



# Financial regulation: consumer safeguard or straitjacket?

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## Introduction

There seems to be, at the moment of writing, a sigh of relief from some people in financial services thinking, “pew we got away with that then”. There is talk of green shoots after a shallower and shorter recession than many had feared. Whether from here we steadily climb back from the brink or whether, as the effects of the government's massive economic stimulus start to wear off, we begin to sink again, isn't clear.

After the ‘car crash’ there was a determination to ‘drive’ more carefully with much talk of increased regulation and bolstered supervision of the banks, but as optimism increases will we lapse back to the light touch and the old ways of taking too many risks?

The Financial Services Authority has already said that it will be more intrusive, to the point of making judgements about firms' judgements. This has real dangers for the regulator. The further the regulator goes down this route, the more it takes over from the board and ends up running the company and being responsible when things go wrong.

If we go back to where this all started for us in the UK, the failure of Northern Rock, the regulator was criticised for not intervening in the bank and curtailing its risky lending - but just months before it collapsed the Bank was still declaring profits and winning awards, rated best ‘first time buyer’ lender. At what point could the regulator, with confidence, have stepped in?

The U.K. model of less intrusive regulation gave financial services firms, including banks, the freedom to innovate but by extension that meant they might make mistakes. Until the crash, the light touch had been judged to have worked well, making the U.K. the top financial services centre in the world, eyed enviously in the



U.S. The Rock's business plan backfired when the unexpected happened and the supply of short term money, on which the Rock relied, suddenly dried up. It seems to me to be a very difficult decision for a regulator to say to a bank, which has previously been described as successful, "You must change your business model". The reaction from the board will be "why pick on us"? Investors will complain that profits are being curtailed.

Until a catastrophe happens a regulator can't prove that its view of the future is correct. Instead it must overrule the board and risk being proved wrong. Both the FSA and the Bank of England are pitching for new powers to intervene and seize control from a Board when it thinks things are about to go wrong but it will still be a very tough call for any Regulator to make. It means, as in the Northern Rock debacle, a regulator in effect telling a bank that it is making too much profit out of the marketplace and that it must stop.

Intervention on an individual firm basis will always be difficult but action across all firms to target systemic risks stands a much better chance of success. What we need for the whole sector is the regulatory equivalent of the governor on a steam engine. This simple but clever device stops the engine from running away with itself and exploding, instead keeping it running at a constant and safe speed. We need a systemic 'governor' for financial services, which can step in and stop all firms from engaging in over risky activity so that there is no individual commercial disadvantage. And it must be applied worldwide otherwise firms will use regulatory arbitrage to steal a march on their competitors.

To this end the G20 has proposed a new Financial Stability Board, with financial regulation and oversight extended to all financial institutions, instruments and markets. As panic set in its members were desperate to co-operate but as the dust settles and opportunities present themselves can the G20 maintain agreement on worldwide controls? The indicators it must watch out for are over-exuberance in markets. It was property and debt this time round, it could be something else next. The common signals are rapidly rising prices and substantial profits. But markets thrive on price swings. If prices don't move at all, there is no market, so any regulatory intervention must allow some movement but not the dramatic and destructive surge and crash seen in the last 2 years.



### The UK Consumer

I will be quite candid about this from the outset. I do not believe there is a perfect system of financial regulation that can protect all consumers at all times. We can only seek to steadily improve things for consumers, whilst fostering a successful industry.

So where are the most severe deficiencies at the moment? So much of what has gone wrong in the past has been due to mis-selling. From endowment mortgages to pensions and precipice bonds and payment protection insurance, consumers were persuaded to take on commitments which they didn't understand and turned out to be disadvantageous. They were misled by over-zealous marketing material or inappropriately motivated advisors. So much of the dissatisfaction and distrust felt by consumers would vanish if they could understand what they were buying. Instead they are regularly given half the facts about products that are twice as complicated as they need to be.

In some of the most competitive areas like insurance, firms with similar products are fighting to be in the top slot in the comparison tables. If they all have equivalent costs the only way of getting to be the cheapest in the 'Best Buy' charts is by shaving costs off some aspect of the offering and then inserting a condition in the small print which transfers some of the risk back to the consumer, for example, excluding certain medical conditions. This means consumers need to spend increasing amounts of time combing the conditions to tease out the downsides. Or they simply give up reading the small print and assume that their product has the same terms you'd expect for that type of product. When it then doesn't perform to their expectations they feel cheated.

And in the middle of all this there are calls by some in the industry and the regulator, which has issued a discussion paper on the subject, for consumers to be given greater responsibility for their purchasing decisions but I believe they cannot take responsibility if they do not understand what they are buying.

It seems to me that there are just three ways to deal with this lack of understanding. The first is education and the FSA's Financial Capability project is doing much good work in this area, but improving levels of financial understanding is a long term goal with a limit to its effectiveness. Then we can either regulate financial advice much more tightly, or simply ban unsafe and overcomplicated financial products.



### Unsafe Products

The latter is the route which may now be adopted in the United States. Harvard University law professor, Elizabeth Warren's proposal for a Financial Product Safety Commission has been backed by President Obama and is now before Congress. As professor Warren has put it,

*"It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street."*

The bill, as presently drafted, could mean that a new commission will be able to rule against products which are considered to be unreasonably risky. The commission will also be able to "prevent and eliminate practices that lead consumers to incur unreasonable, inappropriate, or excessive debt." This is clearly targeting the sale of mortgages to people who could not afford them, so called 'sub-prime mortgages', which are a widespread problem in the US, now seen as one of the causes of the present worldwide crisis.

We have always resisted regulating financial products in the UK but product regulation has been creeping in. The widespread mis-selling of Payment Protection Insurance has been tackled in part by regulation and single premium products, the most toxic, have been banned. Some of the worst aspects of Lifetime Mortgages, which enable older people to get an income from the equity in their homes, are also now controlled by regulation, but should we go further and say some people should not be able to buy certain riskier products? In fact, this now happens to a degree in the sale of some investments where, for example, unlisted securities can only be marketed to so-called 'sophisticated' investors.

Is this a route which we should pursue? Banning the sale of products to some consumers has a moral dimension. Is it right to prevent certain members of society from obtaining products available to others?

The sale of mortgages highlights the dilemma. Many mortgages have been sold to people who now cannot afford them. Citizens Advice reported on this last year, detailing cases like the 41 year old woman who had been persuaded to take out a £53,000 mortgage. She hadn't wanted to buy her local authority home and had three



children and a total income of just £1,278 a month. Spiralling into debt, she had gone to the CAB.

The negative view might be that mortgage brokers were pushing people into loans to grab the commission, as much as £1,000 per mortgage. But there is another view. Imagine you have found the home of your dreams and need a mortgage. You see a broker who tells you that on your present income it is unlikely you will get one. In desperation you ask if there is any way of getting a loan. You explain you will do anything to get this house, including giving up smoking, drinking and carousing, if the broker can only find some way of getting you the money. They say there is one possibility, a sub-prime mortgage. They can't say they advise you to do this but with a sub-prime mortgage you pay more interest because the lender thinks it is taking a greater risk. If you really thought that by scrimping and saving you could manage the repayments, try a sub-prime loan although it will be more risky.

In this situation the broker is the home buyer's hero and you could sympathise with a couple prepared to put in the extra effort and take the risk. As a society, rightly or wrongly, we have embraced home ownership as a good thing. Property gives you a stake in the community and, present conditions excepted, a growing asset. Should people be discouraged from trying to fulfil their dreams by giving them the chance, even though they might fail? Would banning products like these strike the right balance between safety and opportunity? In simple terms do we want a nanny state or personal responsibility?

Certainly, if consumers are given greater responsibility for buying financial products, which the regulator seems to be considering in its discussion paper, then surely we must ban products which are just too complicated for some consumers to understand?

### **Reliable Advice**

The alternative way to tackle mis-selling is to improve advice to consumers. In my view incentive payments to advisors are the cause of much mis-selling. A lack of appropriate qualifications is also important, but paying an advisor more for selling a particular product has got to distort their advice.



I've always believed that Independent Financial Advisors should be truly "independent". This means they should act as the agent of the consumer, with no financial interest in the product they finally recommend. I would advocate IFAs taking this one stage further - becoming the consumers' champion in the High Street, in an increasingly complex financial world. This means changing the present basis upon which a large part of the advisor community operates.

Instead of relying on commission paid by the product provider, IFAs would be paid by their client, the consumer. The outcome of the FSA's Retail Distribution Review has led to such a model for investment advisors, with the FSA's latest consultation paper proposing a complete ban on commission payment - and there are now signs from the regulator that this may be extended to mortgage brokers. My view is that this should apply to all financial advisors who want to be called independent.

The response from the industry is usually that consumers don't want to pay for their advice, but obviously they must be paying for it already in higher fees and charges to product providers, who then pay the commission. In the case of a mortgage the £1,000 of commission for the brokers is paid by consumers in the interest rate charged over the life of the mortgage. Advice isn't free to consumers now. We can avoid the need for the consumer to hand over cash to their independent advisor by arranging for the cost of the advice to be added to the product. The important factor is that the consumer and the advisor agree a fee for the advice at the outset, regardless of which product is recommended.

Now comes the really difficult part. Most financial products are sold by the High Street Banks by sales staff usually motivated by bonuses. If they sell more of product X, they get paid more. They are obliged by the regulator to sell only products that are suitable for the customer from the products in the Bank's range. The product doesn't have to be the best for them in their circumstances and the 'Advisor' can even sell them something they don't really need as long as it is suitable. This appears to be where most mis-selling arises.

The regulator has tried for many years to curtail this mis-selling without enduring success. A solution might be 'safe' products. If the regulator produced a list of straightforward, simple and safe products, which it defined in regulations, products which were not going to do harm to a consumer, although they may not have the



best performance either, these could be sold by Banks without much damage. This would be an extension of the existing stakeholder scheme.

So there are ways of distributing financial products which will result in fewer mis-sales and big losses for consumers. We must accept that some people find it difficult to understand financial products and are unable to appraise long and complicated terms and conditions. We could design for them a suite of straightforward, simple and 'safe' products which are described by half a page of terms. These will not severely damage them, even if their performance is not the best in the market place.

We could then stipulate that all other products must be sold through independent financial advisors paid by the consumer who will explain objectively what they are buying and who can select from the whole of the market.

### **Conclusion**

There won't be a better time to make radical changes to the regulation of financial services, but the stability of the system is now a worldwide concern and may only have an international solution. Can we expect international agreement to limit wild swings in global markets and, if not, can individual national regulators and governments still protect their own citizens?

In the UK we do have the tools to substantially reduce the mis-selling of financial products but this requires some important decisions to be made. Would it be right to ban the sale of more complex and risky financial products to consumers who might not be able to understand them? If a consumer plainly doesn't understand what they are buying, should a salesperson refuse to sell it to them? If they do sell it to them, should the sales person be liable if it fails? Would it be feasible and desirable to create a suite of straightforward, simple and 'safe' products with no more than half a page of terms? If such a suite of products could be created, should we limit the banks and other High Street retailers to the sale of these 'safe' products?