Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

CONSUMER RESPONSIBILITY

THE FINANCIAL SERVICES CONSUMER PANEL RESPONSE TO DISCUSSION PAPER 08/5

June 2009

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Executive Summary

a) The publication of this Discussion Paper (DP) gives the Panel an opportunity to challenge and hopefully dispense once and for all with the confused debate over consumer responsibility. We think focusing on the flawed concept of 'consumer responsibility' is unhelpful in discussions about how to create an effective and efficient retail market that delivers real benefit to the consumer, the industry and to society.

b) Our primary concern relates to the underlying rationale for 'consumer responsibility' implicit in the DP, and reflected in its objectives. We believe it reflects an approach that places unrealistic expectations on consumers and too little emphasis on the industry delivering products that are fit for purpose and designed to genuinely serve consumer needs.

c) The FSA's use of the term 'consumer responsibility' implies that consumers have obligations to firms beyond their general duties in civil law. That is clearly not the case. While the DP states that the FSA does not intend to impose any responsibilities on consumers, the use of the expressions 'consumer responsibility' and 'balance of responsibilities between financial service providers, distributors and consumers' in the context of a legal discussion, implies otherwise. We note the reference at Para 2.4 that, "In considering the balance of responsibility we refer to the balance between the legal and regulatory obligations of firms on the one hand and the steps that consumers should take to protect their own interests on the other." These steps clearly cannot and should never be defined as 'responsibilities'.

d) Central reliance is placed in the DP on the general principle in s5(2)(d) of the Financial Services and Markets Act 2000 that consumers should take responsibility for their decisions. If this principle was absolute then the statutory objective of "consumer protection" would be meaningless. Consideration of whether there is adequate consumer protection should precede discussions of the principle in 5(2)(d), not the other way around.

e) We believe that the legal analysis presented by the FSA in support of its case for 'consumer responsibility' is flawed. We highlight why this is the case in our response and, in particular, in our legal commentary in Appendix 1.

f) Fundamentally, financial products are quite different from tangible consumer products. However, it seems to have been accepted in the industry that complex and potentially detrimental products can be widely promoted provided they are transparent through good disclosure. This is accompanied by an expectation that consumers can, and should, acquire the skills, knowledge and understanding required to deal with this complexity and choice. This places an

unreasonable burden on the consumer and is not an approach adopted by other industry sectors.

g) In the demanding world of retail financial services we think the FSA's focus must be on requiring the industry to pay more attention to product design. The FSA's articulation of its 'better world' talks about simple products for simple needs. This is a concept the Panel supports.

h) We also support the FSA's aim to help consumers become more informed and in particular the proposal to promote sensible actions consumers might take when engaging with financial services. While we see the focus on 'consumer responsibility' as an unnecessary distraction, we look forward to an ongoing and useful debate with the FSA on ways consumers can become more informed, more knowledgeable and more able to take better decisions.

The aims and objectives of the Discussion Paper

The DP in paragraphs. 2.17 & 2.18 states that the aim is to provide greater clarity on the FSA's approach to consumer responsibility *and* to provoke debate amongst stakeholders, including consumers about the nature of 'consumer responsibilities', sensible actions consumers could take, and the consequences of failing to do so. We have significant concerns with the FSA's stated aims.

First the DP basically asks whether more might be done to ensure that, in their own interests, consumers understand their 'responsibilities' and are capable of undertaking them. As such, this DP reflects a regulatory approach that historically, in the name of choice and competition, has largely allowed firms to supply products with any degree of complexity, provided there is disclosure (an approach that focuses primarily on regulating sales and advice processes rather than products). This approach has tried to ensure (with limited success) that products and services are transparent. But ultimately it placed the burden on the consumer to understand and choose between the often complex features, options, risks and nature of many of the product/s and services on offer.

Unlike in other consumer markets, there are no formal 'manufacturing' or 'production' standards applicable to retail financial products and the industry has been free to determine for themselves whether "products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly[1]." We believe that this regulatory approach has paid insufficient attention to issues of product design in order to ensure that firms deliver products and services that are fit for purpose and designed to genuinely serve consumer needs.

To take an example outside the financial sector, consider the car. Cars have become technically, more complex over the years but at the same time they have become safer and easier to maintain because of the attention paid to product design. Consumers are of course required to drive carefully and to maintain the vehicle in a roadworthy condition, but maintenance and safety features (such as warning lights and air assisted brakes) have been embedded in car design itself, rather than relying simply on disclosure to alert consumers to various features or risks associated with their use. We think this approach has much to commend it and we believe there is much more scope for the industry to reduce or remove the need for consumers to constantly be vigilant.

Fundamentally we believe the discussion about consumer responsibilities is a diversion from the real issue which is firms' behaviour, and product design. We continue to support efforts to alert consumers to sensible actions they can take but, despite transparency regimes and consumer capability initiatives, there will always be information asymmetries between consumers and firms and transparency initiatives (such as KFDs) and financial capability initiatives

[1] Treating Customers Fairly Consumer outcomes - Outcome 2

will always be in a state of playing catch-up with product complexity. This is evidenced by the recent proliferation of structured products as an alternative to traditional savings products. It is singularly difficult to find a clear and consistent definition and explanation not only of implications of their myriad of different features, options and risks but also of the advantages and disadvantages of these products over other savings and equity products.

We agree there is a need for the FSA to ensure the industry offers simple and straightforward options for straightforward needs, leaving complexity for those who need it (paragraph 6.22). We also believe that what consumers urgently need is access to good quality, independent advice, as we have stated in our responses to the RDR.

Second it is not clear who the intended audience is. Certainly the DP is not in a format which is likely to be read by consumers, nor has it been published in an arena likely to bring it to the notice of consumers.

Third some of the consumer 'responsibilities' described in the DP are, as the Paper acknowledges (see paragraph 3.15), in fact circumstances in which the consumer's ability to recover loss from a firm may be limited by contributory negligence or failure to mitigate loss. It is our view that whether these circumstances might constitute contributory negligence or failure to mitigate are, in each case, properly matters for the FOS (or the courts), not the FSA. We would further add that this is **not** an area we believe is appropriate for Industry Guidance.

Context of the DP – consumers and financial services

That consumers are expected to take greater overall responsibility for their long term financial security is now well documented. Government policy is designed to encourage long term saving and individual provision for their retirement. But while it is reasonable to expect consumers to make decisions about pension provision this surely does not mean that consumers are expected to have a deep understanding of the structure of individual types of retirement products.

There is little doubt that financial 'products' are unique and fundamentally different from other, tangible, products. Many financial 'products' are 'credence goods' – which means that consumers may not know whether the product has performed as expected until after a number of years have passed. Their risks and uncertain outcomes can be difficult to understand or assess in advance and the fact that they are bought infrequently makes it difficult to accumulate lessons from previous purchases.

Unlike many other consumer products, not only is their value expected to increase after purchase, but their performance post sale (ie their 'risk') is dependent on a number of factors, including the *subsequent* actions of others about whom the consumers have little knowledge, and no control. Recent events show that regulators failed to fully evaluate and understand the business models of high street banks. Consumers (and certainly the private retail consumer) are much less likely to know about, or be able to evaluate, their business models, let alone evaluate the soundness of decisions taken by pension fund or collective scheme managers, or their asset allocations, or the care taken in managing funds or processing transactions.

Consumers aware of the complexity of such products often rely on financial advisers who they believe will recommend the most appropriate products. However, this is not enough to ensure that consumers will purchase the right products that correspond to their needs. There is a need for robust regulation to ensure appropriate levels of consumer protection.

Financial Capability

The Consumer Panel has been keen to support initiatives intended to ensure that consumers are better informed about money management, debt, different types of products, and the importance of planning for the future. We have therefore supported the FSA's financial capability and literacy initiatives, the development of Money Guidance, as well as supported attempts to ensure that consumers are knowledgeable about the steps they would be well-advised to take when buying financial products and services. However these should be seen as a complement to, not a substitute for, effective financial regulation and there needs to be proper recognition of the limits of what these initiatives are likely to achieve (and we are not aware that the FSA has in fact set outcomes for the financial capability initiative).

Financial capability and literacy have their limits and can never be a substitute for well regulated retail markets that deliver fair value for money products with clearly observable characteristics that meet the genuine needs of consumers.

The statutory framework

As the DP states, consumer protection is one of the FSA's four statutory objectives. In discharging the consumer protection objective, the FSA must have regard to

(a) the differing degrees of risk involved in different kinds of investment or other transaction;

(b) the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity;

(c) the needs that consumers may have for advice and accurate information; and

(d) the general principle that consumers should take responsibility for their decisions.

The DP claims to be justified on the basis of the consumer protection objective, but in issuing it central reliance is placed the legal framework, including Section 5(2)(d) "the general principle that consumers should take responsibility for their decisions". If this principle in 5(2)(d) was absolute then the statutory objective of "consumer protection" would be meaningless. In fact the FSA does not offer blanket or no-loss protection to consumers. If a firm complies with the rules and Principles, the customer has to take responsibility for his or her decisions. That is the meaning of section 5(2)(d). Consistent with section 5(2)(d) the FSA (like previous regulators) has never operated a 'no-loss' regime. Consideration of whether there is adequate consumer protection should precede discussions of the principle in 5(2)(d), not the other way around.

The current economic crisis

We do not believe that publication of a DP on consumer responsibility would be appropriate at any time, but especially not while we are in the midst of a crisis acknowledged by the Chairman of the FSA to be the most severe global financial crisis since the Great Depression. Focussing on consumer responsibility is a distraction from the real issues which are firms' behaviour and product design.

The Retail Distribution Review

We are also concerned that its publication at the same time as the RDR may lead some sectors to conclude that there is a logical sequitur between the RDR which aims, amongst others, to raise standards of professionalism in the industry, and 'clarifying consumer responsibility' (see paragraph 2.11). There

is no quid pro quo between consumer 'responsibility' and the desperately needed raising of standards of professionalism within the industry.

Principles based regulation

Paragraph 2.11 also refers to the implementation of principles-based regulation as raising the issue of "consumer responsibility". This suggests that firms are looking for greater certainty in their dealings with consumers such that if they were to follow particular procedures (such as supplying Key Facts Documents or suitability letters) consumers will have no recourse against them. We would be concerned if this were to lead to, in effect, the re-introduction of a 'tick-box', procedures-based regulatory approach under the guise of clarifying 'consumer responsibility'.

Regimes based upon high level principles, the outcomes of which are dependent on the particular facts in each case rather than on whether specified procedures have been followed are a fact of life in other markets (e.g. the 'satisfactory quality', 'fit for purpose' and 'as described' principles under the Sale of Goods Act. And of course there is also the 'good faith' regime under the Unfair Terms in Consumer Contracts Regulations – which of course also applies to the retail financial sector). We will be holding the FSA to its declared intention to focus on outcomes, including 'Treating Customers Fairly', as outlined in this year's FSA Business Plan.

Risk based regulation

We are also concerned that implicit in the discussion over consumer responsibility are issues around responsibility for risk. As recent events indicate, all financial products carry risks, even saving accounts - traditionally promoted as the safest of all savings products. As recent events also indicate, identifying and quantifying risk is extremely problematic. We are concerned that financial literacy/education campaigns and information disclosure documents such as Key Facts Documents should not provide the justification for firms transferring responsibility for investment risk onto the consumer.

While we support more effective disclosure and documentation which is clearer and more meaningful to consumers, we do not see this as providing a plank for introducing 'consumer responsibility'. Effective disclosure should not be a hook on which to hang consumers. As EU Commissioner Kuneva said in her recent speech in Lisbon[2] "It is normal that in dynamic and innovative markets, consumers bear some of the responsibility for the larger availability of choice. This is why education, and in our case at hand, financial education is, and will remain a key part of our policies. However, education is an essential but not sufficient response to this new reality. Consumers should not be asked to bear all the possible risks attached to a transaction. Because they are often ill-prepared to assess and handle many of these risks, the

[2] "Restoring consumer trust in retail financial services", DECO Seminar on Financial Services and Consumer Interest, 27 April 2009, http://ec.europa.eu/commission_barroso/kuneva/speeches

result is markets that undermine consumer trust and produce less than optimal outcomes.”

Specific comments on Chapters in the Discussion Paper and our responses to the questions

Chapter 2: Introduction

We have already commented above on the DP objectives as set out in this chapter.

In the context of identifying 'drivers and obstructions to achieving a better world' we would add the following:-

We believe that a better world would include consumers having access to

i. high quality, independent, and accessible financial advice, and

ii. a set of straightforward and simple products with clearly observable characteristics that deliver value for money and which place the genuine needs of consumers first. We believe the industry still has a long way to go in this respect. While we welcome the FSA's shift to focus on outcomes rather than principles, until this shift has bedded down and we can witness how effective the Conduct Risk Division is at testing outcomes, we cannot be satisfied that retail products will be consumer welfare enhancing.

Chapter 3: The legal and regulatory landscape

Q1 Do respondents have any comments on this summary of the basic legal position?

Overall, we do not agree with the legal analysis given in Chapter 3. It may have been the intention of the FSA to produce a short and accessible summary of the relevant law in this area, but we believe the summary is unbalanced and potentially misleading, particularly to those audiences less familiar with the subtleties of the particular facts of these cases (which the DP acknowledges are very important to the case outcomes) and the extent to which these cases may or may not be relevant in the context of financial services. The broad statement in paragraph 3.16 that 'it will not always be appropriate to read these across to the position of the average consumer' begs the question exactly what the 'average consumer' stakeholder (or other stakeholder) is to make of the discussion of them, and how they are to respond.

Our fuller commentary on the legal analysis is provided in Appendix 1, but in summary we believe

1) Consumers have the responsibility not to break the criminal law requirements typically under the Theft Act 1968 and 1978. They can also be sued for breach of contract and misrepresentation when this causes loss to a firm with which they have a contract. This is broadly the limit of consumer responsibility.

2) It is correct to say that in some limited circumstances, various forms of carelessness and bad faith might reduce or even prevent the recovery of compensation. However, this is not a general rule and depends on the application of certain legal rules relating to contributory negligence, failure to mitigate and policyholder non-disclosure and fraudulent claims. These do not prevent the recovery in full or in part of compensation in all or even most such cases.

3) A lack of timeliness in bringing complaints could bar actions under the Limitation Act. Equally, though, a failure to take action *promptly* would in most cases have no effect at all. (Indeed, prompt action itself might still be too late under the Limitation Act.)

4) The general 'principles' of reasonable care, good faith, participation and action as outlined in the DP find no basis in English or Scottish law. Indeed, there is authority to show that in many cases compensation would not be reduced even where these principles were clearly broken by consumers.

5) The authorities cited in the DP provided little or no support for the broad principles that the DP assert exist in this area. Many were not authority for the propositions concerned or represented examples of the limited circumstances described in paragraph 2 above) where compensation might be reduced or extinguished. A number were simply authorities decided under the specific terms of the Limitation Act, a statute which does not apply to the Financial Ombudsman Service. One case, an unreported 1979 decision, is referred to without stating which country's legal system it related to. The DP appears to have relied on the discussion of this case contained in a conference paper presented in 2002. In the section in that paper prior to the discussion of this case it refers to well-known English authorities which are described as reaching the opposite conclusion.

6) We are also surprised that cases of more direct relevance to consumers in the retail financial sector have not been referred to at all, such as Chrysalis Scotland Limited v Clydesdale Bank Insurance Brokers Limited [2008] CSOH 144 (in which an argument based on the claimant's unreasonableness in not reading the Key Features Document was rejected).

Chapter 4: Consumers in the retail market

Chapter 4 focuses on the low level of financial capability in the UK, and the reason for this. Paragraph 4.2 refers to the Financial Capability Baseline Survey and to the finding that 'consumers do not take adequate steps to choose products that meet their needs...or to shop around to find a good deal', and that 'under 40s are, on average, least financially capable...'. Consumers are constantly exhorted to shop around for the best financial product, and the best adviser. This is in addition to other exhortations to shop around for every other product and service a consumer needs. The reality is however that consumers, particularly those in the under 40 group, are generally busy working and raising young families. Not only is there a

physical and mental limit to the amount of time consumers can shop around for every conceivable product or service, but, at least in the case of financial products and services, there are very real issues, as we have already explained, around the criteria on which they are to compare the myriad of (often complex) products and services available. For example, how is a consumer to select one adviser over another? A 'good deal' in terms of price may not be a good deal in terms of quality. The evidence suggests that in the absence of any objective basis on which to decide, many decisions are simply made on perceptions of trustworthiness (brand name, recommendation, gut instinct), which may or may not turn out to be misplaced.

The chapter discusses other cognitive biases that can have a negative impact on consumer decision making, referring to initiatives such as Moneymadeclear, and financial capability as helping consumers to help themselves. However, as already indicated, we believe there are limits to what these initiatives can achieve. In addition we are not convinced that cognitive biases can be easily recognised or, even if recognised, overcome by the individual decision maker concerned.

Again we suggest that the presence of these biases, together with the reality that consumers generally lack either the time or the ability (or both) to shop around effectively suggests the need for access to good quality, independent, and affordable advice. Furthermore we are not convinced that the proliferation of choice in the retail financial market has in fact made it easier for consumers to engage effectively in it. We believe greater consideration should be given by the FSA to 'architectural' solutions to consumer detriment - requiring safer and simpler financial products - where good product design seeks to ameliorate potential firm misbehaviour, inevitable informational asymmetries, and behavioural failures (by both firms and consumers). After all, as the FSA's own review of Behavioural Economics by De Meza[3] points out, 'behavioural failures' appear very resistant to conventional information-based financial education programmes.

Chapter 5: Consumer responsibility and the FSA

In paragraph 5.8 the DP refers to the fact that the FSA will take into account differing levels of consumer knowledge, experience, capability and understanding when setting regulatory requirements for firms, and that those regulatory requirements flex to reflect the capability of consumers "e.g. those with little education or mental health problems". This implies first that it is possible for the regulator and firms to accurately assess knowledge, experience, capability and understanding, and second that only those with little education or mental health problems are particularly vulnerable. We reject both of these implications.

The DP gives the example of a car purchase as illustrative of a market where consumers are more able to engage and to understand why they have chosen

[3] "Financial Capability: A Behavioural Economics Perspective" (Consumer Research 69) prepared for the FSA by David de Meza, Bernd Irlenbusch, Diane Reyniers, London School of Economics, published at www.fsa.gov.uk

a particular model. However, as the DP acknowledges, "when purchasing investment products there is unusually a far greater difference in knowledge between advisers and consumers. The requirement to provide a suitability report helps to address that gap...". We think it is easy to overlook the fact that there is another significant difference between the car purchase and the investment product purchase. Despite the FSA believing car purchasers are better able to engage and understand their choices, it is also the case that cars, unlike investment products, must comply with a myriad of product manufacturing and safety standards (in addition to the general requirements that a car must be fit for general purposes, of satisfactory quality, and match its description when sold by a retailer).

These standards have increased over the years as cars have become more complex, despite consumers becoming more experienced, more engaged and more knowledgeable. Cars are an example where the advice and information that was once provided to the consumer with the car has instead become '*embedded*' in the design of the cars themselves. Whereas once a car came with a thick manual warning the buyer to, for example, regularly check the oil, check the radiator water etc, today cars come with oil and temperature warning lights. These tell the consumer when attention is necessary instead of relying on the consumer to read, follow the manual and check, thus compensating for consumer 'behavioural failures'. (And of course buyers must first pass a test to get a licence before being allowed to drive one, and cars over three years old are subject to a compulsory MOT.)

All this is irrespective of how knowledgeable, experienced, or capable the individual car purchaser is. Be they a mechanical engineer or someone with 'little education or mental health problems', the same standards apply and this is in a market where the consequences of wrong decision making for the consumer are arguably far less than in the financial market.

We do not mean to suggest that consumers do not have any role to play in protecting their own interests. Car owners, for example, are no longer expected to regularly check the oil or water, but they will generally have no recourse if they fail to do so when the warning lights come on. In the retail financial sector we believe that much more can be done by the FSA and the industry to embed information and advice into the design of products so as to achieve beneficial consumer outcomes, rather than demanding that consumers have or acquire specific knowledge, understandings or behaviours. For example,

- we think that banks (and building societies) should include the current interest rate on all bank statements, as is the case of Northern Ireland.

- we think that banks (and building societies) should be required to tell consumers that a better rate of interest is available on a similar product.

- we think that consumers should be informed of penalty free exit dates for with profits polices.

- we think that cash machines should warn the consumer they are about to go overdrawn before the money is withdrawn and give the consumer the option to cancel the transaction.

- Good examples of embedded 'advice' include the new Personal Accounts whereby consumers will be automatically enrolled unless they opt out, or the Stakeholder Child Trust Funds ('CTF'). The stakeholder version of CTF is the default option - so if parents do not choose a fund to invest for their newborn child (and every child in the UK born after September 2002 has a CTF) then the Government puts their money into a Stakeholder CTF. The rules set by the Government for Stakeholder CTFs dictate that the fund must be life-styled and moved to less risky assets as child approaches 18. In the US we understand the 'target date retirement fund' automatically adjusts the asset allocation and corresponding risk return profile as the consumer ages.

We acknowledge that there is also a need to improve the quality of the discussion between the provider, any intermediary and the consumer. This needs straightforward 'safe' products with known characteristics and a common language. We believe, as paragraph 6.22 of the DP suggests, that there is a very strong case for simplification and offering simpler options for simpler needs, saving complexity for those who need it.

Q2 Do respondents believe that the current balance of responsibilities, as defined by the common law and FSA regulation, is appropriate?

If by the question the FSA is asking whether the FSA is providing an appropriate degree of consumer protection then we would answer that we have broadly supported the direction of the FSA's work to date. However, we think the FSA needs to broaden its approach going forward. We believe that there will always be information asymmetries in the retail market and that behavioural failures on the part of consumers, and firms, will always be present. We also believe that despite the RDR it is likely there will always be the potential for skewed incentives to lead to consumer detriment. These reasons, together with the slow progress many firms have made in implementing their current obligations suggests that the FSA needs to be more aggressive in its approach, and in this regard we welcome the commitment from the FSA that intends to do so.

Against this background we believe that the FSA should consider taking more action to protect consumers. This will include making more rules. We also think the FSA needs to consider how to identify product risk more effectively and eliminate toxic products from the market. The Panel welcomes the establishment of the Conduct Risk Division within the FSA as we think this will enable the FSA to focus on identifying risks to consumers from retail products, separate from other internal risk identification functions. We anticipate this Division will feed into the ARROW process and supervisory work, enabling the FSA to require firms to take action to reduce the risk of consumer detriment from inappropriately designed products. We think this would be particularly

useful at a time when there is a risk that market conditions may result in the FSA's attention being concentrated elsewhere.

Q3 Is there more that FSA can do to make clear how we differentiate our expectations on firms dealing with consumers with different levels of capability?

We do not believe that client differentiation should be based upon levels of financial capability as we think the issue is much more complex. Not only are levels of financial capability difficult to assess but as the FSA's own baseline survey illustrates, even consumers with high levels of education may not be as capable as anticipated. There are also particular dangers in allowing the use of consumer self-assessment to form the basis of any differentiation.

While we have been very supportive of the financial literacy and capability initiatives led by the FSA we would recommend extreme caution in making any such assumptions about outcomes and impacts that are not based on evidence. It may be that the outcomes of these initiatives will be more modest than anticipated, and we draw your attention to the evidence of outcomes from other jurisdictions, some of which is referred to in the FSA Consumer Research paper[4].

Chapter 6: A 'better' world and actions for FSA, firms and consumers

The chapter articulates what 'a better world' might look like. The Consumer Panel also has views about what it would like to see in 'a better world'. These include the following:-

- A better world reflects three key principles – that firms provide fair, value for money products and services with clearly observable characteristics that meet the genuine needs of consumers; that firms comply with rules; and, that FSA takes effective action against those firms that do not

- Characteristics of firms in the better world include: that TCF is embedded; firms are well run with sustainable business models; products are designed to meet genuine consumer needs

A world in which, for example:-

- Consumers can make informed choices about the performance of individual companies, with more disclosure about compliance and enforcement issues, the accuracy or otherwise of their financial promotions, and complaints to the Financial Ombudsman Service. If this requires appropriate amendments to FSMA, then we would support them.

- Consumers can make informed choices with key documents that are concise and in plain language, rather than the language of the industry.

[4] ibid

- That the FSA is fleet of foot in penalising poor performance on regulatory issues. Where firms do comply there could be a regulatory dividend. In the better world the FSA's enhanced supervisory process and increased enforcement measures deliver demonstrably better results for consumers.

Q4 Do respondents have any comments on the suggestions above, or further suggestions for actions that the FSA, firms and others might take to help consumers to better understand their role?

This begs the question 'what is the consumers' role?' As already indicated above, we do not agree with the consumers' role as set out in the DP, and for the reasons we have already explained we think the focus on helping consumers to better understand that role is misplaced.

We believe that consumers have a general obligation to act honestly and not to breach their contracts. We believe consumers generally understand these obligations though they may not be aware of what this might mean in individual situations. For this reason we would support the wider dissemination of FOS case studies, in a format with which the consumer can engage.

More contentious however is the role of the firm, and we suspect there is still a significant mismatch between consumer expectations of the role of the firm, and the firms' understanding of its role. Consumer confidence is dependent on trust. Consumers want to be able to trust firms to deliver the elements of the better world identified above. We believe the industry still faces a considerable challenge in meeting these, perfectly reasonable, expectations and this is where the FSA needs to concentrate its energies.

Annex 1 of the DP: Sensible actions for consumers

Q5 Do respondents have any comments or suggestions on the list of sensible actions for consumers in Annex 1?

The Consumer Panel has been engaged with the FSA and the Practitioner Panel in this debate since 2004. Whilst considerable agreement could be found on actions which consumers might take, the Consumer Panel felt it inappropriate to describe these as responsibilities. It is against this background that the Consumer Panel offers its comments on the DP.

We believe that a number of these sensible actions fail to acknowledge the reality for many consumers, fail to fully incorporate the insights from behavioural economics discussed in Chapter 4, and place too high a burden on the consumer. But even if consumers were to carry out the actions referred to in Annex 1, the FSA continues to find poor behaviour on the part of firms which would seriously impact on the ability of consumers to protect themselves. In pursuing the Retail Distribution Review, the FSA is acknowledging that the retail investment market is not working efficiently and effectively. With this in mind we reiterate that the emphasis should be on

raising standards of behaviour in the marketplace and quality of products rather than on misplaced notions of 'consumer responsibilities'.

Moreover, the FSA is expecting consumers to understand products that quite often the industry does not understand. The 'herd' mentality; the fashion for particular products; not to mention the incentive to sell due to commission; means that advisers can sell products without fully understanding how the product is structured and how it will perform. And to take a non-retail example, the financial crisis has highlighted that the industry and the regulators failed to understand the risks associated with derivatives and securitised credit.

That said, we do acknowledge that consumers do need to be more empowered to look out for their own interests and to that end we encourage the FSA to communicate sensible actions which consumers might take. However, the list of sensible actions as drawn up by the FSA only serves to highlight further the extent to which firms' behaviour lies at the root of the problem. We can point to almost any one of these actions and highlight the FSA's own work to illustrate that firms are not meeting the currently required standards.

For example, (the bold type refers to the FSA's 'sensible actions', and below that are our comments on each)

Pre-sale

Read and make efforts to understand advertisements and other promotional material before acting upon it

FSA rules require that all financial promotions should be 'clear, fair and not misleading'. The FSA continues to find non-compliance in this area[5]. For example the FSA recently looked at internet promotions and found that while standards were improving there are still a quarter of firms' websites which are difficult for consumers to navigate and fail to signpost key information. A review of branch and instore promotions also showed that while standards were improving, firms could still do more to highlight risks; ensure that information is balanced; is suitable for the target audience and is clearly laid out. The review also found that standards of compliance were lower for investments than other products, when arguably these are less well understood by consumers and therefore in need of higher standards of compliance.

Seek assistance/advice where appropriate

Consumers cannot be confident that they are receiving suitable advice. The FSA recently reviewed the quality of advice given to customers to switch into a personal pension or self-invested personal pension (SIPP). Unsuitable advice was found in 16% of the cases reviewed, and in a quarter of firms, a

[5] www.fsa.gov.uk/pages/doing/regulated/promo

third or more of the cases reviewed were assessed as unsuitable. The FSA found evidence that advisers were recommending switches without good reason; and, recommendations did not match the customer's attitude to risk and personal circumstances. We would repeat that if the FSA was confident that the current marketplace is in fact delivering suitable advice, there would be no need for a Retail Distribution Review.

Check the authorised status of the adviser firm on the FSA website

The FSA website is not particularly user-friendly or navigable to consumers. Consumers ought to be able to take for granted that a firm that states that it is authorised by the FSA actually is, without needing to double check (in the same way that consumers are not expected to have to double check that e.g. their dentists, lawyers and doctors are in fact registered).

The FSA register contains a considerable amount of information, but can be difficult to navigate and almost impossible for consumers to find out all the information they need about a particular firm. To give just one example, unless or until enforcement or other formal regulatory action has been completed, no 'warning' will appear on the register.

Help adviser understand needs where applicable and:

- answer questions factually and fully to the best of their knowledge;
- help diagnosis of their appetite and capacity for risk;
- shop around for advice; and
– read the Suitability Report

In order to encourage customers to engage in this way, consumers will need to be confident that the adviser is offering objective advice free from commission and product bias. The outcomes of the Retail Distribution Review will hopefully contribute to a world where consumers engage more openly and in an atmosphere of trust.

Suitability letters will however need to be fit for purpose. When the FSA looked at quality of advice, it found that the suitability letter, required significant improvement in over half of firms. Suitability letters issued to customers often fail to provide the customer with a tailored, clear and concise record.

Read all documents with the keyfacts logo and other regulator required material and:
- point out any errors in the information provided;
- ask questions if you don't understand

Key Facts documents (KFDs) should clearly and concisely explain the key information the consumer needs to know when buying a product. Too often KFDs are too long, poorly laid out and not clearly written. In 2007, the FSA found that only 15% of KFDs were effective. 35% were ineffective and a half, while compliant with the FSA's rules, were badly written.

With such poor standards there can be no guarantee that even if consumers did read the KFDs they could understand what they are buying.

Even if KFDs were clear and concise, making reading documents a 'responsibility' which can potentially dictate the outcome of a subsequent complaint is not acceptable.

When a consumer uses an adviser we believe the consumer is perfectly entitled to rely on the adviser's advice as was held in Chrysalis Scotland Limited v Clydesdale Bank Insurance Brokers Limited [2008] CSOH 144, and should not, for example, be criticised for failing to read the key features document or other material. As Lord Glennie stated, 'I do not think it is reasonable to criticise an investor for failing to second guess the advice given to him by the financial advisor from the materials which have been left with him'[6].

Ensure understanding of the ongoing services available from adviser and provider – including any limitations to those services

Where the sale is advised, the consumer may have every expectation that the firm will be proactive in maintaining communication with them. The work undertaken by the FSA on SIPPS illustrates that advisers failed to explain the need for, or put in place, ongoing reviews when necessary.

Pay money on time

Consumers understand they need to pay on time and know what to expect if they do not.

<u>Create contract</u>

Tell firms of changes to needs or personal circumstances before contract is made

Consumers should expect to alert firms to any change in circumstances – but only if the consumer is made aware that that sort of change is potentially relevant in the first place.

Check documents received and:
- point out any errors;
- ask questions if you don't understand

Consumers may not in fact realise that they don't understand the documentation. As Sir Callum McCarthy said, 'Many financial products are complex; they are bought infrequently; they have a long duration, and at the time between making a decision and finding out whether it has been a good decision is therefore protracted; and that decision involves an understanding

[6] At para 58

both of the reward and the risks involved – neither of which may be easy to assess. There is often a massive imbalance between the knowledge of the vendor and that of the purchaser of the financial service – the information asymmetry problem."[7] A previous Chairman of the Panel put the issue in starker terms, 'But reading the documents or asking questions offer no better guarantee of understanding. Some people will read the document and understand, some will read and not understand, and some will read and think they understand when they don't. Some will understand when they read it, but some months later when another decision needs to be made, they may not understand it again.'

- where allowed, cancel within the specified cancellation period if not happy with the recommendation or own decision

Behavioural Economics suggests that 'confirmation bias'[8] can prevent us from rationally considering whether our decision might have been wrong.

Post-sale and regular review/ renewal

Pay premiums

Review financial needs and circumstances on a regular basis

Monitor performance/read periodic statements and:
- consider altering asset mix;
- ask questions if you don't understand;
- seek advice where appropriate

It is suggested that consumers should take decisions regarding their asset mix. We believe that this is too much to expect of most consumers, without at least recourse to suitable advice. What constitutes a suitable asset mix will alter over time, depending on the consumer's own changes in circumstances and market conditions. Previous FSA work looking at the quality of advice shows that advice firms often promised their clients regular reviews which did not subsequently materialise. In these circumstances consumers might have misplaced confidence in the firm and expect that that their asset mix is under regular review but in fact it is not.

Tell firm of changes to circumstances or needs affecting the policy

Pay money on time

Protect personal information

[7] http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/0210_cm.shtml

[8] Confirmation bias is described as the tendency to want to continue to believe what we expect to believe and to avoid, downplay or reject new information that contradicts our previous beliefs. See e.g. Ripken, S. K. The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation, SSRN, http://ssrn.com/paper=936528

Common sense applies here and we would expect that consumers are indeed protective of their personal information.

Break Points

Consider any reminder or notice received and act where appropriate

Ask questions if don't understand anything

As with KFDs, in order to fulfil this action, the customer needs to receive clear information. When the FSA reviewed the quality of annuity provider literature and alleged delays in the transfer of annuity funds, a number of firms failed to provide clear information to pensioners approaching retirement age to enable them to make informed decisions about their retirement options, in particular clearly informing them about the option to take the open market option when choosing an annuity.

Maturity/Claim

Study options:
- ask questions if you don't understand;
- seek advice where appropriate

Supply information requested

Reply accurately and promptly

Again, in order for consumers to be able to fulfil these actions, they need to receive clear information from firms so that they understand what they are required to do and by when. When looking at annuity providers the FSA found that in over 60% of the annuity transfers reviewed there were delays in processing them. In some cases this was due to customers being confused by the actions they needed to take to complete the transfers, but the delays were often caused by the pension firms and the retail intermediaries. Poor quality communication from insurers makes it very difficult for consumers to know what actions they need to take in order to maximise their retirement income.

Problems

Complain promptly when problems occur

Too often we see examples of industry wide poor practice where clearly firms are taking the chance that few customers will complain. Sales of payment protection insurance (PPI) and unfair applications of bank charges are two clear current examples. If consumers were more likely to complain firms may cease taking that risk, however we believe that the FSA can do more to ensure that where such practices are identified, action is taken quickly and firmly so that collective consumer detriment is minimised.

The Financial Ombudsman Service handled a record 794,648 initial enquiries and complaints in 2007/08, an annual increase of 27%. The Panel views such significant and rising numbers as a potential indication of a problem the industry needs to address (and even though most enquiries did not proceed to the next stage).

Chapter 7: Conclusions and next steps

As has been mentioned, the Consumer Panel has been involved in debate with the FSA on what might constitute consumer responsibility going back to 2004. That we are now in 2009 only in the position of debating a DP shows how difficult this area is.

Whilst we maintain that the problems lie fundamentally with firms, we still think there is value in promoting sensible consumer actions. However, any messages for consumers have to be simple and clear and we believe that the actions as drafted are too long, too many and too ambitious. We are conscious that we have been robustly critical of the DP in a number of places, but we do agree that there are sensible actions consumers can take to better protect themselves, and we are happy to work with the FSA in support of actions to help consumers be better informed and capable in the 'better world'. We would encourage the FSA when looking at next steps to look at these, not from the perspective of legal obligations but against the background of what is known about firms' behaviour. We believe that consumers can only be helped to help themselves if they are made more aware about firm's responsibilities - and the extent to which they currently meet them.

Appendix 1

As already indicated, the Panel believes that the legal analysis presented by the FSA in support of its case for 'consumer responsibility' is flawed. We believe the analysis is incorrect in a number of material respects and we don't accept the existence of the principles as being of general application or their description as being technically accurate. We also have particular concerns over the cases chosen as examples of the application of these principles. Below we set out our concerns with the cases chosen, followed by examples of other cases that we believe could have been used in order to set out the position differently.

1. The principle of reasonableness

In Marplace, the case used to justify a principle of reasonableness, the case did not involve a consumer but a corporate client. The Court concluded that there was no obligation on the part of a solicitor to give advice where none was expected or received. It has nothing to do with any principle of consumer reasonableness. In fact, the judge's findings at paragraphs 475-6 on the claimant's responsibility were entirely in the claimant's favour:

> "Contributory Negligence
> If this issue had arisen I would have accepted the Claimant's argument that Chaffe Street had not shown any fault on the part of the Claimant.
>
> Mitigation
> There is nothing in the point on the Contract (Rights of Third Parties) Act 1999, and there would have been much force in the Claimant's point on speculative litigation."

2. Good faith

McLellan v. Fletcher is a partly reported judgement from 22 years ago given by a Family Division Judge. It does not relate to good faith but is a rare example of contributory negligence. (In fact, the case is arguably wrongly decided in any event because the defendant solicitor should have succeeded on causation). The judgement sets out all the things the deceased did:

> "He had been clearly informed by the company of the need to give instructions or pay the first premium if the cover was to commence. There were no grounds whatever for his belief that he had paid the first premium, for the documents and figures before him were quite clear and required no lawyer's advice or construction or interpretation. He had been told by the defendant that he must pay the premium. On August 16 he had assured the defendant that he had paid. He failed to respond to the defendant's chaser letter (and in this I accept the defendant's evidence) within a reasonable time."

The other feature of this case is that this concerned the liability of the solicitor not a financial adviser. The solicitor has a duty to advise generally on the

transaction but is not expected to process the financial services aspect of it. So, judging his negligence against the claimant's raises the standard expected of the claimant as compared with the consumer customer of a regulated firm.

3. Participation

Reid v. McCleave, cited as support for a principle of participation is an unreported 1979 decision. The DP does not even identify the court that decided this case or even the legal system concerned. This case can only be found by normal search methods in a paper given by John Murdoch and Diana Kincaid at a conference in New Zealand in 2002, entitled "Negligent valuations – passing the buck". A much clearer idea of what was intended can be found from a quotation from the relevant section of the paper. The authors comment:

> "The idea that a client has a duty to second-guess an expert adviser, always an unattractive proposition, is at its weakest in cases where the recipient of that advice is a layman. In a number of actions brought by house purchasers against surveyors and valuers, defendants have raised the defence of contributory negligence, but with conspicuous lack of success. The following extract from the judgment of from Park J in Yianni v Edwin Evans & Sons [1982] 2 QB 438 is typical:
>
> "[Counsel] says that the plaintiffs should be held guilty of contributory negligence, because they failed to have an independent survey; made no inquiries with the object of discovering what had been done to the house before they decided to buy it; also failed to read the literature provided by the building society, and generally took no steps to discover the true condition of the house. It is true that the plaintiffs failed in all these respects, but that failure was due to the fact that they relied on the defendants to make a competent valuation of the house. I have been given no reason why they were unwise to do so."
>
> What might be regarded as a rather paternalistic view of lay clients (also to be seen in Davies v Parry [1988] 1 EGLR 147 and Whalley v Roberts & Roberts [1990] 1 EGLR 164) reached its apogee in Allen v Ellis [1990] 1 EGLR 170, where the plaintiff, a year after purchasing a house on the basis of a report which he had commissioned from the defendant surveyors, fell through the asbestos roof of the garage in the course of investigating a leak. In holding that the defendants were liable for their client's injuries, on the ground that their report had given him a misleading impression as to the condition of the roof, Garland J rejected the defendants' argument that, since asbestos roofs are notoriously lacking in strength, anyone who steps out on to one without support is guilty of contributory negligence. As the judge noted:
>
> "The plaintiff is a layman. He knows nothing, or virtually nothing, about building or property ... I find it impossible to hold him contributorily negligent. If he were unaware of the risk - and I accept his evidence

> that he was unaware of the risk - then it cannot be said that he was negligent in failing to comprehend it."
>
> Such protective attitudes, though prevalent, are not universal, and judges have occasionally made it clear that paying a professional adviser does not entitle a layman to lay aside common sense altogether. In Reid v McCleave (16 October, 1979, unreported), for example, a motorist relied on an assurance from his brokers that he was insured to drive, notwithstanding that the only cover note which they had issued had clearly expired. The motorist was held 25 per cent responsible for his resulting losses, since he ought reasonably to have realised the possibility that the brokers had made a mistake."

The only other reference to this case appears to be a brief reference in the 3rd (1991) edition of Jackson & Powell, Professional Negligence. It does not appear in any subsequent edition (including editions published after the implementation of FSMA).

Paying an adviser "does not entitle a layman to lay aside commonsense altogether". However, there is a big stretch between this and a general principle of "participation" which simply does not exist in English law. It is not possible to examine the full facts of the case because the judgement is clearly as unavailable. At best, it is authority for the fact that with motor insurance, an area where consumers tend to be more aware because of the legal and safety requirements, a degree of vigilance on the part of the consumer can be expected.

4. Disclosure

Mundi v Lincoln Assurance is a pretty standard case of policyholder non-disclosure. It does not stand for a general duty of disclosure since it relates solely to a claim on an insurance policy to which specific legal rules apply. It merely stands for the well-known propositions about the duty of an assured to disclose material facts within his knowledge to an assurer when applying for a policy or, in this case, the reinstatement of one.

5. Action

The reference to Shore v. Sedgwick as supporting some principle of "action" is puzzling. This is a case where a businessman would have succeeded in his claim for negligent advice with respect to income drawdown but for the provisions of the Limitation Act 1980. The Court of Appeal only considered the application of the Limitation Act. Beatson J would have found for the claimant but for that Act. He dismissed a contributory negligence argument. He said at paras 192-194 in the judgement cited in the DP:

> "The defence of contributory negligence was raised in paragraph 44 of the defendant's re-amended amended defence served on 20 June 2007. The defendant relies on the claimant voluntarily leaving his employment on 11 May 1997 and failing to seek a consultancy as he

indicated he was planning to do, his withdrawing the maximum permissible income from June 1997 onwards, and continuing to do so, even after the triennial review in June 2000. It also relies on him transferring the investment of the fund from the Security Plus Fund to the Mixed and Global Funds on 27 May 1998 which increased his exposure to the risks of the markets.

In the light of my findings that Mr. Shore, although informed of the operation of the GAD limits, was neither warned of the risks of taking the maximum permitted income nor of Sedgwick's recommendation that no more than 75% of the limit be taken, I reject the submission that his continuing to draw the maximum income before he became aware of the position constituted contributory negligence. By that time he was locked into the arrangement and needed to take the maximum income which, after the triennial review, was no longer sufficient to meet his requirements. As far as his investment in the Mixed and Global Funds is concerned, in the light of the absence of adequate advice and a warning about the risks of taking maximum income, I do not consider this amounted to contributory negligence.

With regard to the secondary claim, the defendant's submission is that Mr. Shore knew that annuity rates could fall and believed that they would do so, and took the risk. In this context too they rely on what is said in the personal financial report and in Mr. Ormond's notes. Again, given the absence of adequate advice as to the risks of taking the maximum permitted income and information as to Sedgwick's recommendation that no more than 75% of the maximum should be taken, I do not consider that Mr. Shore's conduct in deciding not to purchase an annuity, in the circumstances of the advice he received, constituted contributory negligence. On Mr. Ormond's evidence the issue of an annuity was not an important factor in relation to the matters discussed at the meeting on 9 May. He said that at the time he considered that an annuity was not appropriate for Mr. Shore because it would lock him in to particular benefits and deprive him of flexibility. He had not revisited the issue in the light of Mr. Shore's greater need for income and changed circumstances and did not put the question of taking an annuity adequately to Mr. Shore."

6. Consumers should take reasonable steps to mitigate losses

Jamal v Moolla Dawood is a case decided by the Privy Council on appeal from the Chief Court of Lower Burma on the meaning of the Indian Contracts Act. The defendant failed in his argument that the Court should take into account a gain made on the shares subsequent to the date of the breach. The case in any event did not involve consumers as far as one can tell. The case is not about a failure to mitigate. The Privy Council does provide a short account of the law in this area at pages 179-180:

> "It is undoubted law that a plaintiff who sues for damages owes the duty of taking all reasonable steps to mitigate the loss consequent

> upon the breach and cannot claim as damages any sum which is due to his own neglect. But the loss to be ascertained is the loss at the date of the breach. If at that date the plaintiff could do something or did something which mitigated the damage, the defendant is entitled to the benefit of it. … But the fact that by reason of the loss of the contract which the defendant has failed to perform the plaintiff retains the benefit of another contract which is of value to him does not entitle the defendant to the benefit of the latter contract."

It found for the Claimant on that basis. The case is authority for the opposite proposition to the one presented in the DP. It demonstrates that if the seller retains the shares after the breach and makes more money from reselling them, the profit does not need to be deducted from his damages.

7. Examples of other cases that could have been used to set out the position differently:

Chrysalis Scotland Limited v Clydesdale Bank Insurance Brokers Limited 14 October 2008 [2008] CSOH 144 provides a clear recent statement of the law on contributory negligence and failure to mitigate as applied to an experienced businessman seeking personal financial advice. This involved the failure to explain a market value reduction in a with-profit bond to an experienced businessman. In rejecting an argument based on the claimant's unreasonableness in not reading the key features document and other materials, Lord Glennie said at para. 58:

> "I do not accept this. I have found, of course, that Mr Robinson was provided with the KFD on 11 July 2000. He and Mrs Robinson were, I think, left a copy of the Report and Recommendations at the meeting of 28 July 2000. They were sent the other CMI material on 18 August 2000 (7/37). These documents do of course provide the material which would enable the investor to form a view and, if necessary, to withdraw from the proposed investment up to the end of the cooling off period. It may be said that Mr Robinson should have read the KFD after the meeting of 11 July and raised questions with Mr Lind. But this seems to me to put too heavy a burden on an investor. The financial advisor is the person who explains to the investor what the advantages and disadvantages are of any particular investment. To hold a financial advisor liable for failing to give proper advice, but then to reduce the damages flowing from that because the investor, having the written materials, has not carried out his own research, would undermine the duties owed by the financial advisor. I do not think it is reasonable to criticise an investor for failing to second guess the advice given to him by the financial advisor from the materials which have been left with him. The main purpose of leaving the materials with the investor, or sending them to him, is to enable the investor to reflect upon what he has been told and, if what he has been told has left any nagging doubt in his mind, to look further into that issue in the documents with which he has been provided. The starting point must be what the investor has

> been told; and that will inform any consideration which he is minded to give to the written material sent to or left with him." (Emphasis added.)

Even with a sophisticated businessman, Lord Glennie declined to find contributory negligence in a failure to read the key features document and other material.

Park J in *Yianni v Edwin Evans & Sons [1982] 2 QB 438* expresses the point well.

> "[Counsel] says that the plaintiffs should be held guilty of contributory negligence, because they failed to have an independent survey; made no inquiries with the object of discovering what had been done to the house before they decided to buy it; also failed to read the literature provided by the building society, and generally took no steps to discover the true condition of the house. It is true that the plaintiffs failed in all these respects, but that failure was due to the fact that they relied on the defendants to make a competent valuation of the house. I have been given no reason why they were unwise to do so."

The Court of Appeal in *Vesta v. Butcher [1989] AC 852* and the decision of the House of Lords in Standard Chartered Bank v. Pakistan National Shipping Corporation [2003] 1 AC 959 both indicate the technical limits of contributory negligence.

On policyholder non-disclosure, the Court of Session in *Cuthbertson v. Friends Provident Life Office [2006] ScotCS CSOH 74 (10 May 2006)* provides useful information (at least in relation to life insurance contracts under Scots law) which again qualifies the view taken in the paper on a duty of disclosure by making it clear that the duty only extends to facts that the customer has reason to believe will be material and to know.

Manifest Shipping Co Ltd v. Uni-Polaris Insurance Co Ltd (The Star Sea) [2003] 1 AC 469 at pp. 502, 512-3 also demonstrates the limits of the obligation of disclosure in insurance contracts and shows that exaggeration is not fraudulent non-disclosure.

The reality is that there is very sparse case law in this area. This means that such submissions are rarely presented and are often dismissed on their facts without reference to wider principles (ie *Shore v. Sedgwick*).