Should we tighten this screw?

The Financial Services Authority and its successor agencies are being urged to turn the regulatory screw further by greatly increasing their "product intervention". JOHN K ASHTON and IAN DEWING question whether this approach should be welcomed.

Since March 2010, the FSA has been more intrusive and interventionist in regulating the conduct of business in financial services. This involves examining new products firms wish to bring to market, how they will be marketed and distributed, and the existing incentives in financial services markets.

Overall, regulatory examination should occur throughout the product value chain, including firms' marketing and product development functions. These developments, which move beyond the recommendations of the 2009 Turner Review, may also be extended to involve price interventions, limited non-advised sales, banning certain products and product features, and even more competence requirements for financial advisers.

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We'd all hope any regulatory change should be more than a re-branding of past approaches, but an important question is whether this new approach can be justified. In the past, the FSA accepted that, if retail products were suitable for some customers, they should be made available to promote choice. Banning products and other forms of product intervention were believed to be unnecessary since well-managed firms would not develop poor financial services, and well-informed customers would only choose products that served their needs.

So, regulation of conduct focused on the form of advertising, the methods of sales and customer information provision. It implicitly assumed poor purchase decisions were influenced by how the product was sold, how well the needs of the customer were synchronised with the product features, and whether the customer took a purchase decision knowingly. Given that this focus on the end sale of financial services has been in place for the past 20 years, is it now in need of reform?

The FSA justifies extending the regulation to product intervention by reference to recent mis-selling scandals. Despite the regulatory array focused on the "selling" of financial services in the UK, "mis-selling" episodes persisted and have been expensive for all involved.

In three past mis-selling episodes, customer redress cost UK financial firms nearly £15bn (£3bn-plus for mortgage endowment redress, £11.8bn for pensions and £195m for capital investment trusts). The recent mis-selling of Payment Protection Insurance (PPI) also followed this trend: FSA fines exceeded £12m, customer redress already exceeds £1bn and future provisions for PPI redress made by just eight banks total more than £6bn (Lloyds TSB alone has allocated £3.2bn). We can only wait and see if the continuing debate about current account overdraft fees morphs into another such mis-selling episode.

We suggest that wider commonalities among these mis-selling cases exist and therefore justify the new regulatory stance of product intervention. In all the mis-selling episodes, the financial service concerned has been widely sold with regulatory intervention occurring only once a significant number of complaints have been made.

And many mis-selling cases have involved complex products often misunderstood by the customer and, in some circumstances, by the staff selling them. Norwich and Peterborough Building Society was fined £1.4m in April 2011 and faced a £51m compensation bill after failing to provide customers with suitable advice about the sale of investment products. This case rested on the relatively low-risk rating attributed to these investments. In practice, though, the potential risk was far higher and reflected a lack of comprehension by both customers and staff.

The distribution and marketing of a financial service has also been important in many mis-selling episodes. For example, firms faced much criticism about the methods of assumptive sales and pricing of PPI when this insurance was distributed jointly with credit.

In most mis-selling episodes, an earlier examination of these concerns would have limited the highly adverse outcomes. Using a medical analogy, just as the Medicines and Healthcare Products Regulatory Agency examines the safety and efficacy of UK health services, might we not also examine the safety and efficacy of financial services products in a systematic regulated process, before their widespread sale? Indeed, without such product intervention, are we expecting too much from both customers and financial advisers?

These are persuasive arguments, but might such a regulatory extension have negative ramifications? Additional intrusive regulation is unlikely to be popular with firms and will impose substantial costs. In particular, firms must ensure compliance with new regulations or face increasingly robust sanctions. It's a very real concern: a comparison of FSA fines levied between 2004-07 and 2008-11 shows a 250 per cent rise; average fines in each "final notice" case rose by 49 per cent; the number of cases involving fines rose by more than 125 per cent.

At the very least, extending the scope of regulation demands further investigation and scrutiny by both the press and academics. Indeed, scrutiny of the regulators is essential for the regulated, especially in the context of the establishment of the new UK regulator. It's an excellent opportunity to influence the needs and requirements of business conduct regulation for the next 20 years.

This scrutiny should include these questions:

- **CHOICE:** will product intervention limit customer choice within financial services markets?
- **CONTROLS:** will possible future price controls lead to adverse and anti-competitive outcomes as witnessed when interest rates have been regulated?
- **CREATIVITY:** will increased intrusion into marketing and product development functions limit creativity and reduce enterprise and innovation?

Embracing safer financial services that meet customer needs is clearly an aim shared by the financial services industry itself. Equally, the high cost of the status quo with its repeated mis-selling episodes suggests regulatory change is essential. But it's unclear whether product intervention represents the most effective way forward. CB

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