<u>The Impact of Regulation upon the Retail Financial Services Sector</u>

Overview

Within the retail financial services sector the Financial Services Authority (FSA), in collusion with both the Financial Ombudsman Service (FOS) and the Pensions Ombudsman (PO), administers regulation. All three bodies are used to implement Government policy and strategy and cannot truly be considered as independent organisations.

All three organisations form part of a cause and effect chain whereby their rules, sanctions, initiatives and feedback serve to create or exacerbate many of the problems they are charged with resolving.

These organisations were established to provide a framework of regulation and protection for the consumer. The FSA's statutory objectives are;

a) The provision of market confidence

b) The promotion of public understanding of the financial system

c) Securing an appropriate degree of protection for consumers

d) The reduction of financial crime

Regulation has not been a success. Rather than instilling confidence in the UK as a financial centre the FSA has actively participated in painting a picture of constant systemic mis-selling of financial products and by its actions and pronouncements has brought the financial services industry into disrepute. Its actions have directly weakened the savings market and led to mis-trust of the industry and advisers in particular.

The UK currently suffers from record public and private sector pension deficits and also a record personal protection deficit. The incidence of personal debt is the highest, per head, in the world. It is clear that due to lack of public confidence, a lack of consumer education, an increasing cost burden and other disincentives to firms there is an increasing gap in retirement provision and life/health insurance provision.

The FSA has weakened the financial advice model and created confusion by the removal polarisation – the system whereby consumers dealt either with independent advisers or representatives tied to one company. Not one financial journalist has spoken in favour of de-polarisation as it is clear to them as it is to us that the only tangible result is consumer confusion and consumer detriment.

Financial crime is a growth industry and an area where FSA effectiveness is not discernible. Conversely it has failed consumers in a number of very public areas, most notably the Equitable Life debacle. Financial journalists regularly bemoan apparent FSA inattentiveness or inaction in dealing with financial scams ranging from so called 'boiler room' activity to unregulated financial dealings.

Regulation in itself is not the problem. However from modest beginnings it has burgeoned into an industry which feeds off itself and grows inexorably. With such growth comes the burden of cost and as industry funded animals both the FSA and the FOS are caught up in the ongoing pursuit of income whether from industry paid fees or from fines levied on those deemed guilty of rule breaches. As self-perpetuating industry bodies they hold a duty of care to budget responsibly and they should seek to diminish non-essential spending. Under their Principles of Good Regulation the FSA confirms, '*The need to use our resources in the most efficient and economic way*:

In reality the FSA acts in a profligate manner by lavishing vast sums on works of art for its offices - £253,000 at the last count, including one appropriately titled 'You've Gotta Lota Nerve'. It spends vast sums, £1.7m at the last count, on foreign travel and thinks nothing of spending upwards of £200 on taxi fares for its personnel, with £46,111 directly spent (as opposed to fares reclaimed via expense accounts) when last calculated.

The continued pre-eminence of the UK as leaders in the financial world is in danger of being eroded by the impact of regulation which in reality achieves the opposite effect intended. Whilst consumers are promised cheaper and more flexible products there is now a much lower choice due to companies such as Royal & Sun Alliance, Pearl Assurance, NPI, Alba Life, Britannic Life, Equitable Life, Abbey Life, Colonial Mutual Life and many others no longer able to continue trading because of economic and regulatory conditions.

The Problems

These specific headings are distinct but also bleed into other areas where they combine to augment and sustain the problems.

1. **The disincentive to consumers saving**
2. **The disincentive to advisers advising/selling**
3. **The stifling of competition**
4. **The constraints on creativity and commerce**
5. **The fee/commission debate**
6. **Product defects where advisers suffer the blame**
7. **The following matters have served as disincentives to consumer saving**
8. **The Paper Trail**
9. **The cost burden**
10. **The role of the Financial Services Authority (FSA)**
11. **The role of the Financial Ombudsman Service (FOS)**

1) The disincentive to consumers saving

- Loss of confidence due to the stockmarket volatility 1998-2003
- The legacy of Maxwell, the Equitable Life debacle, the Government's failure to act following the Parliamentary Ombudsman report on governmental culpability regarding pension scheme wind-ups. Additionally the gradual removal of the final salary pension scheme for non-public sector workers.
- The Treasury's £5bn annual tax on pension schemes, current estimated total £200bn
- The Pension Credit system, which penalises responsible consumers who save for retirement.
- The legacy of the three Pension Reviews, which incorrectly implied the systemic mis-selling of Personal Pensions on the false assumption that occupational scheme benefits were guaranteed.
- The impact of the split-caps collapse, which was in part caused by the knee-jerk reactions of regulators.

2) The following issues have created disincentives to advisers advising and selling;

- FSA rules, principles and sanctions.
- The 'rule' RU64, which inhibited firms from advising on personal pensions by warning of potential attention from the regulator. RU64 was proclaimed to be in the interests of consumers yet it served to reduce the take-up of pensions due to adviser concerns.
- The plethora of paperwork which advisers are required to provide to clients and prospective clients. See Part 7 'The Paper Trail'
- The accepted commercial protection of *caveat emptor* does not operate within financial services. This distinction provides for fear\and apathy within the financial community as claims seem to be encouraged by the press, the Financial Ombudsman Service and by the Financial Services Authority both on its website and within its public pronouncements.
- The actions of the FOS, which operates as a one-way system where innocent firms meet the cost – split between an annual levy and individual case fees – where the refuge of normal commercial law is denied. Under the terms of FSMA 2000 the FOS ignores the 15-year longstop on stale claims, allows hearsay evidence, refuses the right of cross-examination, ignores the European Court of Human Rights (ECHR) requirement for an appeals procedure and applies an inconsistent subjectivity to adjudications and decision-making in general.
- The Governments forcible design of pension plans whereby a 1% charge cap was applied to Stakeholder pension and John Hutton has recently suggested a 0.30% p.a. charging structure. Such structures barely allow for provider profit and fail to enable worthwhile commission incentives. On October 5th 2006, Professional Adviser reported that "*Abigail Morrison, head of retirement planning at Standard Life, said that because the commission they pay IFA's for distributing stakeholder pensions is very low, financial advisers tend not to sell the products. In terms of setting up a single premium for a new customer, Morrison explained that an adviser receives no commission and even for a pension with a 25-yearterm, an IFA only gets 8% commission of the first years premium. It is a challenging situation to make money from. Alasdair Buchanan, head of communications at Scottish Life, said the firm was not actively marketing its stakeholder pensions to individuals for the same reasons as Standard Life*."

3) The stifling of competition

- The FSA has taken to involving itself in the design of financial products. These activities are outside of its specific remit but its power is such that product providers and firms are helpless and afraid to show public dissent for fear of provoking a response.
- Regulatory Update 64 (RU64) warned advisers not to disadvantage clients by arranging pension plans that didn't accord with the provisions of stakeholder pensions. This was over two years before the introduction of stakeholder pensions and it served to seriously reduce the levels of adviser pension activity.

4) The Constraints on creativity and commerce

- The far ranging impact of the FSA's 'treating customers fairly' mantra is that it allows firms and providers to be reprimanded and sanctioned for failing to adhere to a principle. This subjectivity is a useful weapon for the FSA as it allows individual interpretation of some action or inaction however, as the FSA is witness, judge, jury and executioner, it creates an unease, which erodes confidence and suffocates creativity.

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5) The fee/commission debate

- The push from consumerists, the Government and various interested parties towards advisers switching to a fee-based model continues. Stakeholder pensions were designed to encourage social classes C, D and E to save for their retirement. One of the reasons behind its abject failure is the inability, inherent in the design of stakeholder pensions, to allow reasonable commission payments to advisers. The alternative, charging fees is doomed because the target market, social classes C, D and E, are both unwilling and unable to pay fees. They have effectively been disenfranchised.
- The inference that only fee-based commission can be independent and worthwhile whereas commission-based advice is portrayed at best as wanting and worst as reprehensible. The method of remuneration is a matter for the adults who are party to the advice process to decide. It is fact that the take up of personal pensions was higher before the introduction of stakeholder pensions. It is fact that the majority of advisers have switched their emphasis from retirement planning to mortgage, protection or investment planning.

6) Defects in product design

- Unlike any other industry the sales adviser suffers the responsibility and regulatory opprobrium stemming from the manufacturers faulty product design. This occurs despite the design faults being unknown at the time and despite the products having been 'approved' by the regulator.
- Between 1988 and 1995 the then regulator LAUTRO mandated that all pension/endowment providers should use a fictitious charges assumption when illustrating future investment returns. Twelve providers went further and used the fictitious charges, which were considerably lower than their real charges, to calculate premium levels. This resulted in hundreds of thousands of policies being issued on an incorrect basis. One of the eleven providers is assumed to be Standard Life because they have confirmed that in one instance a mortgage endowment was off-course from the outset by over 11%. It is not surprising that such plans have veered off-course and have therefore been the cause of consumer detriment. Additionally, the effect has been to incite complaints against the adviser. The adviser is liable for any losses as it is the advice that is investigated and not the product, this is yet another flaw of the Ombudsman system.
- The FSA is aware of the twelve companies responsible but refuses to name them or to confirm what, if any, action is being taken against them.
- The FSA has also confirmed that it considers itself a completely separate organisation from previous regulators even though many of the same staff continues to work there with uninterrupted service for final-salary pension purposes. This stance also provides for them to conveniently distance themselves from unwelcome accusations regarding

previous regulators misdemeanours. In fact the FSA is the same company as the Securities and Investments Board Limited, which was incorporated in 1985, it was simply renamed in 1997. It is company number 01920623, a company limited by guarantee with directors who are appointed by HM Treasury.

7) The Paper Trail

- The FSA believes that if firms provide consumers with reams of paperwork it will enhance investor protection. IFA clients who despair at the pages, brochures and other information they are bombarded with, do not confirm this viewpoint. By way of illustration a typical client who wishes to arrange a mortgage repaid by an Individual Savings Plan (ISA) and protected by a life assurance will receive the following documentation.

  a) A Business Card
  b) A Terms of Business Letter – typically two or three pages
  c) An Initial Disclosure Document (IDD) – typically three pages
  d) A mortgage Key Facts Illustration – typically six to eight pages
  e) An ISA illustration – typically one to three pages
  f) An ISA Key Features document – typically three to thirty pages
  g) A life assurance illustration – typically two to five pages
  h) A life assurance Key Features document – typically eight to twenty pages

  In addition to this the client will receive a mandatory product suitability letter for the ISA as well as a non-mandatory suitability letter relating to the mortgage.

  In total the client is likely to receive around seventy-five pages of documentation which experience tells us is unlikely to be read.

8) The Cost Burden

- There are numerous regulatory costs which firms are compelled to meet in order that they may continue trading.

  a. Annual FSA membership fees. These vary depending on the scope of business undertaken and the numbers of regulated individuals within the firm.

  b. A typical sole trader with one Clerical worker is likely to pay £2,978 for the current year.

  c. Annual FOS levy. Typical sole trader cost £190

  d. Annual Financial Services Compensation Scheme (FSCS) levy. Typical sole trader cost for current year is £2,982

  e. Annual Professional Indemnity Insurance (PI) varies greatly but a premium of around £5,000 would not be untypical with a compulsory £5,000 excess per claim.

7) The role of Financial Services Authority (FSA)

- Standard Life - by forcing Standard Life to offload £7.5bn of shares at the bottom of the recent bear market the FSA did a grave disservice to millions of with-profits policyholders. Standard Life reduced the equity content of its with-profits funds from 59% to 34% at the very time that markets began to pick up. Since then markets have increased by 50% and this has reduced the bonuses which policyholders would otherwise have enjoyed.
- Standard Life – in forcing the insurers hand the FSA set in motion the chain of events,

which precipitated the de-mutualisation of Standard Life. It is generally accepted that a mutual, whether insurance company or building society, provides better benefits and acts in a fairer manner than its non-mutual counterpart.

- The split caps fiasco – The FSA were warned about a small number of split capital trusts, which were possibly over-geared. They did nothing for six months. When put under pressure they made public pronouncements stating that they were investigating wrongdoings in the splits market. The press seized on this promoting woe and disaster, which became self-fulfilling. Investments trusts were hit across the board (20% of the FTSE350 index were investment trusts). Press comments panicked the consumer into selling which drove the FTSE100 down to the 3,400 level. As a result, good quality splits had to sell stocks to repay bank debt. The FSA has since set up FDL for claims against trust mis-selling resulting in many people receiving compensation without having suffered any loss.
- Depolarisation – a mistake of such magnitude that the scale of consumer detriment cannot be calculated. Until June 1st 2005 the consumer was aware that financial advice was provided either by an independent adviser (IFA) or the agent of one company. A type of free-form madness has replaced this where the adviser might be independent, restricted to selling the products of one company (tied) or restricted to selling the products of a number of different companies (multi-tied). Dan Waters, Director of Retail Policy at the FSA stated "*the removal of polarisation restrictions allows market participants to create innovative business models that respond to current market challenges and the needs of their customer base*" The reality is confusion for the consumer, an opportunity for banks and other organisations to maximise profits by offering a low standard of advice but nonetheless passing it off as if akin to 'independent advice'.
- The fear culture - historically the FSA and previous incarnation, the Personal Investment Authority (PIA), has ruled by fear. An example being the then Chief Executive of Prudential, Mick Newmarch, who dared to stand up to the PIA in respect of the Pension Review. He was swiftly removed as a result of regulatory pressures.
- The FSA claims not to be above the law. Additionally it claims to be accountable to Parliament yet, in 2004, it allowed consumers an additional six months to claim for endowment mis-selling. This negatively altered the protection afforded to firms under the Limitations Act 1980 and was carried out without the sanction of Parliament or the OFT and without consultation with IFAs who were denied the human rights and placed in a precarious position with their Professional Indemnity insurance once again.
- The FSA allows providers to use the cash surrender value as the base figure when re-projecting mortgage-linked endowment policies. Naturally this produces a lower figure than would have been achieved by using the true value. As low re-projections stimulate mis-selling complaints the FSA is actually eroding consumer confidence in financial services.
- The FSA has compiled rules relating to the calculation of compensation for mis-sold mortgage-linked endowments. The rules insist that the surrender value be used as the base figure for loss calculations even though the endowment may be retained. This results in betterment and flies in the face of the prima facie device of placing the complainant back in the position he would have been had the endowment not been purchased.
- Additional to the above, the FSA rules, as applied by the FOS, does not allow within the compensation calculation for any saving the complainant may have enjoyed through lower monthly outgoings using the endowment method. The end result is that a successful complainant will not be placed back in the position he would have been had he not taken the endowment route, he will enjoy betterment funded by the firm.

- The FSA is not only a costly, extravagant organisation it is also growing rapidly with a proportionate increase in cost. The following figures show how costs have risen;

1998/99	£168.3m
1999/00	£170.0m
2000/01	£179.8m
2001/02	£187.7m
2002/03	£221.1m
2004/04	£215.4m
2004/05	£253.2m
2005/06	£267.4m
2006/07	£276.1m

- The Centre for Policy Studies has issued two reports titled 'The Leviathan at large' and 'The Leviathan is still at large'. These in depth studies provided the following comments and snippets;

"The FSA is one of very few regulatory agencies which is funded not by the taxpayer, but by the industry it regulates"

"Many senior figures in the industry, understandably and lamentably, appear to be becoming obsessed with the daily detail of surviving the barrage of regulation, and the costs and management time associated (or perceived to be associated) with this"

"The increasing burden of regulation also leads to the risk, some would say inevitability, that financial institutions are pricing themselves out of parts of the mass markets for savings. the very markets that need encouragement"

"One of the most powerful and least accountable institutions created in the UK since the war"

"Its lack of accountability has nurtured a sense of disengagement and growing disillusionment within the financial services industry"

"The ability of the industry to plan and innovate is severely undermined"

"Innovation is at risk of dwindling, competitiveness falling and consumer choice declining"

"Revise the FSA's accountability to make it much less dependent on the Treasury, and more accountable to the industry that it serves"

"Address the ever-increasing indirect costs of regulation and their effects on the competitiveness of the industry both at home and abroad"

"Recognise the skills, sophistication and ability of senior management to manage their own business risks; and removing many of the prescriptive compliance burdens under which they labour"

"Clearly differentiate between wholesale and retail market sectors. This will demand functional separations within the regulator of far greater sophistication than at present"

"Quantify and reduce the administrative burden of regulations"

"Remove responsibility for consumer education from the FSA's remit; and to assign the responsibility for policing financial crime to the relevant criminal prosecution authorities"

"In conclusion, the FSA's original aim to be the .world's best regulator misses the point. Instead, the FSA should aim, by being the world's best regulator, to regulate the worlds cleanest, most competitive, most innovative and most successful financial market. Nothing less will do"

9) The role of the Financial Ombudsman Service (FOS)

- Due to the framing of the Financial Services and Markets Act 2000 (FSMA2000) FOS does not have to comply with UK law. Specifically it does not allow the accepted and essential commercial protection of the 15 years longstop on stale claims. This provides for a non-ending burden on firms which means they are unable to limit their liability. Former advisers – retired or in ill-health – and their widows, are hounded by the FOS in respect of historic advice. This persecution is not allowed in respect of any business activity other than financial services.
- FOS has assumed powers that extend beyond that of the judiciary. Chief Ombudsman Walter Merricks has confirmed that the FOS is "*not accountable to Ministers*." "Power tends to corrupt, absolute power corrupts absolutely".
- Unlike the court system the FOS does not place the onus of proof on the complainant. Neither does it allow personal hearings, cross-examination or full provision of evidence. FOS does allow hearsay evidence where inexperienced adjudicators sit in subjective judgement.
- The FOS does not offer an appropriate appeals process. Any 'appeal' over an adjudicators decision results in an Ombudsman reviewing the adjudication. This is an ineffective system as confirmed by statistics showing that only 5% of 'appeals' are upheld.
- The FOS frequently claims that firms have recourse to a Judicial Review. However there are two problems with this – firstly the cost is prohibitive and beyond the scope of most firms, secondly, a Judicial Review can only investigate whether due process has been carried out. The logic of any FOS decision cannot be considered.
- Whilst the complainant is able to pursue disallowed claims through the court system such a device is denied to the defendant firm. This and the aforementioned matters places the actions of the FOS in breach of Article 6 of the Human Rights Act, as confirmed in 1999 by the then PIA Ombudsman Sir Anthony Holland in evidence to the Parliamentary Committee vetting the FSMA Bill.
- Walter Merricks has acknowledged the FOS's unique position explaining, "*It is a one-sided scheme offering an unlevel playing field broadly supported by those playing up hill*". He has further confessed, "*We do not have to pretend to 'find' what the law is. We unashamedly make new 'law*."
- The Financial Services Practitioner Panel has also expressed unease. "*The panel has repeatedly pointed out the concern over the FOS's quasi rule-making abilities and the often blurred line of demarcation between the FOS and the FSA*."
- Firms are currently allowed two 'free cases' each year. After this the FOS will charge them £360 for each complaint regardless of the outcome. This means that fraudulent and opportunistic claims will cost the firm £360 even though the firm is exonerated of any blame. Retired advisers are charged £475 whether they are innocent or not and without being afforded the right of "equality of arms".

Suggested Solutions

1 The repeal of FSMA 2000 and its replacement by a system where there is a demarcation between the advice and the product. The current top-heavy FSA to be closed down and replaced by less unwieldy bodies which respectively regulate product providers and advice providers.

The FSA has shown itself to be impervious to criticism or challenge and as the CPS reports stated it hears but fails to listen. Clearly it is an organisation which is not willing to alter course or shape, and must be removed. Pruning and selective lopping will only result in later growth as it reverts to type.

2 The dismantling of the FOS to be replaced by tribunals made up equally of consumers and advisers. The basis of the tribunals should be established UK law and both parties should be allowed recourse to the courts if they believe the decision to be illogical. Additionally, there should be a complaint fee of £50/£100 which would be fully refundable in the event of a successful complaint. This would greatly reduce the incidence of fraudulent and opportunistic complaints and would also ensure that the tribunal would be a far smaller land less expensive organisation than current.

3 The acceptance that in the financial services sector there is room for both fee-based and commission-based advice. Neither route is the exclusive preserve of the skilled adviser and nor will either route provide an absolute guarantee of quality of advice.

All advisers have to meet minimum qualification standards with additional qualifications required in areas deemed to be specialist. Product or commission bias cannot be sustainable within an industry that relies on personal referrals and repeat business. These factors appear to have been ignored in the rush to find the new big idea for the promulgating of financial advice.

SUMMARY

The current system of regulation is not working. It has failed consumers and the industry alike.

UK financial services, like UK pension provision, were once the envy of the world. Both are now in a state of disrepair, which will ultimately lead to depredation if left without Governmental support and nurture.

The industry is finding it difficult recruiting suitable entrants who are anxious to avoid what is seen as a demoralised, withering industry where new ideas and entrepreneurial skills are often ignored or punished.

The industry is suffering from a despondency, which filters through to all areas including interaction with clients. Insurers have left and continue to leave the market. Foreign insurers are reluctant to enter the UK market as little profit can be envisaged whilst the downside of regulatory disapproval seems a likelier prospect.

Even Tony Blair was moved to comment adversely about the FSA, stating it was *"seen as hugely inhibiting of efficient business"*.

Any future regulation must act within and be seen to act within the law. Aiming for consumer enhancement without balance will spell the end of a once fantastically successful industry.