant MiFID changes. We also plan to publish separately our assessment of the overall costs and benefits of this Directive. Looking further ahead, the most significant Directive on the horizon is Solvency II, designed to establish a risk-based capital regime for insurance companies across the EU. We are closely involved in preparatory work for the Directive, in particular through our membership of CEIOPS (the Committee of European Insurance and Occupational Pensions Supervisors), on which John Tiner represents the FSA.

41. The FSA devotes considerable senior management and other resources to the work of the "Lamfalussy" committees (the Committee of European Securities Regulators, CEIOPS and the Committee of European Banking Supervisors). These committees play a key role in advising on the substance of European financial services regulation and in promoting supervisory convergence.

Exchange consolidation

42. The future ownership of the London Stock Exchange has been an important question over the past year, as has been the potential combination of Euronext, LIFFE and the New York Stock Exchange. We have been keen to ensure that the market and the exchanges' stakeholders are fully aware of the longer-term implications of a takeover, including where regulation of the exchanges' markets would take place. As long as the London Stock Exchange and LIFFE remain UK exchanges we will continue to seek to ensure that they meet our regulatory requirements. We remain neutral about the nationality of any future owner. We support the Government's proposal to enable the FSA to veto disproportionate rule changes proposed by recognised bodies.

Financial stability

43. We have continued to work closely with the other Tripartite authorities—the Treasury and Bank of England—to enhance the ability of the financial services sector to respond to financial crises and major disruptions and to uncover issues needing attention. Currently, to improve the capacity of the sector to cope effectively with a pandemic flu outbreak, we are leading a six-week Market-Wide Exercise—which started on 13 October—to test the preparedness of the Tripartite authorities and the financial services sector in this area. Many participants—major firms and infrastructure providers, government departments, health agencies, service providers, foreign regulators and other experts—are working with us on the design and delivery of the exercise. We will publish a summary report on the key lessons learned within a few weeks of the end of the exercise. We will follow this up with a series of workshops and seminars in the new year to reinforce the messages and promulgate them more widely.

E. Concluding Remarks

44. By early 2007 we will have set out our future plans, and our view of the main challenges facing us, in our Financial Risk Outlook, International Regulatory Outlook and Business Plan. We will provide the Committee with copies.

October 2006

Supplementary memorandum by the Financial Services Authority

A. Introduction

1. When we gave evidence to the Committee on 24 October, we undertook to provide further information on:

- what we are doing for consumers in Northern Ireland;
- our recent Discussion Paper on "*The responsibilities of providers and distributors for the fair treatment of customers*";
- our involvement in the Information Commissioner's inquiry into offshore information security;
- the Transparency Directive and suspected back-dating of stock options; and
- our approach to enforcement.

2. We also agreed to provide further information about Payment Protection Insurance and our approach to financial promotions. These are covered in Callum McCarthy's separate letter of 17 November to the Committee Chairman.

B. The FSA in Northern Ireland

3. Our Financial Capability survey published in March 2006 demonstrated that NI fares particularly poorly relative to the rest of the UK when it comes to planning ahead, staying informed about financial matters and choosing financial products effectively. As a result, we have significantly accelerated our activity in NI:

- We co-chair the *NI Financial Capability Strategic Partnership* with the NI Consumer Council. This was established in June 2006 to help implement the FSA's National Strategy for Financial Capability in NI and brings together representatives from the public, private and voluntary sectors.
- To implement that strategy effectively, we have proposed to fund a Financial Capability "champion" to coordinate and take forward the work in NI identified by the Strategic Partnership. The Consumer Council is currently considering our proposal.
- We are working with the Personal Finance Education Group on the NI Financial Education Forum which met for the first time in March 2006. This allows participants to exchange ideas, resources and information to take forward our *Schools* programme and make the most of changes to the maths curriculum in NI.
- In September 2006, we recruited a secondee from Northern Bank to be an Employer Relationship Manager, based in Belfast, for our programme of financial education in the *Workplace*. With strong support from the FSA, her role is to secure further employers throughout NI and then ensure effective delivery.
- Also, as part of the *Workplace* programme, we have delivered financial education packs and seminars to the Department of Enterprise, Trade and Investment (NI). Four more employers with a presence in NI—the BBC, Business in the Community, the Consumer Council and the British Medical Association—are also joining the programme. We are encouraged by the strength and depth of interest so far and are working with employers' organisations, consumer bodies, trade unions and trade associations to really step up the pace in signing-up further employers.
- In collaboration with Citizens Advice NI, we are delivering training to organisations such as the Western Education and Libraries Board to improve financial capability among *young adults*. Workshops are to be delivered to Opportunity Youth, a charity working with the hardest to reach young people, and at resource fairs in Belfast and Londonderry with the NI Youth Service Curriculum Development Unit.
- Omagh Independent Advice Services (OIAS) was one of twelve beneficiaries of the FSA's 2005 *Innovation Fund*. OIAS received over £13,000 to produce a financial booklet and website for people with cancer and their carers. The FSA Innovation Fund team have spent several days in Omagh providing advice on the project's set up, launch and evaluation.

4. We are currently reviewing our consumer campaigns strategy, press relations and distribution of our consumer publications to ensure that, where relevant, these are achieving maximum impact in NI and in other parts of the UK. We will launch a specific media campaign on financial capability in NI in early 2007.

5. We have also been heavily involved in addressing *financial crime* in NI. In late 2005, we reviewed what the four main NI banks could do to reduce the possibility of their institutions being used for fraud, money laundering and, in particular, terrorist financing. Our colleagues in the Northern Ireland Office (NIO) had raised concerns that:

- The NI bank practice of not issuing cheques crossed "a/c payee only" as standard was leading directly to money laundering, particularly linked to fuel smuggling;

— procedures for handling "stained" banknotes (ie notes likely to have been obtained via armed robbery) were disjointed; and

— there was confusion over new staff vetting arrangements.

6. We visited all four NI banks in December 2005 and worked closely with colleagues in the NIO, Police Service of Northern Ireland (PSNI), HMRC, and Assets Recovery Agency (ARA). This work has led to a number of successes—since April 2006 all the NI banks issue their cheques automatically crossed "a/c payee only"; there are now homogenous procedures for dealing with stained banknotes, and we have made the banks more aware of forthcoming changes to staff vetting procedures, with the aim of enhancing banks' overall systems and controls. We continue to have bi-annual meetings between NI banking supervisors and representatives from NI law enforcement and have been invited to sit on the NI Organised Crime Task Force. Our work has helped ensure that banks and, as a result, their customers are less likely to be used as a vehicle for serious financial crime.

7. In addition to all the above, we continue with our usual regulatory activity including regular contact with the larger regulated firms in NI, as well as training, speeches and roadshows targeted at smaller firms in NI.

C. The Responsibilities of Providers and Distributors

8. We believe that providers and distributors of financial products have differing but interlocking responsibilities for treating customers fairly (TCF) and need to work together to help avoid potential future detriment to consumers. We published a Discussion Paper in September 2006 to help providers and distributors understand their respective responsibilities to consumers and help improve cohesion, confidence and efficiency in the combined distribution effort. The paper sets out our view of what the existing Principles for Business mean in a practical sense. It does not introduce new rules.

9. The paper articulates providers' responsibilities—to design their products with greater care, to provide higher quality information, to monitor distribution channels more effectively, and to undertake better post-sale analysis of the performance of products.

10. It also articulates distributors' responsibilities—to scrutinise more closely information they receive from product providers and ensure that specific products are suitable for the target consumer group. This should result in fewer cases of unfair outcomes for consumers, for example, where a distributor believes on the basis of information from a provider that a product is suitable for a customer. Our paper includes a number of case study illustrations designed to help firms think through the implications of the Paper for their own businesses. The deadline for feedback on our paper is 29 December. We will then communicate our findings with the industry.

D. The Information Commissioner's Inquiry into Offshore Information Security

11. The security of personal data is an increasing concern for consumers and the FSA. Personal financial data is increasingly held outside the financial sector for payment reasons (for example, by telephone or utility companies) and outside the UK in offshore administration and call centres. As a consequence, the reputational risk to the financial services sector is increasing. We are therefore considering the risks with other relevant regulators, including the Information Commissioner, so that we can clarify our joint responsibilities. The next steps will be to assess the relative roles, responsibilities and resources of these other regulators to decide how and when we should examine collectively the methods used by all types of firms to protect and control consumers' personal data which is sent offshore. A key concern for us at this stage is that the lack of security can arise in non-financial sectors; however, the abuse of personal data always affects the financial sector in terms of both loss and reputational damage.

E. The Transparency Directive and Stock Options

12. The Transparency Directive forms part of the EU's Financial Services Action Plan and is designed to enhance transparency across the EU's capital markets by harmonising information requirements for regulated markets. The Directive will introduce requirements in three areas:

— publication of financial information;

— disclosure of shareholdings; and

— the dissemination of the financial information required by the Transparency Directive, including financial reports and information relating to shareholdings.

The Directive does not deal with the granting of stock options, other than generally requiring the timely disclosure of major shareholdings (which might include potential holdings through options). Therefore, we do not believe that the Transparency Directive will have any impact on the suspected back-dating of stock options.

F. Our Approach to Enforcement

Impact of our Enforcement Process Review on our approach to enforcement

13. The changes made as a result of the Enforcement Process Review (EPR) have:

- made a significant difference to how the FSA uses enforcement and the fairness of our processes, as well as the perceived fairness of our processes;
- provided greater transparency about the decision-making process; and
- led to better co-operation between our Enforcement Division and supervision teams.

14. One of the most successful and most welcomed aspects of the EPR changes has been the new settlement process under which we have, since October 2005, been able to settle cases on the basis of agreement by two FSA Directors. Indeed, the majority of our disciplinary cases are now being concluded by executive settlement.

15. In relation to those cases that do not settle, the introduction of additional checks and controls, such as our Enforcement Division's legal review process and the separate legal support now available to the Regulatory Decisions Committee (RDC), has significantly enhanced the stringency with which the grounds for taking regulatory enforcement action are tested before formal decisions are made by the RDC.

The impact of the Paul Davidson case and the Tribunal's test of reasonableness

16. The Financial Services and Markets Tribunal (the Tribunal) may order the FSA to pay the successful party's costs if the FSA's decision leading to the referral was "unreasonable" (FSMA, Schedule 13, paragraph 13). In the *Davidson* case, the Tribunal confirmed that its approach is to consider whether the FSA's decision was unreasonable, given the facts and circumstances which were known or ought to have been known by the FSA at the time the decision was made. On the facts of the case, the Tribunal concluded that the decision to fine Mr Davidson was unreasonable; it was concerned at the FSA's approach to the evidence, to the law, and the level of penalties. These concerns were case-specific. The Tribunal accepted that success by an individual or firm before the Tribunal does not automatically entitle a party to recover its costs.

17. The Tribunal also said that the matters it had identified as unreasonable are unlikely to recur in the future as our original decision was taken before the implementation of the enforcement process review's recommendations. Against this background, we are not proposing to reassess our enforcement procedures in light of the outcome of the case. We are, however, as a matter of routine good practice, considering whether there are any other lessons to be learned from the case.

18. We are currently in discussions with Mr Davidson and Mr Tatham about the level of costs payable to them. We will recover any costs incurred through our normal fee raising procedures.

Bringing successful prosecutions for insider dealing

19. The Committee were interested in the practical and evidential difficulties of bringing insider dealing prosecutions. There are two avenues we can pursue when taking enforcement action for the misuse of information in relation to securities trading: we can take action under the criminal insider dealing regime or under the (civil) market abuse regime. Although to date we have brought no prosecutions under the criminal regime, we have successfully imposed significant fines (the highest to date being £750,000 fine of Philippe Jabre) under the market abuse regime.

20. The key challenge in prosecuting insider dealing is proving to the required standard ("beyond reasonable doubt") who it was that passed information and what that information was. In many cases where there is a strong suspicion of insider dealing (due to a timely trade, resulting in significant profit or loss avoidance, ahead of a Regulatory Announcement) there is little or no documentary evidence relating to the passage of information; accordingly, cases are often circumstantial, giving rise to a significant evidential challenge in proving who passed information to whom, and when, and what the "inside information" was—including meeting the statutory test that it was specific or precise and likely to have a significant effect on share price. As to price sensitivity, our experience is that it is difficult to find experts who are able and willing to give evidence to a court on an issue which is inherently subjective, although we are working with industry bodies, including the ABI, and firms to identify ways to provide such evidence to courts.

21. In addition, there are a number of defences available to defendants, including a defence of "I would have done what I did even if I had not had the information". With the vast range of sources of information available it will often be difficult for a prosecutor to be satisfied that such a defence is unlikely to succeed.

22. These issues are compounded because it will only be the most serious cases of insider dealing which are prosecuted under criminal law: if a fine is the appropriate sanction, we would generally take action under the civil market abuse regime (where we have an unlimited power to impose financial penalties); it is only in the most serious cases—including ones where a custodial sentence is a likely sanction—that a criminal prosecution is likely to be brought, which often brings into sharp focus the difficulty in proving beyond reasonable doubt what is usually a circumstantial case with no documentary evidence.

23. A further issue is, in contrast to the position in the United States, the fact that plea bargaining is not a recognised practice in the UK. Many criminal convictions in white collar crime cases in the US are secured with the assistance of evidence from co-wrongdoers in return for more lenient treatment. In the UK, however, prosecutors will not encourage suspects in criminal matters to plead guilty to an offence in return for the prosecution not pursuing more serious charges.

24. The giving of "Queen's evidence" by a co-accused has, on the other hand, now received legislative endorsement. The Serious Organised Crime & Police Act 2005 (SOCPA) clarified that prosecuting authorities may grant a suspected offender an immunity from prosecution in return for the offender's assistance with the prosecution. This power was available at common law, but the Act provides a statutory framework for its use. SOCPA names certain "specified prosecutors" who may exercise the statutory powers to grant immunity etc. Currently the FSA is not a specified prosecutor.

25. We are considering the extent to which it is open to the FSA to conclude agreements with potential suspects in criminal cases in return for their cooperation. It would be desirable for the FSA to be included in the list of prosecutors who have recognised statutory capacity to grant immunity in appropriate cases (the prosecutors who have such power are the CPS, Revenue and Customs Prosecution Office, the SFO and the Northern Ireland Director of Public Prosecutions Office). This would send a powerful message to the market about the FSA's commitment to protecting market integrity and the action we will take if necessary.

Suspicious transaction reports

26. The Committee were interested to know how many suspicious transaction reports received by the FSA have led to enforcement action. Between 1 July 2005 (the coming into force in the UK of the mandatory suspicious transaction reporting regime) and 1 November this year, we have received 266 suspicious transaction reports. Of these, 12 have been referred to our Enforcement Division for formal investigation.

Takeover announcements and insider information

27. The Committee were interested to know the basis on which the figure of 28.9%—the proportion of takeover announcements that resulted in a potentially significant sign of insider information—was calculated. Our sample included the 102 merger and acquisitions which were announced between January and December 2004. Of these, 57 announcements were deemed to be "significant" (ie they resulted in a significant price movement in the relevant security) and 22 were considered to be indicative of an informed price movement. However, the figure for informed price movements needed to be adjusted for statistical bias since, even if there is a large price movement ahead of an announcement, this may have had nothing to do with insider trading. After these adjustments were applied, this produced the percentage figure that, of the "significant" announcements, 28.9% were indicative of informed price movements.

November 2006

Supplementary memorandum by the Financial Services Authority

A. Payment Protection Insurance (PPI)

Current work on refunds

1. The Committee has raised concerns about some firms' approach to providing refunds of PPI premiums in various circumstances.

2. Industry trade associations have recently agreed that firms should not include so-called "nil refund" terms in their PPI policies. Firms will therefore give their customers refunds if they repay the associated loan early or if they choose to cancel the PPI policy without repaying the loan, except where the policy is near its end, the customer has made a successful claim or if a customer chooses to transfer cover to another product.

3. As these arrangements have only recently been agreed with the industry, not all firms will have revised their contracts and other arrangements accordingly. Firms may also need to amend their internal systems to be able to reissue the loan without the PPI. The firm referred to in your letter has confirmed to us that they will provide partial refunds of the premium where consumers choose to cancel the policy. They are in the process of amending their contracts and systems to deliver this.

4. Our work to secure improvements in firms' handling of refunds continues; the improvements we seek include clearer communication by firms to consumers on the circumstances in which refunds are available and the amount that is likely to be refunded. We will further publicise, by the end of March 2007, the concrete benefits this is delivering to consumers when this work is completed. We will also be checking that these refund arrangements are being implemented effectively across the industry.

The wider PPI market

5. As the Committee is aware, the OFT is of the view that there are deep-rooted barriers to effective competition in this market which go to the heart of why consumers fail to obtain a fair deal. They are currently consulting on whether they should refer this issue to the Competition Commission; we continue to assist the competition authorities in their work.

6. In parallel, we are taking forward a programme of action to deliver the improvements we must see in the way PPI is currently sold.

— We are urgently examining a range of options for adding PPI to our suite of comparative tables, including giving information on price and commission. This is not straightforward because of the differences in the PPI products sold by different providers. We will have decided by the end of March 2007 what should be done. In the meantime, we will build on the information that is already on our consumer website. In particular, information on PPI and other insurance protection products will be more accessible and clearer when we launch our new consumer website next month. This material will be promoted as part of a consumer awareness campaign on general insurance starting in February 2007.

— Enforcement: as a mark of the seriousness with which we are following up deficiencies in sales standards, we have referred 10 firms for investigation, with a view to possible enforcement action. We have recently fined two of these firms, generating significant media coverage to follow that driven by our joint announcement with the OFT in October. This will underline to all firms in the market the seriousness of having effective controls in this area. We will be making further announcements about the outcome of our enforcement investigations in the coming months.

— Supervisory work: in addition to formal discipline, we will follow up with firms in this market—those involved in our thematic work and others—to ensure that they have taken appropriate action in the light of our findings. If they have not taken appropriate action, or if we consider it insufficient, we have not ruled out further referrals to Enforcement.

— Trade associations: the industry-led initiatives which concentrate on, among other things, information for consumers and better training material for firms are slowly beginning to bear fruit. The Association of British Insurers and the Finance & Leasing Association have recently launched consumer guides for consultation. We will press the industry on what steps they are taking to get this material to consumers at the right time. These guides complement the advice to consumers that we included in our October announcement and which feature on the consumer pages of our web site.

— FSA communications to small firms in the PPI market: we are currently running a series of national roadshows aimed at motor dealers, in conjunction with the National Franchised Dealer Association, to reinforce the standards we expect of them. This includes how we expect insurance products to be sold alongside motor finance, an area of particular deficiency identified by our latest work. We are also setting up a dedicated motor dealer section on our Small Firms website to encourage greater compliance by such firms, which typically transact insurance business as the "third leg" of their business (eg a car sale, the financing of the purchase and then the associated PPI).

— Rule changes: we are not convinced that the existing general insurance regime, introduced in January 2005, is delivering the protections that customers deserve in this area. We are, therefore, examining the case for changes to existing rules or the introduction of new rules. This is being carried forward as part of the review of our regime for general insurance regulation—on which we sent the Committee a separate note on 15 November. We will publish the outcome of that review in the first quarter of 2007.

B. Transparency of Mnitoring Financial Promotions

7. The Committee raises concerns about the transparency of the FSA's work on financial promotions, compared with the approach adopted by the Advertising Standards Authority (ASA).

8. The Committee has urged the FSA to be more willing to "name and shame" individual firms. The Financial Services and Markets Act 2000 (FSMA) and the administrative law requirement, which applies to public bodies, to follow due process, restrict our ability to do this. Unless a firm expressly agrees to be named, we are not permitted to issue statements which amount to "public censure" without first taking the matter through our formal disciplinary process.

9. Our overall strategy to dealing with financial promotions in the financial services sector is to be proactive. We systematically scan print, internet and broadcast media in high risk areas and we do not rely on consumer complaints to alert us to problems. This also enables us to examine other compliance issues in the firms concerned—our experience is that deficient advertising can indicate more general problems in the way a firm is managed and controlled.

10. In the course of this proactive work, we are often able to spot pre-emptively material threats to consumers and take swift action to head them off before consumers are harmed and before complaints are made. Our ability to do so relies on resolving the vast majority of issues in discussions with the firms, without using our formal disciplinary powers. Since April 2004, we have pursued more than 930 cases directly with firms. While we did not need to take action in all these cases, in around 60% of them firms quickly amended or withdrew the advertisements without the need for formal disciplinary action. In a number of cases, firms also offered compensation to consumers who had been misled and suffered loss, again without resort to formal disciplinary action. We published the number of cases and the themes emerging from them in August.

11. Use of formal discipline would, in our view, be disproportionate except in the more serious cases and would—given the due process we are, rightly, required to follow—significantly delay resolution of the problems. We might well not, for example, be able to require the withdrawal of potentially misleading advertising until the conclusion of the disciplinary process. We publish full details at the conclusion of formal enforcement actions of the issue, penalties imposed and any redress secured for consumers. We have done this in respect of financial advertising on 12 occasions over the last two years, levying in total £1.5 million in fines.

12. While we do not name the firms concerned (unless there has been a formal enforcement process taken to a conclusion), we publicise the main themes to emerge from our supervisory and thematic work and communicate them directly to the industry to make clear the standards we expect and the areas in which we have continuing concerns and plan follow-up action. This transparency often has the effect of raising overall standards in those areas very quickly.

13. Although we do not rely primarily on complaints, we launched a Hotline in 2004 to enable consumers and industry to report issues to us. Over the last two years we have reviewed over 1,500 reports. There has been a broadly even split between complaints from consumers and those from the industry itself. We publish periodically the number of complaints we receive and their source.

14. We believe that our strategy, based on these different elements, is delivering real benefits to consumers. Over the last two years we have seen a material reduction in the number of complaints posing a high risk to consumers. The Consumer Panel's recent research suggested that only four of the 220 advertisements they reviewed posed high risk.

15. A further significant influence is our move to a more principles-based approach to regulation. Around 50% of our current rules on financial advertising are likely, subject to consultation, to be removed by November 2007, enabling us and the industry to concentrate on the big things that matter most in financial advertising—in this case that advertisements are clear, fair and not misleading to the benefit of consumers—rather than technical breaches of rules which pose a low risk of consumer detriment.

16. In recent months, we have built on our good working relationship with the ASA. In particular, the ASA continues to consider advertising where the concern is either a matter of taste or decency or where concerns relate to non-financial claims in the advertising. These can be settled by the ASA formally or informally. In the case of informal adjudications, the ASA publishes these in skeleton form on its website and makes the nature of the complaint available on request. It is able to do this largely because the ASA code is voluntary and does not impose the process disciplines mentioned earlier which restrict the FSA.

17. We are holding further discussions with the ASA to decide what further opportunities there are for collaboration and what more we can learn from their approach.

November 2006

Memorandum submitted by Citizens Advice

1. Citizens Advice has Been Asked to Submit Evidence to the Treasury Select Committee Scrutiny of the FSA's Annual Report in Relation to the FSA's Progress in Regulating Payment Protection Insurance (PPI)

2. Background Summary

2.1 The Citizens Advice evidence report *Protection Racket* identified a number of problems with PPI sold by lenders or retailers selling goods on credit. Thematic work by the FSA and the ongoing OFT market study have made similar findings. The most serious of the problems can be summarised as follows:

- High price of products and variable quality of products both suggesting limited or no competition where PPI is sold by lenders.
- Policies often pay limited benefits that don't actually cover people against credit risks and policies often contains various exclusion clauses that remove common causes of credit risk from cover.
- CAB evidence suggests that policies are frequently mis-sold to people who, because of their personal circumstances, would not be able to benefit from all or part of the cover they have paid for.

2.2 The FSA thematic work has so far mainly been concerned with addressing the problem of mis-selling. The aim of this work could perhaps be summarised as ensuring that consumers are able make informed choices about the product they are buying, that they understand what the product does, what it costs and that it is broadly suitable for their needs. The FSA has paid rather less attention to the other main problem areas.

2.3 Citizens Advice believes that there are two main issues which arise from the FSA's thematic work on PPI. Firstly, how well has the FSA thematic work addressed the problem of mis-selling. Secondly, why has the FSA paid less attention to other problem areas.

3. FSA Work on Mis-selling

3.1 The FSA approach has been initially to ask industry trade associations to come up with proposals that would address the PPI mis-selling. The industry response has been to propose a consumer guidance leaflet for prospective PPI purchasers. We saw an initial draft of this guidance written by the Finance and Leasing Association and Association of British Insurers that provided a quite clear plain language generic guide to PPI. We felt that this could certainly help consumers to understand the nature and content of PPI policies. The guidance is most likely to be helpful if it is used by firms in their PPI sales process as a prompt to ensure that a policy is suitable for the needs of a prospective purchaser.

3.2 However we are concerned that a truncated version of the guidance was published by the ABI on 19 October. This is a two page leaflet that gives a brief overview of PPI and some of the main things to look out for. Again this leaflet will no doubt help consumers, but only to a limited extent. We are concerned that the leaflet emphasises that the onus is on consumers to read policy information rather than on firms to ensure that consumers get the help they need to understand policy terms and conditions. As we understand that this leaflet has been published with the FSA's blessing, it is unclear why the leaflet does not give a stronger message to firms in this respect.

3.3 Whatever the quality or merits of this leaflet, one might also ask whether a two page leaflet represents a reasonable return for a year of regulatory activity by the FSA on consumer information. However the quality of printed guidance for consumers is not at the heart of the mis-selling problem. It is the behaviour of firms in the way that they sell PPI to consumers that needs to be addressed.

3.4 The FSA say as much in the minutes of their 6 April meeting with the industry trade associations. This states that the trade association proposals deal with neither wider competition issues nor the sales process itself. While this is a fairly explicit criticism of the limits of the trade association proposals, it also contains an implicit criticism of the FSA approach so far. The trade associations are unlikely to move outside of the consumer leaflet comfort zone unless directed to by more prescriptive and active leadership from the regulator.

3.5 This is not to say that there has been no other movement in the sector. We understand that individual firms have been making changes to their PPI policies to simplify terms or improve benefits. This might be in response to work by the FSA, or the OFT or simply to adverse publicity on problems with PPI. Again, any action by firms to improve sales practices and provide consumers with a better deal is welcome. But if the PPI sector as a whole is going to make a step change away from mis-selling problems, then more co-ordinated action is essential. It is unacceptable to leave individual firms to choose what changes to make and when to make them, because this will not improve PPI products for all consumers.

3.6 This seems to be reflected in the second round of thematic work, where the FSA reports seeing some improvements in an otherwise mixed picture of good and bad practices. The FSA thematic work has been going on for over a year and a mixed picture is some way from the step change in sales practices that a regulator should be able to bring about. We would hope to see the FSA seeking to pick up the pace of change from here on. *A key question here is how the FSA plans to bring this about.*

3.7 The summary of the second round report sets out a list of key outcomes the FSA want to achieve in sales practices and the actions they believe firms will need to take to achieve these. These outcomes and actions seem fairly well targeted at the sort of problems highlighted in CAB evidence but we believe the approach suffers from two broad shortcomings.

3.8 Firstly the FSA are tackling PPI mis-selling within the structure of their current ICOB rules that differentiate between *advised* and *non-advised sales* with firms required to make more onerous and wider ranging checks on product suitability *advised sales.* However *non advised* PPI sales will generally pitch PPI by asking borrowers to consider how they would repay a loan if they lost their job or became ill. The PPI product is sold to borrowers as offering peace of mind or reassurance against this risk. This all sounds rather like advice and as only one product is generally offered by lenders, this offer seems rather like a recommendation. We believe that where PPI is sold with a credit product, the distinction between types of sale in the ICOB rules is a fiction that allows firms to reduce suitability checking to little more than providing a leaflet. Couple this to a reasonably hard sell and the potential for mis-selling is clear.

3.9 It is notable that the FSA found a particular concentration of bad sales practices among firms that sell PPI as a tertiary business, such as car retailers selling hire purchase. Given the large commissions that firms are making from PPI sales one might expect them to actually do some work in ensuring product suitability. In this respect the FSA should look to the effectively of this distinction in ICOB rules.

3.10. Secondly, and more fundamentally, we are not at all sure that the actions listed by the FSA in the report summary are strong enough or place enough onus on firms to help consumers make the right choices. Here are some examples:

— Firms are urged to take *reasonable efforts* to ensure eligibility is always checked but if this is not possible customers should be provided with information. The key point is surely what these reasonable efforts should be. Given the scale of mis-selling problems we believe that the FSA need to set out clearly and comprehensively how firms must check eligibility and suitability and how this should be evidenced. Equally the *caveat* that firms can provide information where such a check is not possible seems to provide an easy escape route for firms that want to take it.

— In all PPI sales firms are urged to make customers fully aware of any parts of the policy that they may not be able to claim under. The key point here is what happens next. There is no sense of whether the FSA are telling firms not to sell policies where consumers are ineligible for particular parts of the cover or whether firms are merely required to point out the limits of cover. We have seen examples where people have been persuaded to buy PPI policies when they are unemployed on the basis that they might get a job and examples where people who are unable to work because of a pre-existing illness or disability have been sold PPI on the basis that another illness or disability might arise. Policy information can be interpreted to mislead and confuse consumers into a purchase that will not benefit them.

— Firms are required to make consumers aware of exclusion clauses and tell them where to look for more information. We are not sure how this will differ in practice from what has happened previously and the FSA report summary does little to spell this out.

— The report sets out more detailed requirements for *advised sales* which we believe should broadly apply to all sales. However, again it is not clear how this improves on what *should* have happened in the past.

3.11 The purpose of these outcomes and actions seems to be to provide additional guidance to the existing ICOB rules and high level principles that will apply specifically to sales of PPI. We would ask questions on the wording and degree of prescription contained within this. In this respect the statement by the FSA that they are considering further specific regulation on the PPI market is also a welcome recognition that the rules are not working well for this sector.

3.12 However, Citizens Advice would temper this support with three further observations.

— If the existing rules are not working well to protect consumers, then they need to be redrafted. The requirements of firms under ICOB tend to be detailed in terms of scope by fairly general and vague in terms of application. For example, the ICOB rules run to around 170 pages with 28 pages on sales and 31 pages on product disclosure alone. Yet a year of regulatory work and further guidance is needed to try to pin firms down on how these rules should be applied in sales of PPI. We believe that the problem is not necessarily with the amount or extent of regulation but with the effectiveness of the FSA's approach to regulation.

— We are concerned that the FSA analysis does not seem to be particularly reflective of the problem described above. The report summary places requirements on firms that are partly defined, open to interpretation and often accompanied by caveats. In this respect the FSA strategy is to set out a broad framework and then trust firms to do the right thing. But the evidence on PPI mis-selling suggests that firms cannot necessarily be trusted to do the right thing. Conversely, we do not believe that the FSA have fully demonstrated that it is capable of telling firms what the right thing is or ensuring that firms do it. In more general terms the FSA proposals to move to more principle based regulation brings more dread than hope.

— Finally we are concerned that more does not seem to have been done. It is nearly a year since the first round thematic review and the FSA still reports problems in the market. While this is perhaps not surprising, we would now expect to see a more prescriptive and urgent approach to tackling mis-selling problems. While this second report certainly represents progress, we are not convinced that this has moved far enough or fast enough.

4. FSA Work on Other Areas

4.1 The FSA report pays little attention to price and competition issues, although FSA are clear in stating in the report that they believe the market to be flawed. However, FSA has taken a consistent line that it is not a price authority and that price and competition issues are a matter of the OFT. This is an interesting position given findings by the OFT that the high cost of many PPI policies is due to commission payments to lenders in downstream markets. We understand that issues relating to commission are considered to be with the FSA's remit and that the FSA is working on commission bias issues in other areas.

4.2 This is a missed opportunity as the rules governing the sale of PPI are clearly capable of stimulating further competition. By way of example, the second round report list an outcome for assessing suitability in *advised sales*. This states that firms must take account, among other things, of the cost of the contract with regard to the consumer's circumstances. However we understand that this stops short of disclosure on costs relative to alternative products, particularly PPI available from other providers. One wonders how a

lender sold PPI policy can be said to be suitable for the demands and needs of a consumer when the same cover can be bought elsewhere at a substantially lower price. Lenders will know this, consumer may not. By thinking about the role of the sales process in a more expansive way the FSA might be able to address some of the competition issues.

4.3 The FSA report also says little about the product content issues; the variation in cover offered by similarly priced policies and the various exclusion clauses found in many policies. The FSA discusses these in terms of disclosure in the sales process but is unwilling to look into the content of products to see whether they provide consumers with a good deal.

4.4 The exception to this is the work carried out by the FSA on the lack or refunds in single premium policies under the Unfair Terms in Consumer Contracts Regulations 1999 (UTCC regs). This is a discrete piece of legislation and so outside the general sweep of the FSA approach. This work is most welcome.

4.5 However outside of the UTCC regs there seems to be little appetite to move the PPI industry towards better products. We cannot see an argument against such an intervention on competition grounds. On one hand there is little or no competition in the sector. On the other, the baseline approach taken by the CML on MPPI does not seem to have limited product competition or innovation while successfully ensuring that MPPI products sold by CML members perform to a considered reasonable standard. Again the opportunity to build on this work and extend it to other areas of the broad PPI market seems to have been missed.

4.6 On this point we are concerned that the wider product content questions will also become sidelined as the OFT investigation is refereed to the competition commission. Citizens Advice initially voiced concerns about PPI not just because we found many instances where these products had failed consumers but because we are seeing large increases in the number of people struggling with consumer credit debts. Citizens Advice would like to support PPI as a way that the additional and external costs of debt could be minimised though self insurance. Unfortunately it seems that the lending industry has been more concerned to treat PPI as an additional profit centre, rather than a way of dealing with over-indebtedness.

4.7 In this respect the quality and content of PPI policies is not merely a competition issue, but a responsible lending issue. We are concerned that this feature of our report *Protection Racket* has been forgotten as the regulators have followed their own concerns. We would ask the Treasury Select Committee to consider this wider issue of PPI in limiting the problems associated with debt and the role of lenders in this.

4.8 Finally we would also point out the OFT report on the outcome of their market study published on 19 October 2006. At paragraph 7.12 the OFT notes that they have not decided to pursue action on mis-selling on PPI under consumer credit licensing powers. We have heard much recently about the efforts that the OFT and the FSA have been making to work together. We would argue that persistent and systematic mis-selling of PPI policies should call in to question the fitness of the firm in question to hold a consumer credit licence. There would seem to be a clear read over here between the FSA and OFT to co-ordinate enforcement powers in this area. Therefore we surprised and concerned that the OFT has stated in this report that it is not aware of any breaches of the Consumer Credit act in respect of sales of PPI.

October 2006

Printed in the United Kingdom by The Stationery Office Limited
1/2007 351175 19585