

FS 11/3

Financial Services Authority

Product intervention

Feedback on DP11/1

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This Feedback Statement reports on the main issues arising from Discussion Paper 11/1 (*Product intervention*).

Please address any comments or enquiries to:

Jason Pope
Financial Services Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Telephone: 020 7066 2075

Email: dp11_01@fsa.gov.uk

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Glossary

ABI	Association of British Insurers
Consumer detriment	Consumer loss due to breaches of our rules or the general law.
Distribution strategy	A firm's decisions on how a product is to be sold and by whom: e.g. with or without advice; by independent financial advisers or by tied agents.
ECJ	European Court of Justice
EU	European Union
Financial Conduct Authority (FCA)	The government announced in its consultation on financial services regulatory reform that it will create a new body, the Financial Conduct Authority, with a primary statutory responsibility to promote confidence in financial services and markets.
FSCS	Financial Services Compensation Scheme
FSMA	The Financial Services and Markets Act 2000 (as amended)
IMD2	The revised Insurance Mediation Directive
MiFID2	The review of the Markets in Financial Instruments Directive
Money Advice Service	A free, independent service set up by government and funded by a levy on the financial services industry that aims to help people manage their money better. The Money Advice Service gives clear, unbiased money advice to help people make informed choices.

Mortgage Market Review (MMR)	Our review that sets out the case for regulatory reform of the mortgage market, aiming to ensure a sustainable market for all participants that works better for consumers. It was launched in DP09/03 Mortgage Market Review.
the ombudsman service	Financial Ombudsman Service
OFT	Office of Fair Trading
PPI	Payment Protection Insurance
PRIPs	Packaged Retail Investment Products
Product	Financial contracts for retail customers – such as bank accounts, general insurance, mortgages, investments and pensions.
Product governance	Systems and controls in relation to product design, product management and distribution strategies.
Product intervention	Regulatory interventions focused on products, including greater supervisory focus earlier in the value chain and of ongoing product governance, rules targeting product features, rules limiting sales of products and setting down specific conditions of sale.
Product value chain/ life cycle	The different stages in the life of the product, from design, its sale to customers and after-sale monitoring and services.
Prudential Regulation Authority	The government announced in its consultation on financial services regulatory reform that it will transfer operational responsibility for prudential regulation from the FSA to a new subsidiary of the Bank of England. This new Prudential Regulation Authority will be responsible for prudential regulation of all deposit-taking institutions, insurers and investment banks.
Responsibilities of providers and distributors for the fair treatment of customers (RPPD)	Handbook guidance on the regulatory responsibilities of providers and distributors for the fair treatment of customers.
Retail Conduct Risk Outlook (RCRO)	The RCRO is a key component in the FSA's consumer protection strategy to identify risks earlier, proactively intervene earlier in the product chain and prevent consumer detriment. The report's analysis of current and upcoming risks informs how the FSA will set its priorities and deploy its resources.

Retail Distribution Review (RDR)	Our review, launched in 2006, of the distribution of retail investments. See our web pages for further information: www.fsa.gov.uk/pages/About/What/rdr/index.shtml
Stress testing	Scenario modelling or other forms of analysis used to identify how the product might function under a range of market conditions and how the customer could be affected.
Target market	The group of consumers for whom the product has been developed.
TCF	Treating Customers Fairly
UCITS	Undertakings for Collective Investment in Transferable Securities

1

Overview

- 1.1 In January this year we published a Discussion Paper (DP) that explained our proposed new approach to the regulation of retail financial services.¹ The DP is part of a wider debate about the future regulatory philosophy, particularly as the powers and scope of the new financial regulator, the Financial Conduct Authority (FCA), are being discussed.
- 1.2 We noted that, in the past, the FSA has worked primarily on the basis that effective consumer protection would be achieved provided sales processes were fair and product disclosure was transparent. Experience has shown, however, that this has not been enough to guard against a series of product failures leading to significant consumer detriment. So we have considered what more we need to do to improve customer outcomes.
- 1.3 Our starting point is that the Government has indicated that the FCA should have a lower risk tolerance than that of the FSA and should seek to minimise consumer detriment by intervening more intensively at all points of the value chain.
- 1.4 In the DP, we argued that we need to adopt a new regulatory approach that involves earlier regulatory intervention, looking at product governance processes and engaging with firms to ensure that products truly do serve the needs of the customers to whom they are marketed. This means that, as well as the existing focus on the latter parts of the value chain (including point-of-sale standards such as financial promotions, disclosure documentation and advice), we should also be considering product governance (i.e. the way that products are designed, brought to the market and managed over their lifetime).
- 1.5 There are a number of risks in moving to this approach, including the possibility of unintended consequences, disproportionate costs compared to the benefits achieved and regulatory failure. So we asked readers for their opinions on the approach.

¹ DP11/01: *Product intervention* (January 2011)

- 1.6 We received 84 responses to the DP – from consumer organisations, individual consumers, industry associations and individual firms. We also ran a series of six roundtable events for trade bodies, firms, consumer organisations and academics to debate issues arising from the DP. These were very useful sessions to talk through particular issues in more detail. We would like to thank all attendees of these sessions and those who provided formal responses to the DP. A full list of non-confidential respondents is set out in Annex 1 and copies of individual responses are available on request.
- 1.7 We will shortly be publishing a paper that offers more detail of the FCA's approach to regulation. In late June 2011 we will be running a conference to encourage further discussion on the FCA and what stakeholders expect from it.

Purpose and structure of this paper

- 1.8 In this Feedback Statement we:
- summarise the feedback we received to the questions posed in the DP and our responses to this feedback;
 - consider the place of product intervention in relation to other relevant projects (such as the Treasury's work on simple products, development of the FCA and work underway at EU level on product governance responsibilities); and
 - discuss our next steps and expectations for the future.

Summary of key themes and feedback

Product intervention

- 1.9 Our DP signalled a new direction for retail financial services regulation, moving away from an approach largely focused on the point-of-sale, to one that actively regulates all aspects of the product life cycle, including the design, development and management of products. This stimulated a variety of responses from a range of stakeholders.
- 1.10 Broadly, consumer organisations were supportive, arguing that an increased focus on the early stages of the product life cycle is an efficient use of regulatory resources and is desirable for consumer protection.
- 1.11 Industry reactions were more diverse. Some respondents see the point-of-sale as the part of the product life cycle where consumer detriment originates, arguing that almost all products are suitable for at least some consumers and what matters most is how they are sold. Respondents cited the Retail Distribution Review (RDR) and Mortgage Market

Review (MMR) as key initiatives that will help raise standards at the point-of-sale and will mean product intervention is unnecessary. Others, however, welcomed a product intervention approach and supported the idea of high-level, outcomes-focused requirements to give clarity to regulatory expectations for product governance.

- 1.12** We remain of the view that a product intervention approach is an essential means of achieving an appropriate level of consumer protection, as is confirmed in the Treasury's consultation on the structure and powers of the FCA.² The detailed feedback we have received has helped us refine our view of how it should be implemented in practice. We recognise that further thinking and analysis will be required as we take forward our approach in specific areas.
- 1.13** We agree that the point-of-sale is a critical part of the value chain and is a key determining factor in whether consumer detriment will arise. However, we consider that product design and decisions made by product designers about how – and to whom – products will be distributed play a significant role in determining consumer outcomes.
- 1.14** Our starting point is not a desire to dictate product structures to the market, rather to put right problems where competition and the regulatory approach outlined above have been ineffective in delivering on genuine customer needs. We are looking primarily at the product governance processes employed by firms, whether competition is working effectively for consumers, and whether firms are exploiting consumer behaviour. Increasing our focus on these parts of the value chain is necessary for consumer protection and as a means of stopping problems before they gain traction.

Market failure analysis

- 1.15** Most respondents agreed with the market failure analysis in the DP, which discussed how demand-side weaknesses in some financial services markets may inhibit effective competition that works in consumers' interests.
- 1.16** However, some reiterated the point that the issues which lead to consumer detriment originate at the point-of-sale. Others argued that demand-side weaknesses should be addressed by raising financial capability over time and encouraging consumers to take more responsibility for their decision-making. Some argued that the large number of products available shows that competition is effective in financial services markets.
- 1.17** We consider that our market failure analysis is a sound analysis of problems that arise in financial services markets. We maintain that products can be designed – deliberately or inadvertently – to take advantage of consumer behavioural traits in ways which are contrary to their interests and that consumers can be unable to exert competitive pressure on firms to support their interests. We do not accept that simply because a large number of products are present in the market, this means there is effective competition.

² *A new approach to financial regulation: building a stronger system*, HM Treasury (February 2011)

The EU context

- 1.18** A continuing theme in a number of responses was the importance of taking account of work underway in the EU. In particular, concerns were raised about the competitive position of UK firms if UK regulation takes a more interventionist, product-based approach than other EU member states. Some respondents felt that product intervention is best pursued at an EU level, rather than us adopting a national approach which may not be consistent with EU developments, particularly given the evolving role of the European Supervisory Authorities, the Markets in Financial Instruments Directive (MiFID) review and the Packaged Retail Investment Products (PRIPs) initiative. More broadly, respondents referred to the risk of cross-border arbitrage; that is, that products originating outside the UK would undermine the effectiveness of UK product interventions.
- 1.19** We are aware of these issues and they will be taken into account as we develop our approach to product intervention. We are closely involved in a range of EU projects and are seeking any necessary changes to relevant directives and the development of an appropriate product intervention approach at the European Supervisory Authorities.

Supervision

- 1.20** The DP described our emerging supervisory approach to scrutinising products and their governance as part of our wider adoption of intensive and intrusive supervision. Almost all respondents supported the approach. Many asked us to be clearer about our expectations and areas of concern, with some requesting us to publish additional guidance.
- 1.21** A minority of respondents felt that supervision should continue to focus on the point-of-sale and that increased focus on product governance would raise costs for firms which would be passed to consumers.
- 1.22** Some firms will already have noticed the change in our supervisory approach as we begin to supervise product governance more intensively. The supervisory approach is still in development and we will take account of responses as we continue to refine it.

Development of the regulatory framework

- 1.23** The DP also raised the possibility of new product governance rules to support the new supervisory approach. Many agreed that this would be helpful and that a restatement of existing Treating Customers Fairly (TCF) guidance as rules would be a practical way to raise standards in the market. A majority of industry respondents, however, opposed this and argued that the existing regulatory framework already provides sufficient detail and clarity in this area. Some suggested further FSA guidance, others suggested industry guidance as a means of raising standards.

- 1.24 We believe that our new supervisory focus on products should be supported by a single set of rules and guidance on product governance. Building on what is already in place, the existing framework of principles, systems and controls rules and TCF guidance should be updated to take account of our new approach.
- 1.25 We will take this forward taking account of the development of the FCA's approach and of work already underway at EU level, notably by the European Supervisory Authorities and MiFID2.
- 1.26 Our *Business Plan* for 2011-12 highlights our work on product intervention as being integral to the delivery of our consumer protection strategy.³

Additional product intervention options

- 1.27 We do not intend to consult on any specific new rules immediately. We will, however, develop our thinking on possible additional product interventions (as discussed in Chapter 6 of the DP). Where we identify risks which we believe may be effectively mitigated by a rules-based product intervention approach, or where we see a need for further clarity on our expectations, we will consult in the normal way.

Next steps

- 1.28 We believe that it is necessary for us to make changes to our regulatory approach to consider the entire product life cycle, including product governance and distribution standards. We are already supervising firms' product governance under our new intensive approach. In addition, we will take forward a single set of rules and guidance on product governance, including, for example, turning some or all of the TCF material (including RPPD) into rules, and will consider additional interventions going forward.
- 1.29 We are also engaged in wider debates and considering how best to develop the product governance framework to improve standards. In particular, we are seeking any necessary changes to be made to relevant EU directives and are engaging with the Treasury on the development of FCA powers which will have a key role in enabling the new regulator to take forward a product intervention approach.
- 1.30 The government has indicated that the FCA will have an increased appetite to act earlier, making full use of its powers – including any new powers granted – to achieve improved outcomes for customers, prevent risks crystallising, and to improve the operation of markets. Ultimately, the timetable we adopt for introduction of new rules and additional interventions will reflect the outcome of the legislative process within the UK Government and at EU level.

3 Hector Sants, FSA Chief Executive, *FSA Business Plan 2011/12* (March 2011), p12

Who should read this Feedback Statement?

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

2

The rationale for product intervention and our developing philosophy

2.1 In this chapter we:

- summarise the high-level messages we received from written responses to the Discussion Paper (DP) and roundtable discussions held by the FSA in April 2011;
- seek to address some of the concerns expressed over the need for product intervention;
- confirm the scope of the work; and
- explain how it relates to the wider regulatory and legislative framework.

2.2 We received responses from 84 stakeholders, including consumer organisations, firms from a wide range of sectors across the financial services industry, industry associations and consultants, and individual customers.

High-level summary of responses

2.3 Consumer organisations were generally in favour of product intervention and tend to be in agreement with all possible measures set out in the DP. They noted that it is right to seek additional consumer safeguards and thought that product intervention is desirable and would play a role in reducing consumer detriment.

2.4 Industry responses were more mixed:

- Some respondents said that almost all products are suitable for at least some consumers, so a continued focus on the point-of-sale is preferable as this is where consumer detriment manifests, rather than earlier in the product life cycle. There was

a fear that new rules might lead to a loss of choice and innovation. Some firms also expressed the view that the onus should be on consumers to understand the product information provided to them and ensure that products meet their needs.

- Other respondents were more welcoming of changes; indeed, some said that clearer, high-level, outcomes-focused requirements would be helpful to them.

2.5 The views of individual consumers who responded ranged from agreement that intervention in the design of products is necessary, to rejecting product intervention and supporting a regime based on TCF.

Scope of the FSA's work on product intervention

2.6 Some respondents asked us to confirm the scope of the discussion in terms of the types of product and customers likely to be affected.

2.7 Our developing philosophy on product intervention is focused only on the retail market at this time. As we said in the DP, we recognise that retail consumers are not a homogenous group: there are varied levels of financial sophistication among them that may warrant different treatment.

2.8 Other respondents were concerned that a one-size-fits-all approach for all sectors would be adopted. So, we also reiterate from the DP that we recognise differences across the sectors we regulate and would expect that our approach to product intervention will vary according to these differences.

2.9 We were also asked to explain more precisely what we mean by a 'product' when we discuss product intervention. For example, we were asked whether the risk of detriment from a mortgage sold to a credit-impaired customer is more likely to relate to the underwriting decision than the loan itself, which would be the fixed or variable rate mortgage selected by the individual. It is our intention to capture the widest range of issues in this discussion rather than to treat the 'product' concept in a narrow technical sense. In the mortgage example, therefore, we would want to include the underwriting aspects as well as the type of mortgage.

The need for product intervention

2.10 We received several responses stating that almost all products are suitable for at least some consumers so a continued focus on the point-of-sale is preferable as this is where consumer detriment manifests, rather than earlier in the product life cycle. Some others argued that product intervention might be necessary but that this should not detract from the FSA's work on distribution.

- 2.11** We certainly agree that more work needs to be done to improve distribution standards. The FSA has a number of initiatives underway to do this and we will continue to supervise activities at the point-of-sale. But we believe that decisions taken by firms when designing products have an impact on subsequent distribution and on consumer outcomes. The DP detailed product governance issues where consumer behavioural traits may be exploited in ways where detriment is foreseeable.
- 2.12** It is rare for products to be inherently toxic but, if we do identify any that are, we think we should take them out of the market in order to protect consumers. More often, however, products will be suitable for some customers but problems can arise when they reach the wrong customers or if they form too large a part of a consumer's portfolio.
- 2.13** We will continue our work on the later parts of the value chain – notably through initiatives like the RDR and MMR – but we have concluded that we must do more to consider product governance so that the entire value chain is subject to appropriate regulatory attention.
- 2.14** We believe that firms designing products can do more to put their consumers at the heart of their work. Such a change should help improve distribution standards by ensuring that the entire value chain works in the best interests of customers.
- 2.15** The market failure analysis in the DP described precisely the circumstances where the market cannot be relied on to work and competition can fail to deliver good customer outcomes. In some situations, market mechanisms can be blocked and choice, innovation and competition work such that consumer detriment can persist and grow.
- 2.16** Firms in the market may have incentives to exploit the behavioural traits they have identified and to maintain opacity in product price and quality. This is clear from theoretical models of competition⁴, but equally clear from our experience of how competition can develop and persist around false focal points even in markets with lots of providers. An example of this is the use of past performance as a focal point for investments.
- 2.17** Regulation of selling standards, such as for standardised disclosure or suitability requirements, can often limit the harm caused to consumers. But our experience shows that such measures are often only partially successful. Consumers typically have not used prescribed disclosures to shop around, and the complexity of some products means that many consumers may not be able to assess the trade-offs and risks that are involved. Our published reports have found unevenness in the quality of advice; many reveal failings even where expected standards have been clearly set out in rules and guidance and despite monitoring and enforcement.
- 2.18** We now consider it appropriate to supervise product design more closely to help ensure from the outset that features likely to cause detriment are not included or, at least, that firms have considered all possible detriment. On occasion, we will need to take more direct

⁴ See the summary set out in *Consumer behavioural biases in competition*, report published by the Office of Fair Trading May 2011

intervention at product level to limit harm linked directly to product features, whether that product is already in the market or under development. We expect this type of further intervention to be the exception rather than the norm, but it should be part of the regulatory toolkit.

The government's regulatory reform programme

2.19 Our view that a product intervention approach is a necessary element of consumer protection is echoed by the Treasury in its latest consultation on regulatory reform.⁵ This document sets out proposals for regulation of conduct in the financial services industry and outlines the strategic and operational objectives for the FCA.

2.20 It states that:

'The FCA will have a fundamentally different approach to that of the FSA in the way it intervenes to mitigate risk financial services. The FCA will have a lower risk appetite for issues affecting a whole sector, sub-sector or type of product – it will be less prepared to see detriment actually occur, instead seeking to act in a more preventative manner. This will entail, for example, proactively intervening earlier in a product's life cycle, with greater scrutiny of firms' product design and product governance complementing the traditional focus on sales and marketing, and the disclosure of information.'

2.21 Although noting our existing powers to take action where we identify an issue with a product, the consultation proposes strengthening the FCA's capacity to regulate products by legislating to provide it with additional tools for product intervention. The proposed new powers would enable the FCA to make temporary product intervention rules for a period of up to 12 months, with immediate effect, where it considers it expedient to meet its operational objectives. It also proposes legislation to enable the FCA to make provision on the unenforceability of contracts made in breach of its product intervention rules.

2.22 These new powers would give the FCA a significant advantage in maximising consumer protection through product intervention.

TCF and the Unfair Terms in Consumer Contracts Regulations

2.23 A number of respondents felt that more could be done using the FSA's existing framework, with some indicating that supervision – and enforcement – of product governance could be strengthened. There was some agreement that intervention should focus on product

⁵ *A new approach to financial regulation: building a stronger system*, HM Treasury (February 2011)

governance rather than intervening in the design of products, and so the regulator's role is to ensure that appropriate systems are in place for firms to design products well and to market them to the right people.

- 2.24** Consumer groups argued strongly that product intervention should be complementary to, and should not replace, measures such as TCF and the Unfair Terms in Consumer Contracts Regulations.
- 2.25** Our view is that the current framework has delivered benefits, but has not gone as far as we believe it could. The existing regulatory framework is central to our developing approach but we believe that it could be developed further to improve standards. We are not turning our back on achievements of the past but are seeking to take them further. Firms that have fully embraced TCF will recognise many of the goals of product intervention.
- 2.26** We make the following observations on these components of the existing framework:
- While the TCF initiative has developed over time, Principle 6 has existed in the FSA Handbook since inception. On its own it has failed to prevent some product failures and respondents to the DP informed us of issues across the market that may deserve our consideration under a product intervention approach. Many of these issues have yet to have an impact on the market. So, even now, we question whether TCF is working as well as it might and if we should consider improvements to it; and
 - Under the Unfair Terms in Consumer Contracts Regulations 1999, a contract term is regarded as unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer. As a qualifying body under these Regulations, we can assess contract terms for unfairness unless they fall outside the scope of the Regulations. Terms that set out either the goods or services being provided under the contract or the level of the price of the contract (the core terms) are not assessable for fairness under the Regulations. The Regulations also allow us to make an assessment as to whether a term in a contract (including core terms) is expressed in plain, intelligible language. However, the Regulations only cover how a contract is written and do not consider how firms apply these terms in practice.
- 2.27** Looking at one of the most high-profile cases in recent times, the current regulatory system, involving work by the Office of Fair Trading, the Competition Commission and the FSA, was eventually able to deal with the problems inherent in sales of Payment Protection Insurance (PPI). However, this took several years to achieve appropriate redress for consumers, was subjected to a judicial review and will cost the industry billions of pounds in compensation. We believe that developing the current system to strengthen our ability to supervise and enforce earlier in the value chain would have substantial benefits to consumers and to firms by helping prevent the recurrence of this type of scenario. As the FCA is to have a lower risk tolerance than the FSA and will aim to stop detriment from occurring in the first place, this seems necessary.

- 2.28 We are therefore considering turning some of the Responsibilities of Providers and Distributors for the Fair Treatment of Customers (the RPPD) guidance into rules, both to add certainty for firms and to strengthen our ability to supervise and take enforcement action.⁶
- 2.29 There is some support from consumer organisations and the industry for this approach. As so many firms have told us that they already follow the RPPD guidance, turning (some or all of) this into rules would not lead to such high additional compliance costs as the introduction of new, detailed rules would. It should also mean that the approach is targeted at outlier firms who have failed to embed TCF fully, where we would expect most problems to occur.

The RDR and the role of simplified advice

- 2.30 A number of firms responded that existing initiatives, such as the RDR, will reduce the potential for detriment and should be given time to 'bed down' before new powers are awarded to the regulator.
- 2.31 The RDR will come into effect on 31 December 2012. It aims to increase professionalism in the financial advice sector, to remedy certain conflicts of interests by eliminating commission bias in the investment sector, and to increase clarity for consumers by labelling advice as either 'independent' or 'restricted'. This will help to deal with consumer detriment arising later in the value chain in the advised investment sector.
- 2.32 While we welcome the enthusiasm for the RDR from respondents who consider that it will prevent detriment arising from problems with distribution models in the advised investment sector, it is possible that some potential for consumer detriment will remain. Areas not addressed by the RDR (such as product governance, direct sales and other market sectors) will retain the scope for failings to be manifested as consumer detriment. We consider that a good way to address such potential detriment may be to intervene earlier in the value chain and that product intervention is consistent with and complements the aims of the RDR.
- 2.33 In the investment sector, firms have expressed a great deal of interest in the development of simplified advice models under the RDR. We consider that there are links between this distribution model and our approach to product intervention, as consideration will need to be given to the type of investment products that may be sold under simplified advice.
- 2.34 The development and introduction of a simplified advice process is a matter for firms.⁷ However, we plan to publish more detail on the regulatory framework later in 2011.

⁶ *The Responsibilities of Providers and Distributors for the Fair Treatment of Customers*: <http://fsahandbook.info/FSA/extra/4720.pdf>

⁷ Speech by Hector Sants, FSA Chief Executive, British Bankers' Association (BBA) annual conference, 2 March 2011

Simple products

- 2.35 We are also aware of the Treasury's consultation on simple financial products, which was raised by some respondents.⁸ While several firms called for the outcome of the Treasury's consultation to be known before any further FSA rules are introduced, one consumer body advocated the design of 'straightforward-outcome products' under the product intervention approach, perhaps for use within a simplified advice model, and stressed that there is a regulatory role in the development of these products. Some firms advocated simplification of products with a focus on disclosure of 'truly important' information.
- 2.36 It should be noted that, while our work starts from the same analysis of market failure, the two initiatives serve different purposes. The focus in the Treasury's work on simple products is mainly on helping customers to make better choices. Our work on product intervention, on the other hand, is intended to help the regulator improve the effectiveness and efficiency of competition and help to protect customers from detriment. While we will bear the Treasury's work in mind, we do not consider it to offer an alternative to our own work on product intervention as a means of protecting consumers.

Minimum standards

- 2.37 Some consumer bodies argued for the introduction of industry-set minimum standards devised by a cross-industry standards committee, in a manner similar to those observed in other industries. The issue was also debated at our roundtable meetings. Proponents of the idea argue that minimum standards have potential as positive tools to ensure products are fit for purpose. This could reassure consumers and ensure greater consumer participation in the product-design process, while preserving choice by allowing firms to compete in the space above these standards. They might also free up regulatory resource by reducing the need to monitor firms' culture and product-design processes.
- 2.38 Similar ideas have obtained some traction in the financial services industry in the past (an example being the ABI's introduction of agreed definitions for illnesses in Critical Illness Cover). Industry associations have volunteered to work with us to consider reviewing such codes if this is to be taken forwards.
- 2.39 Some industry representatives at our roundtable meetings felt that industry-developed codes of practice might be preferable to new rules but others expressed doubts.
- 2.40 Such codes of practice could be more flexible and quicker to update than regulation. However, industry-led design processes should take care to acknowledge the needs of all stakeholders (such as consumer groups) in order to produce a product which is suitable for the mass market without bringing potential detriment to consumers.

8 *Simple financial products: a consultation*, HM Treasury (December 2010)

- 2.41 We consider that there may be some merit to adopting industry-set minimum standards. However, for such a regime to be effective, it would require the enthusiastic participation of all stakeholders, including firms, consumer representatives and industry bodies, and the industry would collectively need to ensure that the regime was managed by an effective independent accreditation and supervision scheme.

The EU dimension

- 2.42 Retail financial services markets are subject to a number of EU directives, many of which allow products to be distributed across member state borders and may be ‘maximum harmonising’.⁹
- 2.43 Many respondents addressed the forthcoming changes to the EU regulatory landscape (such as PRIPs, IMD2, the next UCITS directive and MiFID2) and questioned how this might interact with our proposed product intervention strategy.
- 2.44 A consistent theme among industry groups and firms was that a strategy of product intervention which was superequivalent to new EU measures (i.e. our application of the rules would go beyond that agreed in EU directives) would damage the competitiveness of UK firms while leaving consumers exposed to detriment from firms ‘passporting-in’ to the UK market. One firm urged lobbying for changes at EU level rather than unilateral intervention within the UK.
- 2.45 We acknowledge that these are important matters for us when considering our approach to product intervention. It is possible that we cannot make rule changes in some markets without going beyond directive requirements or creating a possibility that products will be set up in other jurisdictions which do not have these rules and then marketed in the UK. Where directives are maximum-harmonising, this may limit our freedom to offer consumers a degree of additional protection where we deem this to be necessary. As many respondents have identified, this may undermine the aims of product intervention.
- 2.46 However, many of our colleagues at other EU regulators and in the European Commission have been interested in our DP and we will continue to support the adoption of further powers of product intervention at an EU level. As we said in the DP, it may be that some aspects of the approach are more appropriately addressed at EU level.
- 2.47 We are working on several projects with our EU colleagues in which we are encouraging a product intervention approach and the responses to the DP are helpful to us in determining our position. These projects include the:
- development of all three of the European Supervisory Authorities and their roles relating to retail product oversight;

⁹ ‘Maximum harmonising’ directives are those under which we generally cannot impose requirements which are less than or go beyond the directive provisions.

- relevant discussions on MiFID2 on organisational requirements for the launch of products and services; and
- further work being done at an EU level on remuneration to consider how remuneration structures may influence the way that firms conduct their business with consumers (rather than focusing on the prudential risks associated with remuneration strategies). This may be relevant for our product intervention approach.

2.48 We will continue with our work here and will bear in mind our responsibilities towards the EU and in maintaining a competitive UK market alongside securing an appropriate degree of consumer protection as we develop our approach to product intervention. We will also continue to promote the development of appropriate product intervention approaches at EU level.

Product intervention and competition

- 2.49** A number of respondents to the DP have argued that there can never be grounds for some of the measures outlined in the DP because they are inherently against competition and there are at least some consumers who benefit from any product. We do not agree with this contention.
- 2.50** While it is true that, in most cases, there will be at least some consumers who have their preferred choices altered by restrictions on a product, that does not mean such restrictions are never appropriate or always against competition. In our view, product intervention, when correctly applied, should not reduce competition in the market and may even play a role in promoting it.
- 2.51** Competition can work in many different ways, and we will consider these interventions are in those markets where a particular form of competition is not working well for consumers, whether because consumers are unable to use information effectively or because they cannot take active steps to remedy initial errors.
- 2.52** We have too often seen that, if unchecked, problems directly linked to product design can grow and become embedded in firms' business models. We have also learned that, in markets where consumers are systematically misjudging value or quality, we cannot always rely on competition to reduce poor outcomes over time.
- 2.53** In such markets, innovation is at least as likely to be designed to exploit consumer vulnerabilities more vigorously, for example by increasing opacity or adding worthless product features, as it is to be focused on aligning products more closely with consumer needs. Tackling such problems to bring an end to competitive distortions is not against competition.

- 2.54 The prospect of regulatory price intervention, in particular, was criticised by respondents to the DP. Some respondents argued that price decisions should be exclusively within the domain of the market and price levels should be determined purely by competition. However, competition problems have been a feature of some retail financial markets in the past and this has allowed excessive prices and poor value for money to go unchecked.¹⁰ Where competition is impaired, price intervention may be one of a number of tools necessary to protect consumers and enable competition to work more effectively. We strongly believe that, in these circumstances, it is necessary for the regulator to make judgements on the value for money of products, and to possess the powers to take action if necessary.
- 2.55 The purpose of intervention is to allow competition to work effectively. Our intention is that the most radical measures set out in the DP – like price capping or product banning – will be taken forward where products have the potential to cause significant detriment or where product features are causing detriment, but that we would expect such instances to be rare. The DP set out the risks of each of these measures and noted that these risks would be weighed up carefully in each case before any decision to make new rules was made.
- 2.56 The Treasury has proposed in its consultation on regulatory reform that it will elaborate on the FCA's objectives to ensure that the FCA exercises its general functions in a manner intended to promote competition where this does not conflict with its other objectives.¹¹ It intends that this will go 'significantly further' than the 'have regard' approach taken in FSMA in incorporating competition into the regulator's remit. While this is subject to ongoing consultation and debate, it seems clear that competition considerations will be a greater focus for the FCA. Our view is that this is entirely compatible with a product intervention approach.

The balance between consumer protection and choice and innovation

- 2.57 Firms and trade associations expressed concerns that an increased focus on products and the possibility of the regulator questioning their judgements in relation to them would lead to a reduction in innovation and, correspondingly, to consumer choice.
- 2.58 However, consumer representatives at the FSA's roundtable meetings questioned to what extent there is genuine innovation in the market, rather than improvements in delivery technology (like internet access), and whether the potential for product intervention to reduce innovation may be exaggerated as a result.

¹⁰ A recent high-profile example is the market for PPI, in which a Competition Commission investigation found a number of impairments to effective competition.

¹¹ *A new approach to financial regulation: building a stronger system*, HM Treasury (February 2011)

- 2.59 They also questioned whether choice and innovation are always good for consumers, and suggested that some innovation may be stifled by industry practice rather than regulation. An example is consumer focus on best-buy tables resulting in the market being skewed towards the creation of products with attractive terms for a limited period only.
- 2.60 As noted elsewhere, the DP and this Feedback Statement represent only one stage of the discussion about the FCA's approach to regulation. We will shortly be publishing a document that will set out how the new regulator might approach its first operational objective of 'facilitating efficiency and choice' and the importance of choice as a driving force in the market place.
- 2.61 The boundary between consumer choice and protection is an ongoing debate to which there are no easy answers. We acknowledge that by acting to increase consumer protections we may reduce choice. While we agree that not all innovation and choice is beneficial to consumers, we must be careful before we act.
- 2.62 However, as noted earlier, our starting point is that the FCA will have a lower risk tolerance than the FSA and will intervene earlier to prevent consumer detriment from arising in the first place.

Consumer responsibility

- 2.63 Consumer responsibility is linked to the debate about where the correct balance lies between choice and consumer protection. Many respondents have expressed concern that a focus on product intervention will lessen the importance of consumer responsibility, arguing that providers might become responsible for poor decisions made by consumers.
- 2.64 Some firms expressed the view that the onus should be on consumers to understand the product information provided to them and ensure that products meet their needs.
- 2.65 Our position on consumer responsibility has not changed.¹² Consumers do have responsibility under common law for their actions with regard to financial services. They have a responsibility to look after their interests when dealing with financial firms.
- 2.66 However, we recognise that there are limits to the responsibility that consumers can be expected to bear. Consumer responsibility does not take away or modify the responsibility of firms to treat their customers fairly or to comply with our principles and rules. Firms have access to, and the ability to act upon, information which is not available to consumers and they also design the marketing and descriptive materials which inform consumer decisions. This imposes a particular responsibility upon firms to treat customers fairly.

12 FS09/2: *Consumer responsibility: Feedback on DP08/5* (August 2009)

3

Deciding when to intervene and our emerging supervisory approach

- 3.1 In the Discussion Paper (DP) we considered a range of issues about the practicality of implementing product intervention under our consumer protection strategy. We looked at how the work relates to responsibilities imposed by the Equality Act 2010, the market failures that might begin to be addressed and the criteria that might be used to focus our resources under this new approach.

Q1: What issues should we consider in relation to how our product intervention approach affects equality and diversity?

- 3.2 We received 38 responses to this question.
- 3.3 The Equality Act requires us to consider the impact of our regulation on equality and diversity issues. It also imposes obligations on firms in their dealings with customers.
- 3.4 Most industry responses (representing the vast majority of responses to this question) regard product intervention as harmful to attempts to improve equality and diversity in the financial services markets. Increased regulatory focus on product design is likely, they said, to reduce innovation and choice, with firms concentrating on safer products that serve the needs of the mass market. This may mean they avoid the creation of products to serve niche interests. The dangers of over-regulation and unintended consequences were stressed. One respondent noted that smaller firms in particular might lose their current flexibility and capability to innovate.
- 3.5 The EU context was also frequently mentioned as an important driver here, with reference made to the recent European Court of Justice (ECJ) judgment on gender discrimination in insurance pricing.

- 3.6** Consumer organisations on the other hand, said that product intervention would have a beneficial impact on equality and diversity in retail financial services. They note that, at present, product design does not always work well for all customers. In particular, the most vulnerable can struggle even with products that are commonly regarded as straightforward.
- 3.7** They agreed that competition does not work effectively to discipline the market, given the demand-side weaknesses identified in the DP, and said that product intervention could be one way to address equality and diversity issues under the Equality Act. It may deliver better outcomes by putting greater focus on consumer needs and outcomes, addressing the social priorities of consumers in parallel with their financial aims.
- 3.8** One consumer organisation contested the idea that product intervention will reduce the number of products targeting niche markets. They argued that increased regulatory focus on target market analysis and distribution strategies will be beneficial; still giving firms the opportunity to bring specialist products to the market but also leading them to take better account of consumer needs in niche markets.

Our response

We will take responses to this question into account as we develop our thinking. We believe that some of the elements at the core of our approach to product intervention, such as requiring firms to think more clearly about the potential target market for a product, should help, rather than hinder, with the provision of products to the protected groups. Any changes to our approach will need to be designed to realise benefits rather than any unintended consequences. However, we note that financial services firms also have obligations under the Equality Act to ensure that their products do not discriminate against protected groups.

Q2: How could we use our focus on products to promote equality and diversity?

- 3.9** We received 34 responses to this question. Most respondents warned that the best way to promote equality and diversity in the market is to avoid too much intervention. Different consumers have different needs and there is a fear that too great a regulatory focus on the way products are designed would tend to simplify the market and reduce the availability of niche products, as they may not be so profitable to firms. So, many respondents warned that product intervention might be detrimental to financial inclusion.
- 3.10** A few industry respondents argued that consumers should take greater responsibility for ensuring that they achieve the right outcome, and that the FSA should investigate how best to aid them through improved financial awareness and capability.

- 3.11** Industry respondents also pointed to a great deal of work that has been undertaken here already by firms, acting under the TCF initiative. But a number of respondents did note that the FSA could have a role to play where firms have failed to take their responsibilities under the Equality Act sufficiently into account.
- 3.12** Consumer organisations believe the initiative would lead to positive outcomes for consumers. It is seen by them as a useful tool to improve diversity for consumers and, they argued, could be used to challenge relevant aspects of product design.
- 3.13** One consumer organisation argued that a simpler market that is easier to understand will benefit consumers. If market forces cannot lead to the development of products that meet niche market needs, this will be easier to see and government action might be needed as part of social policy.

Our response

We will consider responses in more detail as we develop our work on product intervention and our approach to equality and diversity in general, and will seek to minimise the risk of unintended consequences.

We will continue to support the Money Advice Service to improve financial capability.

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

- 3.14** Chapter 3 of the DP discussed our high-level market failure analysis and explained why we see the need to intervene earlier in the product life cycle. We had 59 responses to this question.
- 3.15** Most agreed with the analysis and accepted that product design does play a part in delivering good consumer outcomes. Most consumer organisations supported the analysis; roughly as many firms and trade associations broadly agreed with it as found it unconvincing.
- 3.16** Of those who had doubts about the market failure analysis, most argued that the issues lie with distribution standards and problems can only be corrected at the point-of-sale. They felt that recent initiatives (like TCF, the EU's proposals for a PRIPs regime, the RDR and MMR) will correct problems here and significant consumer detriment should not occur in the future. Respondents noted that these are recent initiatives and may take some time to work to their full effect, so we should not add additional layers of regulation before the need for them has been fully demonstrated.
- 3.17** Others argued that demand-side weaknesses should be addressed by raising financial capability over time and encouraging consumers to take more responsibility for their transactions, not by focusing on supply. The development of simple products designed in line with the Treasury's initiative was also mooted as a possible method to address market failures.

- 3.18** The importance of market pressure and effective competition was also stressed. Some respondents questioned our statement that competition is not always effective given the number of products in financial services markets. Others noted that our interventions should be targeted at improving competition, perhaps by improving disclosure standards. There were also comments that some parts of the market work better than others, so a one-size-fits-all approach should not be adopted; rather we should be focused on sectors where competition is ineffective.
- 3.19** Two respondents noted that the extent and impact of market failures change over time and this can affect the necessary regulatory response. For example, market failures might reduce or be corrected by competition in the future, so regulatory intervention may not be necessary.
- 3.20** A few respondents argued that we should not be looking at the features of specific products so much as the governance structures employed by firms. For example, it was suggested that we should focus on the competence of staff designing new products, perhaps looking at changes to Significant Influence Functions to focus more attention here.
- 3.21** A few respondents suggested that regulatory failure and unintended consequences – such as reducing innovation and choice in the market – were a real possibility as a result of greater intervention and that we must ensure the benefits outweigh the costs.
- 3.22** One consumer organisation, however, argued that innovation and choice do not necessarily serve customer needs. Instead, competition may actually work against customer interests. For instance, if one firm develops a cheaper product that may not be in customer interests (e.g. because it carries more exclusions) others might copy it and it can become the industry norm.

Our response

We agree that effective competition is necessary in order to deliver good customer outcomes. It is our experience that competition in the retail financial services markets is too often ineffective and this can lead to consumer detriment. In Chapter 2 we explained in more detail why we believe this needs to be addressed at all points of the value chain, not just at the point-of-sale. The entire value chain must work together to focus on customer needs and deliver the appropriate outcomes.

We are mindful of the difficulties involved in achieving the right balance and accept we will not always be able to identify and correct problems before they occur. Our aim is to do more than we have in the past and to reduce the amount of detriment suffered. Where things do still go wrong and detriment is suffered, the FCA will aim to be more active in securing redress.

We will continue to develop our product intervention approach on this basis but will take account of responses to this question and undertake appropriate

research to demonstrate that the benefits outweigh the costs. As part of this, we will consider the international implications and the effect on competition. We are already working with the EU on relevant projects as we develop this approach and promoting the idea of an appropriate EU-wide approach to product intervention.

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

- 3.23** This question relates to one of the important issues for us to address in adopting a product intervention approach: how we focus our resources and decide when to intervene. This question attracted 58 responses.
- 3.24** Many responses agreed that the features set out in figure 3 of page 30 of the DP, repeated as annex 2 of this paper, are useful in helping answer this question. They said that these may be used as indicators of products we might want to investigate in more detail. But some firms questioned the resource implications to the FSA of product intervention and the cost implications of this.
- 3.25** Some additional criteria were also suggested:
- where there is evidence of deliberate bad practice (as opposed to situations in which firms act in good faith);
 - the target market for the product (with some respondents suggesting we should focus on products for which the target market is in the protected groups of the Equality Act);
 - markets where competition works ineffectively; and
 - a greater focus on smaller firms which have fewer resources to deal with problems.
- 3.26** Respondents also stressed the importance of reviewing each case on its own merits. They said that we should not treat all sectors of the market in the same way. Some commonly mentioned points include:
- cross-subsidy is not always inappropriate and does not invariably lead to detriment;
 - investments inevitably involve risk;
 - complexity may be necessary for the product to function as expected; and
 - different customers have different needs (in particular, more sophisticated customers may need different products to the mass market).
- 3.27** On the other hand, a few other respondents asked for more certainty so that it is possible for firms to know when the FSA might take an interest. This would suggest a different approach, with less room for sensitivity to the firm's context.

- 3.28** Some respondents also stressed that existing rules provide a satisfactory framework with which to judge issues. Respondents argued that we should be using existing risk-based supervisory approaches. They said additional interventions are only warranted where there is clear evidence of market failure that would create widespread consumer detriment and which would not be curtailed by existing regulatory interventions. In particular, some firms argued that any intervention in product design should be limited to new products only, and that existing tools are appropriate for governing existing products. Some respondents argued that any action on existing products might have adverse implications for holders of these products.
- 3.29** There were differences of opinion on the extent to which the magnitude of possible loss should be a factor in our decision on whether to act. While some respondents stated that the scale of detriment to individuals and the size of the market are most important, others said that we need to look at more than this and take into account wider social factors.
- 3.30** Finally, we also had a few responses that pointed to the importance of consumer responsibility and *caveat emptor* in retail financial services. They expressed a concern that too much intervention could reduce the need for consumers to take responsibility for their actions and increase moral hazard for the regulator. On the other hand, one respondent pointed out that consumers tend to bear most of the costs of failed products – at least until redress is made – and so they take sufficient responsibility for their actions and a reappraisal of the balance of responsibilities between consumers and firms is needed.

Our response

The indicators cited in annex 2 do not invariably mean that products with these features are problematic. But products with these features have, in the past, led to problems so the criteria may help us focus our resources on products more likely to need regulatory intervention.

We also wish to reiterate that products may come to our attention that do not have any of these indicators but over which we may still have concerns. The criteria are not exhaustive and we will need to consider other aspects where appropriate.

We accept that more work needs to be done on how to apply a risk-based approach. For instance, we think we need to investigate further how much importance we put on the scale of detriment and the number of consumers affected relative to other issues, like the type of consumer affected. This risk-based approach will also be core to allocating limited regulatory resources efficiently.

Some respondents commented on how the approach applies to existing products. It should be viewed as covering all aspects of product governance, including the ongoing management of products, not just product design.

As noted earlier, our position on consumer responsibility has not changed: consumers do have a responsibility to look after their interests when dealing with financial services firms. But we are seeking to address some of the difficulties consumers can face when making decisions about their financial planning needs and to ensure that firms meet their responsibilities to treat their customers fairly.

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

- 3.31** We received 49 responses to this question. Many respondents agreed that the criteria repeated in Annex 2 of this Feedback Statement should be considered as indicators that further analysis might be appropriate. Respondents agreed with us that these need to be viewed in the context of the particular product being scrutinised and do not necessarily mean that it is flawed. They should be viewed as warnings that a product might be detrimental (usually when several of them are combined and there is a cumulative effect) if firms have not taken sufficient steps to mitigate the problems. There was however a call for greater clarity on some of the indicators (such as what would qualify as a ‘complex product’ or a ‘non-mainstream asset’).
- 3.32** Respondents mentioned other indicators that should attract further attention including:
- products that cannot deliver on their basic aims;
 - products with high levels of remuneration or profitability for the firm;
 - high levels of, or an increasing trend in, complaints;
 - information from the Financial Ombudsman Service and from the new coordination committee of the Office of Fair Trading, the ombudsman service and the FSA;
 - industry and consumer tip-offs;
 - focusing on new entrants to a particular market;
 - the previous track-record of the firm designing the product;
 - the resources of the provider;
 - sales trends (so a spike in new sales or a rapidly growing market share should attract attention);
 - products designed to mitigate tax liabilities by seeking to arbitrage HMRC regulations;
 - the use of derivatives for investment purposes;
 - exposure to counterparty risk;

- products that seek to avoid specific regulatory requirements;
- new product variants where a firm already has several products of a particular type;
- general insurance with below-average claims ratios;
- front-end loaded charging structures; and
- changing macro-economic or other external factors; for example the ECJ case on gender discrimination may have an impact on product design that might lead to particular issues for customers.

3.33 Some responses argued that the fact that these indicators are not absolute determinants of detriment (for example, complexity or bundling might sometimes be in the best interests of some customers for some products) should mean that they should not be used to identify problems. These responses did not offer an alternative method to direct our focus. Instead, they said the problems lie with distribution standards (making sure, for instance, that complexity or bundling is in the best interests of the customer for whom the product is recommended) and that we should be focusing on the point-of-sale rather than product governance. There was some concern that the list of indicators might reduce innovation and choice in the market.

Our response

We will consider the additional indicators that have been suggested. As outlined in Chapter 2, we believe that it is necessary to consider the full value chain, not just the point-of-sale, in order to secure adequate levels of consumer protection.

We agree that further clarity is desirable wherever possible. As we develop our supervisory approach, we will consider how best to offer greater transparency and to share our findings. This may be, for example, through guidance on good and poor practice identified in thematic reviews or individual feedback to firms.

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

- 3.34** We received 60 responses to this question. Almost all responses were supportive of our supervisory work, believing it will be of benefit and agreeing with a more intrusive approach and stronger enforcement of current rules.
- 3.35** Many argued that the existing Principles for Businesses, the TCF initiative and RPPD provide a sufficient framework for the supervision of product governance. Some industry respondents argued that the initiatives should be given more time to work before any further changes are made.

- 3.36** Another common theme from firms was the importance of ensuring that supervisors have the necessary competence to understand product governance issues. There were suggestions that the FSA must do more to prove that this is the case. Some industry respondents also stated that it is important for them to have the right to challenge supervisor judgments before further action, like enforcement, is taken.
- 3.37** Many responses noted that greater transparency is needed to help firms understand FSA expectations and concerns about the market. The Retail Conduct Risk Outlook, for example, was mentioned as a good source of information on current FSA concerns and several respondents suggested that it be published more frequently.¹³ Others suggested that the FSA should publish more guidance on the approach adopted in its supervision to help firms understand their obligations.
- 3.38** Industry respondents argued in favour of a risk-based approach to supervision, with resources directed at the areas of most concern and that the same approach should not be taken in all market sectors but tailored to the firm's context. Firms in the asset management sector argued that other sectors face less regulation and should be targeted. Firms in the general insurance sector argued that general insurance products tend not to carry risk of consumer detriment and should not be targeted. Larger firms argued that a level playing field is important and that smaller firms must face the same level of intensive and intrusive supervision.
- 3.39** Consistent with answers to other questions, a few respondents said that supervision is important but should be focused on distribution and disclosure standards. Some concerns were also expressed that the supervisory approach on its own will raise costs for firms, and will ultimately reduce choice and innovation for consumers.
- 3.40** There were also some comments about how early we will be able to intervene in practice. Some felt that we would still only be able to spot problems after they have manifested. Others pointed to previous instances where the FSA has been alerted about problems but has appeared not to act. They suggested that we need to do more to engage with the industry and consumer organisations to discuss problems and solutions.
- 3.41** Finally, a few industry respondents identified issues that they feel should not fall within the remit of our supervision:
- price and value for money, which should be left to competitive pressures;
 - business models and firm strategies, which should be left to the firm's Board; and
 - in the general insurance market, commission rates are contractually agreed and subject to market pressures and should not be a concern of the regulator.

¹³ *Retail Conduct Risk Outlook* (February 2011)

Our response:

Product intervention will chiefly be a supervision-led approach at this time. But our supervisory approach to product intervention is not going to replace supervision of other parts of the value chain, such as point-of-sale standards, where we think there is also more to do.

We are committed to improving customer outcomes by looking at all parts of the value chain. This includes looking at product governance, how products are brought to the market and managed over their lifetime, and taking earlier action where we foresee the possibility of detriment. We believe that value should be considered as part of this assessment, as it can have a major impact on customer outcomes.

As always, we will give firms the right to put their case before taking further actions, such as enforcement.

Assessment of firms' business models and strategy forms part of our current supervisory approach; this will continue. Our experience of supervision has shown that many conduct issues in firms are driven by fundamental business model and strategy decisions by firms. Assessment and, where necessary, mitigation of these root causes is necessary to achieve good outcomes.

We will continue to use the RCRO as a key tool for our consumer protection strategy to identify and share our forward-looking view of retail conduct risks before detriment arises for consumers.

We will consider how best to meet the need to offer greater clarity on how we are dealing with tip-offs. It is vital that tip-offs are followed up appropriately and we will engage with other stakeholders to address concerns about transparency. Where tip-offs concern individual firms, we must balance the need for transparency with fairness to the firm while it is under investigation. The document we will shortly be publishing on the FCA's approach to regulation will give further thought to improving our engagement with stakeholders.

With regard to supervisor competence, we have, as part of the development of our more intensive supervisory strategy, specifically recruited staff with experience and expertise in product design. As we develop our approach we will continue to focus on recruitment and training to ensure we have the necessary skills to supervise firms effectively.

We continue to acknowledge that we will not always be able to act before detriment occurs. Our aim is to act earlier than we have in the past to prevent what detriment we can and be more active in securing redress where things still go wrong.

4

Possible development of the regulatory framework

- 4.1 Much of the existing regulatory framework was implemented before our increased focus earlier in the product life cycle. In the Discussion Paper (DP) we asked for thoughts on whether we should develop the framework by adding new rules setting out our expectations on firms.

Q7: Should we give further consideration to new rules to prescribe conduct by firms when designing and managing products?

- 4.2 There were 65 responses to this question.
- 4.3 Consumer organisations were in favour of new rules around product governance, seeing them as helpful in improving customer outcomes and adding certainty for firms and consumers.
- 4.4 There were also many responses from the industry that argued in favour of additional rules, particularly where these formalise existing TCF guidance in RPPD. The ideas put forward in paragraph 5.17 of the DP (repeated in Annex 3 of this paper) were seen by many respondents as a restatement of TCF and a practical way to raise standards in the market. However, respondents noted that such an approach might be superequivalent to some directives and we would need to consider the EU dimension before acting.
- 4.5 As part of the discussion about the EU, the developing role of the European Supervisory Authorities with regard to product intervention was also mentioned. It will be important for the UK approach to be aligned with EU standards.
- 4.6 Most of the responses in favour of new rules preferred that these rules be high level and outcomes focused. On the other hand, one response argued against high-level rules on the basis that they lead to uncertainty.

- 4.7 Most industry respondents argued that new rules are unnecessary. They said the Unfair Terms in Consumer Contracts Regulations, TCF and the RPPD already provide enough detail and further clarification is not needed. New rules would risk adding too much to the costs of regulation, stifle innovation and reduce choice. These respondents tended to argue that increased supervision of – and more aggressive enforcement under – TCF would yield better results than new rules.
- 4.8 A few respondents noted that UK authorised collective investment schemes are already authorised, so further rules would not be necessary. However, we did receive a suggestion to tighten the authorisations procedure further.
- 4.9 The use of industry guidance was also suggested as an alternative method to raise standards without so much risk of damaging the market.
- 4.10 A few respondents argued against new rules but thought that additional guidance to explain our expectations under TCF would be helpful. Some noted that the RPPD guidance should be updated to take account of recent developments, like the RDR.

Our response

Further to the discussion in chapter 2, we believe that high standards in product governance are essential to achieve good customer outcomes. As part of this, we will make sure that the FSA – and, in due course, the FCA – has the right regulatory framework in which to operate.

While the current framework does cover product governance, new rules will be necessary in order to deliver the best results. The Payment Protection Insurance (PPI) case shows some of the limits of the current approach, where it took some years to reach the right outcomes, and problems which could have been eliminated at an earlier stage developed to cause detriment to a great many consumers.

As the FCA is to have a lower risk tolerance than the FSA, we need to find a way to guard against the repetition of such a situation.

To address this we will develop additional rules in support of the current framework.

Q8: If so, what should be covered?

- 4.11 There were 44 responses to this question, with a substantial number suggesting we should consider developing the regulatory framework for product governance.
- 4.12 Most of the responses in favour of such work favoured high-level rules setting obligations on firms to have appropriate product governance frameworks. However, we did receive other responses that said that high-level rules do not always give enough clear detail, and

the regulator's expectations must be comprehensible and predictable. Respondents suggested that different rules might be needed for different market sectors. In any event, before changes are made to the general framework, we should do further analysis, research and consultation.

- 4.13** Changes and improvements to product disclosure were raised as a possible focus. A few respondents asked whether disclosure documents could state explicitly for whom products are and are not suitable, for example. Another suggested the development of standardised approaches to categorising product risks.
- 4.14** Those respondents to question 7 who argued that no changes are necessary to the rules and that product intervention should be a supervisory approach only, if at all, were either silent here or reiterated that message.
- 4.15** Some respondents argued that there should be no new rules but that additional guidance would be helpful. In particular, more examples of good and bad practice would be seen as helpful. Others suggested that we consider encouraging industry guidance (possibly with representatives of industry and consumers and the FSA working on the development of minimum standards).

Our response

Further to the discussion in Chapter 2, and taking account of responses to this question, our starting point is that we expect to turn some of the TCF guidance (particularly the RPPD) into rules.

We note that further detail on MiFID2 is due shortly and this includes the possibility of new requirements for product design. So an EU-level approach might be developed for this sector.

We also note that more work is being done at an EU level on remuneration in the context of conduct of business risks, and there is a possibility that remuneration standards in sectoral legislation might in future cover such retail market issues.

We are involved in relevant discussions at EU level and will continue to take part in discussions, taking responses to the DP into consideration as we promote the use of product intervention in directives and by the European Supervisory Authorities.

Some respondents said that additional guidance would be helpful. We propose to publish additional guidance based on the findings of our supervision of product governance. For example, later this year, we plan to publish guidance on structured product design and development, including examples of good and poor practice.

Q9: *What would the impact be on the market?*

- 4.16** Forty-seven respondents answered this question. The approaches adopted by respondents to this question were correlated with responses to the previous two questions.
- 4.17** Those in favour of further consideration of new rules saw positive benefits for consumers and firms, with greater certainty for firms, improved consumer confidence, fewer problems and less need for redress. We also saw arguments that product intervention should reduce the need for supervision in the future as the market comes to work better and competition works more effectively.
- 4.18** A consistent theme in responses from consumer organisations was that the new approach would require a culture change in firms, development of a consistent and coherent framework for firms to follow, more effective market surveillance and a focus on products and services, rather than process.
- 4.19** Many in the industry noted that the ideas in Annex 3 of this paper are largely good business practice, a restatement of TCF guidance and most firms should already be meeting these standards.
- 4.20** On the other hand, we received many warnings that additional rules risk stifling innovation (particularly if prescriptive rules rather than principles-based rules are used), slowing down product development, cutting choice and raising costs for consumers. There was a fear that this could, in particular, lead to less choice for non-mainstream groups of consumers. There were also warnings of unintended consequences, regulatory failure and over-regulation. Firms said regulation must be proportionate and costs should not outweigh benefits. Respondents stressed the need for informed debate, research and analysis before new rules are introduced.
- 4.21** Some mentioned that not all products are brought to the market by provider firms: in some cases, distributors might design the product and ask providers to manufacture it. Product intervention should take account of this type of business model.
- 4.22** Others noted that there may be chains of firms working together (for example, in the asset management sector, a fund manager might not know their end customer if the collective investment scheme is purchased via a fund supermarket) so obligations to review how actual sales relate to the target market may prove difficult.¹⁴
- 4.23** And, some attendees at the roundtable meetings noted a limit to the ability of providers to control customer outcomes from some products. For example, some products intended for institutional investors can end up being bought by retail customers on the secondary market.

¹⁴ The paper on *Treating Customers Fairly and UK Authorised Collective Investment Scheme Managers*, January 2008 was cited by some respondents as sensible guidance for firms in this sector.

- 4.24** The European dimension was also raised as a major concern. It is important to consider the possibility of regulatory arbitrage if products designed elsewhere in the EU, without similar rules, can be passported into the UK. Unless the regulator can act against products originating outside the UK, there is a concern that market failures will remain in spite of greater product intervention. Related to this were comments about the importance of keeping UK regulation consistent with the approach adopted more widely in the EU, in order to maintain a competitive market.
- 4.25** The possibility of moral hazard was also raised, with consumers possibly believing that financial services products that do reach the market are endorsed by the regulator.
- 4.26** The importance of improving distribution standards, aligning distributor interests with consumer needs, working to improve consumer financial education and helping consumers to take more responsibility were also emphasised.

Our response

It is very helpful to understand respondents' concerns and hopes from this work. As noted elsewhere, we are considering making new rules but we will not rush any changes. We need to develop the right approach and to guard against disproportionate costs and unintended consequences.

We will conduct additional research and cost benefit analysis before making any changes.

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

- 4.27** We received 46 responses to this question. Most respondents felt that services should be treated in the same way as products if any action is taken.
- 4.28** These respondents argued that consumers do not distinguish between products and services but regard the entire package they hold as a single solution. This package might, for example, involve a platform, a discretionary management service and investment products. Respondents also said that, to ensure a level playing field, regulation needs to be consistent and some services can look very similar to products (for example, a discretionary management service can appear similar to a multi-managed fund).
- 4.29** A substantial minority of respondents took an alternative approach, however. They argued that services face different issues and serve different customer needs, so should be treated differently. Much more analysis would be needed before changes could be made to the existing approach for services. Respondents also pointed to ongoing work by the EU Commission with regard to the regulation of services. MiFID2 is a key factor here.

Respondents counselled us to wait for further developments at EU level rather than to develop a potentially incompatible approach.

- 4.30** Some respondents also answered this question, as they had question 7, by saying that the FSA had sufficient rules in place to supervise services and ensure that the firms which provide them treat customers fairly.

Our response

We will take account of responses to this question as we develop our approach. In particular, we are working with the EU Commission on relevant projects, like the MiFID review, and are actively encouraging the adoption of product intervention at EU level. We expect further publications from the Commission over the course of this year.

5

Additional product intervention options

- 5.1 In Chapter 6 of the Discussion Paper (DP) we considered a range of additional interventions that might be needed depending on how far we take the approach and if products likely to lead to consumer detriment continue to appear on the market.
- 5.2 With the exception of product pre-approval (discussed below) we believe there is still a case for using any of these interventions where this is appropriate in the future. Using a full range of tools such as those listed below will better help us to act in a proportionate manner to address problems with different causes and differing severities posed by individual products.
- 5.3 As we explained in the DP, we would not expect to use these interventions frequently or as a first measure (for example only where a clearly toxic product is brought to the market such that no consumer is likely to benefit and it is apparent that other methods would not address it satisfactorily). We expect these to be explored further as we develop the FCA's approach.

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

- 5.4 This question invited comments on the additional interventions raised in Chapter 6 of the DP. Below we have summarised the responses we received.

Product pre-approval

- 5.5 In the DP we said that we do not propose a general requirement for all firms to have all products pre-approved, but we could see a possible need for this – or for firms to pre-notify us – before launch in some situations.

- 5.6 Forty eight respondents commented on product pre-approval. Over four-fifths of these strongly agreed with our decision to rule out pre-approval. Reasons given included the burden which would be placed on the regulator; our lack of sufficient expertise in product design; and the risk that we would be perceived as being liable for any subsequent consumer detriment. Respondents also noted a likely reduction in innovation, observing that pre-approval would necessarily increase the time taken to bring products to market.
- 5.7 Of the remaining responses, some argued that, while they would not support product pre-approval, pre-notification of new products or high-risk products might be a suitable alternative. One respondent noted that, while pre-approval should not be applied generally, it might be used as a sanction against persistent offenders which have previously brought problematic products to the market.
- 5.8 Some respondents noted, however, that product pre-approval already exists in the asset management sector and could be applied to other sectors. They also asked whether further product intervention is necessary if a pre-approval approach were to be adopted. We received one response that suggested the authorisation process for UK-based collective investment schemes could be changed to incorporate some of the value judgements and other interventions discussed in the DP.

Our response

In the DP we ruled out pre-approval of all products as a possible intervention at this time. We have not changed this view. Pre-approval would require a marked increase in regulatory resources and would potentially result in consumers assuming that all products had been endorsed by the regulator, with the result of distorting consumer perception of risk around certain products.

But we do not wish to rule it out completely. If it ever becomes the best solution for a particular issue in the market, we think we should be able to consider it in relation to particular product types, as some respondents have suggested.

Similarly, we are not at this time proposing any pre-notification requirement but do not rule it out for the future.

Banning products, mandating or banning product features or exclusions, and setting minimum standards

- 5.9 Respondents were divided on the desirability of outright product bans where it is likely that there will be significant consumer detriment. Of the 49 who responded on this, over half were strongly in favour or offered some support to the idea of banning problematic products. Consumer organisations were in favour of such bans; but, amongst firms and industry associations, responses were split. Around 40% of respondents were opposed.

- 5.10** Respondents who were opposed to outright product bans highlighted the potential for unforeseen consequences and, especially, the potentially limiting impact on innovation and possible exclusion of niche customers from the market. One respondent considered that outright bans may contravene EU measures on restraint of trade, and that the ability to issue outright bans would give the FSA too much discretionary power.
- 5.11** The DP also considered the idea of banning product features linked to detriment or mandating minimum standards. 30 respondents addressed this option, with most in favour to some degree and a minority opposed. Some respondents who opposed outright bans on certain products offered some degree of support towards banning or mandating product features.

Our response

In our DP we suggested that banning products or mandating or banning product features and exclusions should be considered where products have the potential to cause significant detriment, or where product features are causing detriment. We continue to hold this opinion.

In the DP we noted that we would expect such instances to be relatively rare. We continue to believe that this will be the case. We consider that, by intervening earlier in the value chain, the regulator will be able to prevent consumer detriment before it crystallises, or limit it, rather than seeking ex post redress (as has been the case with Payment Protection Insurance (PPI)).

We note that the Treasury's recent consultation proposes that the FCA be given the power to ban products.¹⁵ In addition, the European Commission is considering the issue of EU-wide product bans.

Price intervention

- 5.12** A more interventionist regulator might focus on product pricing decisions by firms and the value for money that products offer. In the following sections, we summarise responses to the different price interventions considered in the DP.

¹⁵ *A new approach to financial regulation: building a stronger system*, HM Treasury (February 2011), p71

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

- 5.13 Sixteen respondents specifically commented on the idea of requiring firms to design products with appropriate charging structures. Two-thirds of respondents were in approval or broadly approved of such a measure. Respondents offering strong or qualified support to this measure included firms, consumer organisations and industry associations. All respondents who opposed this measure were from the industry.
- 5.14 Firms that supported these measures did so on the basis that this could simplify charging structures in order to make products easier to understand for the mass market. Some suggested that the FSA or industry might introduce guidance to enable this to happen.
- 5.15 Opponents of this measure argued that the regulator should not prescribe charging structures and that firms should retain flexibility to set their own charging structures.

Provider duty to consider appropriate overall charge for products

- 5.16 Seventeen respondents commented on the possibility of a new requirement for firms to consider appropriate overall charges for their products. Of these respondents, less than one-third responded positively. Positive respondents argued that these requirements should be considered as part of a broad range of measures. The remainder, all of whom were firms or industry associations, were strongly opposed.
- 5.17 Reasons for this opposition included:
- difficulty in determining a 'trigger point' where a product ceases to offer value for money and action is required;
 - difficulty setting benchmarks across the industry to ensure a level playing field;
 - concern about the implications this would have for the ombudsman service;
 - determining and reporting the total charge paid by each customer in firms' returns to the regulator would be very costly;
 - where complex distribution mechanisms are in place, no one party is responsible for the total charge;
 - providers should not have a role in overseeing adviser remuneration; and
 - existing rules on disclosure and TCF, combined with competition, are sufficient to ensure the outcomes that the FSA would like to see.

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

- 5.18** Twenty two respondents addressed the subject of a point-of-sale responsibility to benchmark advice against a low-charged substitutable product. Just over one-quarter of these supported the idea. All respondents who disagreed were firms or industry associations.
- 5.19** Almost all respondents rejecting the need for such a measure noted that the RDR would remove commission-based remuneration from a number of sectors of the retail financial services market, which would remove the need for such a measure.
- 5.20** Some even suggested that it is no longer appropriate to retain the existing benchmarking requirement in the pensions sector. One firm noted that the existing benchmarking requirement for pensions has had a negative effect on pension sales and that a possible unintended consequence of benchmarking might be to distract consumers from other distinctions and become more price-focused, potentially choosing less suitable products as a result.
- 5.21** One respondent noted that, while pensions are relatively complex, it is unnecessary to have a similar benchmarking requirement for less complex products. Some argued that appropriate benchmarks would be difficult to locate.

Price capping

- 5.22** Of the 27 responses which addressed price capping, most were strongly opposed. These respondents overwhelmingly felt that the regulator should not have a role in setting prices as this would be detrimental to competition and choice within the market. A small number argued that the regulator should promote competition in order to ensure that prices are not set at a level which was inimical to consumers. One firm argued that setting price caps in insurance markets may result in customers who pose a high level of risk being excluded from the market.
- 5.23** The majority of the respondents in favour of price regulation were consumer organisations. These generally argued that price capping should be considered as part of a wider toolkit available to regulators in extreme cases where competition has failed.
- 5.24** One firm argued that, while price capping negated market economics, it may be justified in egregious cases or as part of an intervention on the grounds of improving competitive pressures. Another contended that a regulator should be able to intervene over 'excessive' prices but should not have the power to set price caps.

Our response

In our DP we suggested adopting a more pro-active approach to price intervention to target products that offer poor value for money.

We note the strong level of opposition from firms and industry associations to any form of price capping, and we recognise that price capping and other forms of price intervention may have unintended consequences. There are strong arguments against the blanket use of price capping, namely that it is likely to reduce innovation and competition, and that it may be difficult to determine at what level charges become unfair to customers.

In spite of this, we consider that interventions over value for money are, in certain circumstances, useful to minimise consumer detriment in markets where competition is imperfect. It is possible to envisage the role of the regulator in imposing limits on price or excessive charges to remedy competition problems. As with all these measures, however, it is essential for the regulator to ensure that such measures are used only when appropriate and where there is clear evidence of risk to consumers.

One possibility is to place a duty on providers to ensure that charging structures and overall charges are appropriate. We already require firms to do this under TCF, but some products still attract charges which may be considered excessive. Examples might include single-premium PPI products and some general insurance products sold as secondary products. Our Policy Statement on pension reform also includes some discussion on this issue.¹⁶

We have not seen a convincing argument against further consideration of a requirement for product charges to be appropriate. Indeed, we believe that such a requirement within the product design process would be likely to accrue some benefits to provider firms, by minimising brand damage caused by failures in the distribution of their products.

We expect the measures in the RDR to have a beneficial effect for consumers by improving transparency and eliminating risk of consumer detriment from commission bias. However, the RDR will not apply to all sectors of the market and we maintain that there is value in the regulator retaining the ability to intervene in all sectors and earlier in the value chain.

We consider that there may be some merit to further considering a benchmarking requirement to help consumers assess value for money. In its recent consultation, the Treasury asked how simple financial products might be used as a benchmark or a comparator. Its consultation invites respondents to consider a range of financial products across different sectors, and how these products may be adapted to help consumers make comparisons. We await the findings of this consultation.

¹⁶ PS11/08: *Pension reform – Conduct of business changes* (May 2011)

Increasing the prudential requirements on providers

- 5.25 In the DP, we raised the idea of increasing prudential requirements for firms designing products that are likely to lead to detriment. The idea here was to ensure firms have sufficient capital to deal with complaints and redress. Thirty three respondents addressed this subject. Of these, only a minority agreed with the idea.
- 5.26 Some respondents agreed with our suggestion that this might work for smaller firms and niche players but would be difficult to achieve for larger firms.
- 5.27 A number of respondents observed that firms were subject to EU and global prudential requirements and that additional solvency requirements might reduce the number of firms participating in the market and therefore reduce competition. This could lead to higher prices and reduce choice.
- 5.28 Negative responses were not limited to firms and industry associations. One other respondent noted that increasing prudential requirements might raise barriers to entry within the financial industry and reduce competition as a result. Another stated that prudential measures may impose negative externalities outside the financial market. And one other respondent noted that an increase in prudential requirements may disproportionately impact small providers.
- 5.29 Many respondents cautioned against using prudential requirements to improve firms' conduct regulation, and noted that there were better tools for the regulator to use.
- 5.30 One respondent noted that, since additional prudential requirements would only affect firms regulated by the FCA, it may generate market distortions. The same respondent argued that an alternative solution might be for higher risk firms to be subject to a requirement to make higher payments into the FSCS.

Our response

In the DP we argued that this would be likely to be more relevant for smaller, niche providers in certain markets. The impact of using prudential tools for conduct regulation would be constrained by the large amount of ongoing work on prudential requirements for firms (which will capture many product providers) at EU level. It is also unclear how this would be implemented for all firms under the aegis of the FCA, given that some types of firms will be subject to the remit of the new Prudential Regulation Authority with regard to prudential regulation.

We have some sympathy with the views of respondents who argued that prudential tools can be a blunt instrument when employed in conduct regulation. We acknowledged in the DP that one of the primary reasons for

setting high prudential requirements might be to discourage providers from producing a product. This would indicate that, while their use should not be ruled out, the issue must be considered with care before implementation and used in conjunction with other measures suggested in the DP.

Consumer and industry warnings and mandated risk warnings

- 5.31** Thirty five respondents addressed the subject of the FSA issuing consumer and industry warnings about products where we deemed this to be appropriate.
- 5.32** Most respondents were either positive or broadly positive about such warnings. Respondents argued that vehicles currently exist for these warnings to be made to industry and consumers (such as the Retail Conduct Risk Outlook) and these could play an earlier role in alerting people about products considered likely to lead to detriment.¹⁷
- 5.33** While all the consumer associations who responded to this issue were positive, the response from firms and industry bodies was mixed. Common reservations included that warnings should be issued sparingly to be most effective and that messages issued to consumers should be robustly tested in order to avoid misinterpretation. One respondent argued that, while providing warnings to consumers may be counter-productive, industry warnings may prove very useful to providers. Another questioned the accuracy of some of the existing consumer warnings.
- 5.34** Twenty respondents discussed the idea of the FSA mandating particular risk warnings to be disclosed in promotions and disclosure information. Support was mixed, with three-quarters either supporting or offering qualified support to the introduction of mandated risk warnings. Some respondents who supported general consumer and industry warnings did not support the use of mandated risk warnings.
- 5.35** Respondents who opposed mandated risk warnings argued that this represented excessive regulation and questioned how products subject to such requirements would be identified. One respondent asked whether mandated risk warnings would be consistent with European requirements (such as the Key Investor Information documents for UCITS).
- 5.36** Many respondents who broadly supported the use of mandated risk warnings still had some reservations, with some firms noting the limits of disclosure as a solution.

¹⁷ *Retail Conduct Risk Outlook* (February 2011)

Our response

In the DP we proposed that both consumer and industry warnings and mandated risk warnings should be retained as possible options. We continue to hold this opinion.

We note respondents' concerns that such warnings should be used sparingly and should be supported by evidence. We agree that this should be the case.

Prevention of non-advised sales and limiting product sales to certain types of customer

- 5.37 The DP also considered the possibility of preventing non-advised sales or limiting sales to certain types of customer where we consider that products are particularly complicated or where there is a high risk of consumer detriment.
- 5.38 We received 41 responses addressing this issue. Most opposed it, with only around 30% being in favour.
- 5.39 Responses in favour of this intervention indicated that it might have benefits for certain products, but that this must be balanced with consumer responsibility and that most products should be available on an execution-only basis.
- 5.40 A common view held by many respondents opposed to this remedy was that it is the customer's right not to seek advice if they so desire. It may also encourage customers to not take responsibility for their own decisions on financial services products. Some respondents argued that a likely impact of such an intervention would be to drive customers away from the market, or at least to impose additional costs of advice upon able consumers who would be unlikely to benefit. Attendees at our roundtable discussions argued that mass market customers needed greater levels of protection due to lower levels of financial literacy, but that such protections are inappropriate for more sophisticated customers.

Our response

We believe that this option should be available to us where we identify particularly vulnerable consumers or particular circumstances in which it is the most likely route to improve customer outcomes.

We accept that the prohibition on sales of particular products without advice or limiting sales to particular types of customer could possibly drive a small number of customers away from the market. However, it is less clear whether this number would be significant, or whether the net outcome of such an intervention would

be negative in terms of aggregate consumer detriment. The option of preventing non-advised sales, or sales to certain consumer groups, would never be used indiscriminately and would only be used where the benefits outweigh the costs.

Additional competence requirements for advisers

- 5.41 We could also consider the possibility of setting additional competence requirements for certain non-mainstream products, where detriment is likely if under-qualified advisers fail to account for risks they do not understand.
- 5.42 We received 33 responses addressing this issue. Most were either strongly or marginally in favour, with around one-quarter opposed. Consumer organisations were unanimous in supporting the measure whilst industry views were divided.
- 5.43 Amongst respondents who supported this measure there was broad agreement that some products are sufficiently complicated that higher competence standards are justified. However, any new competence requirements introduced should be proportionate.
- 5.44 A number of respondents who supported or broadly supported this measure noted that it was likely to be complementary with the competence requirements introduced in the RDR, with some arguing that, while they supported such a measure, similar issues would be addressed by the RDR. Some respondents noted that the RDR requirements should be allowed to 'bed down' before we introduced any new measures. Some responses noted that monitoring ongoing competence requirements would need to keep pace with the flow of new products into the market.

Our response

As identified in chapter 2, we believe that product intervention would be complementary to, rather than duplicating, the aims of the RDR. However, any competence standards developed to identify further levels of professional development which would be required to sell certain products would need to be consistent with the approach taken in setting standards under the RDR.

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

- 5.45 Picking up on the previous point, we asked which activities might be defined as non-mainstream and could possibly require additional competence standards. We received 28 responses to this question.

- 5.46 Many respondents welcomed the RDR approach and felt that the higher competence standards already required for the RDR were sufficient and that no immediate change beyond this would be needed. Once the RDR standards have been in place for a while, respondents said that a post-implementation review might be sensible to find out if there are still further gaps in competence that need to be addressed.
- 5.47 On the definition of ‘non-mainstream’, some respondents drew a link to the European Commission’s work on PRIPs. They said that the widely-available products within this proposed regime should be regarded as mainstream and should not be considered for additional qualifications. Similarly, one respondent said that products capable of being sold with simplified advice should need no further qualification requirements. Of the respondents who discussed this question in relation to the mortgage and general insurance sectors, most said that these sectors should always be regarded as mainstream and not require further qualifications.
- 5.48 We had suggestions of activities that would constitute non-mainstream advice and may require additional qualifications when sold to retail customers, including:
- unregulated collective investment schemes;
 - over-the-counter derivatives; and
 - transactions that cannot be reversed (such as defined benefit to defined contribution pension transfers).
- 5.49 One respondent suggested that the people responsible for signing-off new products at firms should have appropriate competencies prescribed for them. But other respondents argued that this would be difficult in practice as it is unclear which qualifications would be appropriate for different sectors and whether all staff involved in product design would need to hold them.

Our response

We agree with respondents’ views that we should build on the approach taken in developing the professional standards for RDR activities, particularly the modular approach taken for producing exam standards. We intend to build on this when we update some of the non-RDR exam standards, such as for mortgages, later this year.

We intend to carry out a post-implementation review of the RDR, as we do with all major policy initiatives. However, we do expect accredited bodies to be working with their members and subscribers to identify competence gaps which should be addressed by ongoing continuing professional development.

We can see some need for considering qualifications for transactions that cannot be reversed and will pick up the pensions point when we review the pension

transfer specialist exam standards later this year. At that time we will also consider the extent of coverage and linkages between qualifications around pensions and retirement planning.

Q13: Are there any other interventions we should consider?

- 5.50** We received 33 responses to this question. The idea raised most frequently was to investigate the use of industry-agreed standards and voluntary codes to raise standards, perhaps working with industry bodies to update existing codes.
- 5.51** A few respondents noted that an important, if longer-term, intervention is to try to correct the demand-side weaknesses identified in the DP by working with the Money Advice Service to improve financial capability.
- 5.52** We had many other suggestions for other interventions we could consider. These included:
- pre-approving or banning financial promotions for products not deemed suitable for the mass market;
 - focusing more at provider firm governance processes than specific product features;
 - simpler risk-profiling and labelling of products;
 - requiring the use of third-party firms to stress-test products;
 - improved competitive pressure by making it easier for consumers to switch out of products to better alternatives and encouraging them to do so;
 - mandatory professional indemnity insurance;
 - higher prudential standards for platform providers that are currently classed as software providers;
 - increased supervision of aggregator websites for general insurance;
 - requiring distributors to supply benchmarking information for all products;
 - additional FSCS levies for intermediaries selling products for which we have published warnings;
 - mandatory commission disclosure for general insurance products;
 - greater focus on helping distributors sell products only to the target market recommended by providers;
 - improved product comparison tools on the Money Advice Service website to improve benchmarking; and
 - requiring customers to sign an indemnity when taking out certain products.

- 5.53** On the other hand, some respondents observed that no further interventions should be planned as the FSA already has the necessary regulatory tools. These respondents felt that more could be done under the current regulatory framework to reduce the potential for significant consumer detriment and that supervision and enforcement action of this framework must be improved. This supervision should involve more effective discussions between supervisors and firms and stronger enforcement against the firm managers responsible for problems with products.
- 5.54** Respondents also raised concerns about applying too many of these additional interventions too aggressively:
- interventions need to be carefully chosen for the particular issues to be addressed and not simply transposed from one area to another;
 - providers should only be responsible for distributor actions where there is a contract to that effect between the two parties;
 - interventions need to consider everyone affected including, for friendly societies and building societies, the members and not just the customers for that product; and
 - to avoid employing too many interventions to their full effect. This would be highly prescriptive and overly restrictive, perhaps causing consumer detriment rather than reducing it.

Our response

We will take account of responses to this question as we develop our approach. Some of these interventions may be helpful in developing our standard policy toolkit. Where we identify specific situations in which it is appropriate to consider these options, we will conduct analysis and consult on rules to implement them.

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

- 5.55** There were 21 responses to this question, with the answers reinforcing the messages given in reply to question 9.
- 5.56** Respondents in favour of more product intervention see positive impacts resulting from the regulator acting earlier and taking necessary steps to remove foreseeable detriment from the market where firms are unable or unwilling to do so themselves.

- 5.57 Respondents who fear product intervention will lead to over-regulation were concerned that the additional interventions might lead to reduced innovation, reduced choice and higher charges. It was also suggested that the approach would fail to help with market failures as the problems lie at the point-of-sale rather than with product governance.

Our response

We agree that the additional interventions in Chapter 6 of the DP should not be used frequently or where other regulatory solutions or competitive pressure would address a particular problem.

However, we do think that the regulator does need to consider all valid options to protect consumers. The FCA will have a lower risk tolerance than the FSA and be more willing to act sooner. Therefore, we do not rule out the use of such options and will actively consider them when they are needed to deal with a particular issue.

As we see new problems emerging, we will consider whether additional product interventions (made under our existing powers) are the most appropriate response and consult with stakeholders on specific proposals in the normal way. We will of course be mindful of the Treasury continued consultation and debate on regulatory reform and specific new powers such as temporary product banning.

6

Next steps

- 6.1 The Discussion Paper and this Feedback Statement are only one part of a wider debate about the future of financial regulation in the UK and the regulatory philosophy to be adopted by the FCA. We will shortly be publishing a document on the FCA's philosophy, and will be holding a conference on the FCA in late June to encourage further discussion on the FCA and what stakeholders expect from it.
- 6.2 We believe that rule changes may be necessary to give more certainty on our expectations of firms when launching new products and managing them over the product life cycle.
- 6.3 We will continue to include the supervision of firms' product governance within our new intensive supervisory approach. We will move towards new rules on product governance (including design, distribution channels and after-sale issues), and turning some or all of the TCF guidance (including the RPPD) into rules.
- 6.4 Product interventions will form part of our standard policy analysis. We will consult on rules-based product intervention if we believe that such an approach may effectively mitigate identified risks, including providing necessary clarity to regulated firms.
- 6.5 We recognise the link to the simple products agenda, and will continue to work with the Treasury, the Money Advice Service and firms to investigate how our work on product intervention can be useful to them.
- 6.6 We will continue to encourage changes at EU level which are consistent with our approach to product intervention.

Annex 1

List of non-confidential respondents and attendees at the roundtable discussions

ACE European Group Limited

AEGON UK

Age UK

Aspen Insurance Holdings Limited

Association of British Credit Unions Limited

Association of British Insurers

Association of Financial Mutuals

Association of Independent Financial Advisers

Association of Investment Companies

Association of Mortgage Intermediaries

Association of Private Client Investment Managers and Stockbrokers

Aviva plc

AXA UK

Barclays

Berwin Leighton Paisner LLP

Blackrock Investment Management (UK) Limited

Bluefin Insurance Services Limited
Brewin Dolphin Ltd
British Bankers' Association
British Insurance Brokers Association
Brunsdon LLP
Building Societies Association
BUPA Health Assurance
Cazenove Capital Management
CFA Society of the UK
Charles Stanley & Co Limited
Chartered Insurance Institute
Chartis Insurance UK Limited
Chubb Insurance Company of Europe SE
Citizens Advice
Consumer Council for Northern Ireland
Consumer Focus
Co-operative Financial Services
Council of Mortgage Lenders
Dr N Ogg
ea Consulting Group
Engage Mutual Assurance
Fidelity International
Finance and Leasing Association
Financial Services Consumer Panel
Friends Provident
Futures and Options Association
IG Group
Institute of Chartered Accountants in England and Wales
Institute of Insurance Brokers
Intermediary Mortgage Lenders Association
International Financial Data Services

International Underwriting Association
Investment and Life Assurance Group
Investment Management Association
Joint Associations Committee on retail structured products
JP Morgan Asset Management
Killik & Co
Lighthouse Group
Liontrust Fund Partners
Liverpool Victoria Group
Lloyds TSB Bank plc
M&G Group
Money Advice Service
Mortgage Intelligence Holdings
Mr B Cheesewright
Mr D Pope
Mr M Fenwick
National Consumer Federation
National Housing Federation
NEWAsurion Europe Limited
Office of Fair Trading
Openwork Limited
Oval Limited
PDL International
Phoenix Group
Police Credit Union
Practitioner Panel
Prudential
Royal Bank of Scotland
Royal London Group
RSA
Sarasin

Scottish Friendly Assurance
Schroder Investment Management Limited
Shelter
Skipton Building Society
Smaller Businesses Practitioner Panel
Standard Life plc
Tesco Bank
T H March & Co Limited
UIA (Insurance) Ltd
UK Asset Resolution
UK Sustainable Investment and Finance
Which?
Yorkshire Building Society
Zurich Financial Services

Annex 2

Indicators of problematic product features

The following table appeared as figure 3, on page 30 of the Discussion Paper.

General
<ul style="list-style-type: none"> • Complex products, including bundled products or those with opaque structures. • The decision to buy is secondary or tertiary following another purchase. • The product cross-subsidises other products. • The product carries an inherent conflict of interest that is potentially damaging to consumers. • The product's inability to meet customer needs would not be apparent until a considerable time in the future. • Products with secondary charges (e.g. charges contingent on events throughout the life of the product). • Layers of charging due to multiple products or services included in the package. • Products where the customer is attracted by a teaser rate and then tied in. • Exit charges or other features which act as a material barrier to exiting. • Bundled products with a limited overlap of the target markets for each of the products. • Products aimed at consumers facing financial hardship. • Product features outside the core range (e.g. 'bells and whistles' or 'gimmicks' of little use to most customers or at significantly higher margin).
Insurance
<ul style="list-style-type: none"> • Factors affecting eligibility to claim risk undermining the utility of the product or exclude large groups of customers. • Circumstances in which the provider can withdraw cover risk undermining the utility of the product. • Limited risk transfer to the insurer. • Complex claims notification procedures that will deter claimants.
Investments
<ul style="list-style-type: none"> • Use of non-standard assets for investment purposes. • Use of product names that imply greater levels of safety/return than are actually possible. • Charges that do not appear to reflect the level of service provided e.g. a passive collective investment scheme with a high annual charge. • Performance risks that are difficult to assess or are not properly understood by the provider or distributor.
Mortgages
<ul style="list-style-type: none"> • Product structures that encourage irresponsible lending/borrowing. • Products designed to be repaid solely through property appreciation.

Annex 3

Possible development of the regulatory framework

The following ideas were suggested in paragraph 5.17 on page 46 of the Discussion Paper as possible ways to develop the framework by adding requirements for firms covering:

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

- ongoing requirements to consider if the product's risk profile has changed, because of external factors such as market conditions or changes to legislation, for example, or because the firm has made changes to the product's features over time, and to consider what to do if this has happened; and
- requiring staff responsible for signing-off products to have appropriate qualifications.

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The Financial Services Authority
25 The North Colonnade Canary Wharf London E14 5HS
Telephone: +44 (0)20 7066 1000 Fax: +44 (0)20 7066 1099
Website: www.fsa.gov.uk

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