

Financial Services Consumer
Panel response to: A review
for the Financial Services
Authority by London
Economics – *Polarisation
and Financial Services
Intermediary Regulation*

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Introduction

1. This paper is in response to the FSA's invitation to provide comments on the report by London Economics on the polarisation regime (which requires advisers for certain retail financial products either to be tied to one provider or to be independent of providers).
2. This is a somewhat unusual exercise for the FSA. The FSA has not issued a Consultation Paper, nor has it set out specific questions on which it seeks comment. Furthermore, in this case it is Treasury ministers rather than the FSA who will decide how to respond to the criticisms of the current regime made by the Director General of Fair Trading (DGFT) last autumn. However, the FSA's advice to the Treasury will clearly be hugely influential, and it is the FSA that will consult in due course on any rule changes that might be necessary to give effect to Treasury decisions.
3. The purpose of this paper is therefore threefold: to advise the FSA ahead of any advice it gives to the Treasury, to inform the Treasury of the FS Consumer Panel's views (a copy goes to Treasury) and to influence the shape of any future consultation that the FSA may undertake.

Summary of key points

I. The Financial Services and Markets Act sets out the hierarchy that the FSA must observe: in assessing consumer protection and competition effects it is the consumer protection objective that must take precedence.

II. The FSA needs to determine whether the status quo is sustainable and the extent to which EU legislation, future developments in financial services, the effects of technology and the use of product panels militate in favour of change. If it is not sustainable, then the direction of debate is not whether there should be change, but what change there should be.

III. The FSA must be confident that a new regime would offer a better balance between costs and benefits than the current regime. It should thoroughly examine the robustness of London Economics' predictions for each scenario, in particular to see how sensitive they are to changes in assumptions.

IV. We recommend that the FSA conducts further analysis before committing itself to a view about which scenario (or the status quo) it advises the Treasury to adopt.

V. It is a considerable weakness of the FSA's current position that it has done no detailed thinking about how it might achieve an adequate level of consumer understanding of polarisation. Without this work we have no basis for being confident that the aim of widespread consumer understanding about a new regime is at all achievable.

VI. We urge the FSA not to make precipitate decisions about the merits of one regime rather than another without having made a clear assessment of the risks and countervailing protections in each.

VII. Any new regime will need to meet certain key criteria to ensure that standards of consumer protection are maintained.

In summary, the Panel's view is that it is too early to come to conclusions about the best way forward – a good deal more work needs to be done before it is safe for the FSA to recommend change to the existing system.

Objectives

4. The London Economics report is a largely economic assessment (with a strong competition focus) of how a number of policy scenarios compare with the option of maintaining the current polarisation regime. Clearly an understanding of the economic impact of any change is vitally important, but it is not the only basis on which the FSA must consider options.
5. Competition in markets can provide significant benefits for consumers. However, there can sometimes be a tension between the need to protect consumers and the need to minimise any adverse effects on competition that might arise from FSA's actions. The discussion on polarisation exemplifies this: the current regime derives from the fact that historically the regulators have taken the view that polarisation provides benefits in terms of consumer protection that outweigh acknowledged competitive disadvantages.
6. **The Financial Services and Markets Act sets out the hierarchy that the FSA must observe: in assessing consumer protection and**

competition effects it is the consumer protection objective that must take precedence.

7. This does not automatically lead to easy answers – nor does it mean that the Panel has concluded that the status quo should be maintained. The Panel is not wholly persuaded by the competition arguments in the London Economics report (in particular, whether the claimed competitive advantages of Scenario 1¹ would in practice be delivered), but it is also not persuaded that polarisation in its present form is necessarily delivering the consumer protection that had been hoped for.

The case for change

8. There are two reasons why the FSA might choose to change the current polarisation regime:
- the status quo is unsustainable; and/or
 - it is confident that a new regime would offer a better balance between costs and benefits than the current regime.

Is the status quo sustainable?

9. If the status quo is not sustainable, then the direction of debate is not whether there should be change, but what change there should be.
10. There are a number of factors the FSA will need to take into account in reaching a conclusion on this point:
- EU legislation. Whilst EU legislation does not appear at present to rule out maintaining the current polarisation regime, it is clearly open to member states to challenge the regime, particularly once the E-commerce directive is passed. If the FSA wanted to defend the regime

¹ Redefinition of polarisation for all products. In this scenario firms could choose to be independent, tied or multi-tied, with clear disclosure of both status and interest.

it would need to do so on grounds of general good². It is important for the FSA to assess how likely it is that it would win this argument.

- Future developments. There is scope for future developments to give rise to consumer detriment if the current regime were to be maintained. One example of this might be the introduction of Stakeholder pensions. It could be argued that these products will operate on very fine margins and it may be the case that not all product providers will choose (or be in a position to afford) to develop their own product. In these circumstances the view may be taken that firms should be able to offer products from other providers rather than to sell non-Stakeholder personal pensions. However, this depends on whether these firms' customers have access to IFAs and whether alternative means of purchasing stakeholders may develop. It also depends on stakeholder providers being willing to risk the potential weakening of their own brand and position by supplying other firms.
- Technology. The effects of technology are in any case likely to blur the distinction between tied providers and independent advisers, which is one of the major benefits of the current regime. One way in which this might happen is through the further development of internet-based 'financial supermarkets' where well known product provider names become associated with a choice of investment funds from a range of other providers. Whilst there may be considerable benefits to consumers from such offerings, there is also a growing risk that consumers will become confused about the tied/independent distinction, particularly where the offerings appear to have been 'selected' by the supermarket for consumers. The FSA needs to assess the extent to which the consumer protection claims of the current regime are thus compromised.

² FSA would need to argue that polarisation was not discriminatory, was objectively necessary, did not duplicate home country rules and was proportionate to the objective pursued.

- Use of product panels. As the London Economics report notes, concern has been expressed about providers' access to the IFA distribution channel and in particular focusing on the rise of networks and the increased importance of product panels. The report estimates that panels are used in 80% of cases. What the report does not do is to provide information on how many provider firms appear on each panel list and how frequently IFAs review the marketplace in order to assess the need to refresh the panel lists. If it were found to be the case that panel lists were small and infrequently updated then this would bring into question whether the current regime is in practice providing consumers with access to an independent choice of products selected from the marketplace as a whole. Information on this would be very valuable, regardless of whether change is instituted.

11. The FSA needs to determine whether the status quo is sustainable and the extent to which EU legislation, future developments in financial services, the effects of technology and the use of product panels militate in favour of change.

Confidence that change would be for the better

12. Assessing the impact of a major regulatory change is inevitably difficult. Not only does it involve predicting how all the various parties might respond to a change, but it also involves assessing how the changing environment for financial services will affect the variables that tend to increase or decrease consumer detriment. Part of this changing environment is the FSA's new activities in consumer education and comparative information. And, for example, the increasing use of CAT standard or benchmarked products can decrease potential detriment in some areas but increase it in others.

13. Having acknowledged the difficulty, we are nonetheless seriously concerned about the robustness of the conclusions reached by London Economics, including a possible over-reliance on the Continental

Research work as this is based on hypothetical questions which often provide unreliable evidence. Indeed their report notes that, in relation to Scenario 1, whilst they conclude that the size and independence of the IFA channel will not diminish significantly ‘the evidence is not conclusive and this is an area of risk’.

14. Taking their work on Scenario 1 as an example, London Economics’ conclusions are based on three areas of information. These are: a) what industry participants have told LE they think will happen; b) consumers’ own assessment of the value of independence; and c) based on these views, London Economics’ assessment of whether it is in IFAs’ commercial interests to stay independent.

15. But the second and third of these conclusions rests on the assumption both that consumers will understand the distinctions between the three types of adviser and that a significant proportion will continue to choose to use an IFA. This is notwithstanding the fact that there is currently significant confusion about the two types of adviser that have existed for the last ten years. (The issue of consumer understanding is addressed in more detail below.)

16. The FSA must be confident that a new regime would offer a better balance between costs and benefits than the current regime. It should thoroughly examine the robustness of London Economics’ predictions for each scenario, in particular to see how sensitive they are to changes in assumptions.

Structural effects of change

17. The reason why the Panel is keen for the FSA to do further work to assess the sensitivity of London Economics’ conclusions is because it can see a number of potential structural consequences of change in addition to those outlined in the London Economics report. This does not mean that the Panel rejects out of hand the conclusions that London Economics has reached – rather that we see the scope for alternative and (on current

information) equally plausible structural outcomes. Below we have set out a number of plausible alternative (but not necessarily mutually compatible) outcomes for Scenario 1:

- The range of products available to consumers narrows rather than increases if the tied channel is opened up to competition. This could happen if product providers came under pressure to replace their own products in their product range with those of a small number of product providers who were able to leverage their brand or cost base.
- Despite a new ability to introduce other providers' products into their range, in practice product providers in the tied channel carry on much as before, perhaps because of the economics of buying in products. (Such an outcome would be consistent with much of the general insurance market where there are no polarisation constraints.) If this happened in relation to Scenario 1 then there would be no competitive gains in the tied sector to counterbalance the risks of a reduced IFA channel and greater consumer confusion.
- The tied channel does indeed introduce the products of other providers into their product range, but this does not result in any passing on to consumers of price or quality benefits.
- Consumers either fail to understand the distinction between the three types of adviser, or do not place the same value on independence (as opposed to breadth of choice, which could in future be claimed by all three channels) as the London Economics report predicts. In either case this could lead to a significant shrinking of the IFA market.
- Both competition and consumer choice suffer because the networks all go multi-tied, leaving only a small (fee-based) 'true' IFA sector.

18. In setting out these alternative outcomes the Panel is not attempting to argue that they are more or less likely than those which London Economics has concluded would be the case. Rather our point is that on

current information the FSA cannot be confident that change would result in an improved regime.

19. There are a number of steps the FSA might take to achieve greater certainty, in addition to the process it is now going through by inviting comments on the London Economics report:

- Further work with the industry to develop alternative models of what the potential impact might be of the front-runner London Economics scenarios and of the status quo. This would provide a framework for attaching probabilities to each model, and assessing the risks that would emerge if the actual outcome deviated from the model.
- Further consumer research to predict with greater confidence the likely response of consumers to each scenario. The London Economics report provides little detail about the methodology and sample of the research they refer to or of the new research commissioned, but we note that there is no reference to qualitative rather than quantitative research. This looks to be a serious omission given the weight attached to this research and the enormous difficulty of assessing what consumers will actually do rather than what they say they will, or would prefer to, do.³
- Secondary analysis of existing research to provide greater detail about the effects of change on different segments of the market. Conclusions about consumer impact by London Economics are generally at the aggregate level, and a better understanding of segmentation is needed before the FSA can properly assess the impact on consumers who are less knowledgeable and less experienced.
- An assessment of the lessons to be learned from non-polarised markets including the more complicated end of the general insurance

³ The FSA's report *Better Informed Consumers* notes that whilst 41% of decision-makers prefer to use an independent adviser for a straightforward product, and 56% for a complicated product, in practice only 14% of the surveyed products bought were through an independent adviser.

market and the mortgage market. Given the absence of polarisation constraints, what do these markets tell us about the willingness of product providers to introduce products from other companies into the range of products they offer? To what extent are ‘independents’ in the general insurance market (ie those who are not employees or representatives of product providers) multi-tied in practice if not by contract?

20. We recommend that the FSA conducts this further analysis before committing itself to a view about which scenario (or the status quo) it advises the Treasury to adopt.

Consumer understanding

21. The London Economics report identifies in relation to the current regime that

‘... the rules also appear to have had some effect in reducing consumer detriment, by clarifying the status of advisers in the eyes of the public. If the rules are to be changed, this should be done in such a way as to maintain clarity about who is independent and who is not. Otherwise, there is scope for consumer detriment to increase.’

22. The Panel is greatly concerned that a change to the polarisation rules could result in much less clarity than at present for consumers about the status of advisers. The problem would be especially acute in the case of scenario 1, which creates a new category of adviser – the ‘financial adviser’ (or multi-tied adviser). Looking from a consumer’s point of view at a new structure of three types of adviser, they may well be faced with (not necessarily inaccurate) claims such as:

- ‘Although I work for XYZ company I can advise you on a range of products in our product range that are from a number of well known brands’ (tied adviser).

- ‘Our products are very good, and where we think they would not have been so good we have added the best product chosen from across the market’ (tied adviser).
- ‘When we choose whose products we are going to offer we look around the marketplace and select the product providers who have the best ranges’ (multi-tied adviser).
- ‘We select the best products from the marketplace’ (IFA).

In other words, it is highly likely that distinctions between the three types of adviser will blur - particularly given that in other parts of the financial marketplace (general insurance, mortgages) the same categorisation does not apply.

23. It is also important to put the distinctions for investment business products in the context of the total buying process that consumers will experience. It would be quite possible under scenario 1 for consumers to be dealing with one firm or adviser in three different ways (eg independent for a mortgage loan, tied for general insurance and multi-tied for the mortgage repayment vehicle).

24. There are clearly a number of ways that the FSA can hope to ensure that the consumer detriment that the London Economics report notes might arise from a lack of consumer understanding does not crystallise. The two main ways are firstly through the way FSA rules require firms to make certain disclosures about who they are and whose interests they represent (the consumers’ or the firm’s) and secondly through consumer education.

25. It is a considerable weakness of the FSA’s current position that it has done no detailed thinking about how it might achieve an adequate level of consumer understanding of polarisation. Without this work we have no basis for being confident that the aim of widespread consumer understanding about a new regime is at all achievable.

26. The Panel remains concerned that the FSA looks to disclosure and consumer education to solve a wide range of problems. There is no research evidence to back this up, and the Panel's view is that it remains an unrealistic expectation.

Consumer protections

27. As yet we have only a very sketchy view of what the regulatory regime might look like for each of the scenarios covered by the London Economics report. This is not enough to form a view on whether consumer protection would be enhanced or diminished under each scenario.

28. We urge the FSA not to make precipitate decisions about the merits of one regime rather than another without having made a clear assessment of the risks and countervailing protections in each.

29. In designing a regulatory regime in the event of a change to the existing polarisation rules we believe that there are certain basic criteria which any consumer protection regime must meet:

- Consumers have access to an effective mechanism for complaints. By this we mean that it should be crystal clear to the consumer where responsibility lies for dealing with complaints about both the advice given and about the product, and there should be a mechanism by which the FSA has oversight of the firm's handling of those complaints.
 - ❖ There is a subtle distinction in the London Economics report about where the responsibility for advice from the tied channel lies. In Scenario 1 it lies with a lead provider chosen by mutual agreement from all the providers involved, and with Scenario 4 it lies with the tied provider. The ambiguity in the first of these could lead to confusion and disagreement, leading to a poorer result for the consumer.
 - ❖ In Scenario 1 the new category of 'financial advisers' would be responsible for the advice they provide, regardless of who the product manufacturer is. We believe that this is a sensible

approach, and that for it to work the 'financial adviser' will need to be authorised.

- ❖ It is envisaged that 'financial advisers', as with IFAs at present, would be responsible for advice but not for dealing with complaints about the product itself. In other areas of consumer purchases where polarisation does not apply, the lack of transparency becomes less important because, under much consumer legislation (cf Consumer Credit Act 1974, Consumer Protection Act 1987) more than one party in the supply chain might have liability for the product. There are clear benefits for this approach in terms of consumer clarity.
- Consumers have access to an effective mechanism for compensation. As with complaints, it must be absolutely clear under what circumstances a claim on the compensation scheme can be triggered (ie whether it is the default of the product provider or the adviser).
- The regime is understandable. As noted above, there is considerable scope for confusion on the part of consumers. This arises both out of the transition from one regime to another and potentially out of the new regime itself (depending on what the regime looks like). (We note that the status quo is also beginning to struggle on this criterion, as well known tied brands begin to offer selections of products from other providers through financial supermarkets.)
- The regime is transparent. Clearly rules will need to be developed to inform consumers about the status of the adviser and what that adviser will and will not accept responsibility for. This will need to work alongside all the other information that firms must give including about their regulatory status (whether or not authorised), product disclosures and disclosures about access to complaints and compensation schemes.
- There is no weakening of the existing requirements for advisers to ensure that products are suitable. The test for suitability would need to be robust for tied and multi-tied advisers, as it is for IFAs.

- Clear responsibility for monitoring compliance with consumer protection rules.
- Cost benefits should be passed on to consumers.
- Access is not restricted for various groups of disadvantaged consumers. For example scenario 1 because it could increase choice for consumers who tend to use company representatives, but could encourage IFAs to go even further up-market.

30. Any new regime will need to meet certain key criteria to ensure that standards of consumer protection are maintained.

31. We look forward to further discussions on this important subject.

About the Financial Services Consumer Panel

The Financial Services Consumer Panel was established by the Financial Services Authority (FSA) in December 1998 to ensure that consumers' interests are represented in the development of the regulation of financial services. The Panel is independent of the FSA so that it can: advise the FSA on policy as it evolves, monitor the FSA's effectiveness in meeting its statutory objectives towards consumers, review developments in financial services where they impact on consumers, and publicly report its findings and recommendations. It can raise its own concerns and has resources to carry out its own research.

Who is on the Panel?

Barbara Saunders (Chairman)

Barbara is an independent consumer consultant, former public interest member of the PIA Board and past Chairman of the Council of the Insurance Ombudsman Bureau. Among other public and professional appointments she is a Non-Executive Director of the West Hertfordshire Hospitals NHS Trust and a member of the Architects Registration Board.

Colin Brown (Vice Chairman)

Colin is an independent consultant specialising in consumer affairs. Previously Deputy Director of Research at Consumers' Association and Senior Fellow at the Policy Studies Institute, he has over 20 years' experience of social and consumer research.

Jean Gaffin

Jean was Chairman of the Advisory Committee on Telecommunications for Disabled and Elderly People (until 31.12.1999) that provides advice to the telecommunications regulator, OFTEL, and is a Non-Executive Director of Harrow & Hillingdon Healthcare NHS Trust. She has extensive experience of working on behalf of vulnerable consumers. Previous positions include: the Executive Director of the National Council for Hospice and Palliative Care Services and Chief Executive of Arthritis Care.

Yvonne Gallacher

Yvonne is Chief Executive of Money Advice Scotland, which was set up by the Scottish Consumer Council. She has over 10 years experience of consumer credit/money advice issues and of working with vulnerable consumers in a variety of roles, including debt counsellor, trainer and manager. She is Co-Director and Secretary of the Government funded Lead Body for Advice, Guidance, Counselling & Psychotherapy (CAMPAG). Yvonne is a member of the Scottish Consumer Council.

Joan Harbison

Joan is Chief Commissioner of the Equality Commission for Northern Ireland. She was Chair of the Commission for Racial Equality for Northern Ireland since its inception in 1997 and is a former Chairman and member of the Executive Committee of the Northern Ireland Association of Citizens' Advice Bureaux. She has held a number of public appointments including being Vice Chairman of the Eastern Health and Social Services Board and the Northern Ireland Standing Advisory Commission on Human Rights and was a founding member of the Human Fertilisation and Embryology Authority.

Gerald Lanchin

Gerry is a Vice President of the National Federation of Consumer Groups. He is a former Under Secretary of the Consumer Affairs Division of the Department of Trade and Industry and author of "Government and the Consumer". His involvement in consumer protection includes being a former Council Member of Consumers' Association and of Consumer Congress Committee. He was the first chairman of the Direct Mail Services Standards Board and a member of the Data Protection Tribunal for 10 years.

Nick Pearson

Nick is the National Money Advice Co-ordinator for the Federation of Independent Advice Centres. A career spent in advice organisations including the National Association of Citizens' Advice Bureaux where he was manager of the Money Advice Support Unit, he has particular experience of credit, debt and personal finance issues and of working with vulnerable consumers.

Richard Smethurst

Richard is Provost of Worcester College, Oxford University; he chairs the Training Standards Panel of IMRO, of which he is a non-executive Director. He has served as an economic adviser in Whitehall, and the Monopolies and Mergers Commission, where he was Deputy Chairman. Richard lectures widely on financial and economic topics to businessmen and adult education groups. He is President of the National Institute of Adult Continuing Education.

Jane Vass

Jane is an independent consumer researcher specialising in financial services. She was previously Head of the Financial and Economic Research Group at Consumers' Association and is still author and editor of a number of Consumers' Association publications in addition to other research, including work for the National Consumer Council. Her current committee memberships include: Council of the Ombudsman for Estate Agents, the Inland Revenue Tax Law Rewrite Project Consultative Committee and the FSA Training Advisory Panel.

Dave Watts

Dave is a partner in a media business which is involved in publishing, editing and journalism - personal finance plays a large part in this. He is a former editor of "Which?" and "Money Which?" and former Assistant Director of Consumers' Association. He was also a policyholder representative on the Insurance Brokers Registration Council for nine years.

How to contact the Panel

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