

## CONSUMER PROTECTION

### Why does No Monkey Business call for more product regulation?

When the same problems recur as they have in financial services, you have to ask whether there is something fundamentally wrong with the approach to regulation. After pensions mis-selling and mortgage endowments, did we really have to wait for with-profits investing, high income bond products and zero dividend preference shares to blow up in our faces? And what is it about their nature, rather than the way they were sold, that explains their explosive capacity and could have been disarmed?

These questions are largely absent from the FSA's consultation process for reforming the way the UK's financial advice market works, contributing to an impression that it is turning a blind eye to the fault line running through the heart of the regulation process. This is the failure to recognise the need to regulate the design and description of products and make product manufacturers legally responsible for them. It is peculiar to financial services. In other industries where consumer protection is paramount, such as food and over-the-counter drugs, the emphasis is on regulating manufacturers rather than agents in the distribution chain.

IN OTHER INDUSTRIES WHERE CONSUMER PROTECTION IS PARAMOUNT, SUCH AS FOOD AND OVER-THE-COUNTER DRUGS, THE EMPHASIS IS ON REGULATING MANUFACTURERS RATHER THAN AGENTS IN THE DISTRIBUTION CHAIN

Focusing on sales and advice processes required several unrealistic assumptions about the agents in these processes, whether direct sales forces, tied advisers or independent advisers. The first was that they would be willing parties in the consumer protection role. This ignored the dependent nature of the agents' relationship with product manufacturers, of which commissions are a key part.

The second was that distributors would be economically viable after saddling them with the cost of that role. Both the Sandler review and a broadly-based working party set up by the Centre for the Study of Financial Innovation have challenged this vital assumption.

The third was that advisers could spot the flaws in products or in the description of their risks. Since actuaries and regulators, amongst many others, failed to grasp the dynamics of investment products that are not even desperately complex, this seems particularly heroic.

The signs are that the FSA's depolarisation conclusions, due in December, and the Treasury's proposals for the new 'off-the-shelf' products that Sandler recommended, due in the New Year, will once again duck the central issue. However, two things are now occurring that are likely to overwhelm the politics of regulation. The first is that professional indemnity (PI) insurers have decided they are not going to provide all the capital for consumer compensation when products blow up. The second is that the with-profits vehicle for long term savings, representing as much as 20% of personal non-housing assets, is in the process of blowing up.

A crisis for IFAs who must obtain PI cover can be simply predicted as a function of lower capacity limits as many underwriters have withdrawn and, since the limits are expressed in terms of premium income, of premium rates rising sharply. Contrary to the FSA's line on this, the rationing approach underwriters are applying is a blanket one: they turn down

proposers who have past business in the areas where the FSA is inviting claims or exclude that business retrospectively.

The PI crisis reflects a worldwide capacity shortage but it is also a belated response to what insurers, like many on the industry, see as the arbitrary exercise of the FSA's statutory powers to allocate responsibility for negligence to agents instead of manufacturers, or instead of both. For instance, wherever a mortgage endowment policy was sold through an agent, even a tied agent, a claim is always referred to the agent and the cost of any compensation automatically met by the agent's PI underwriters. This ignores the fact that the way the companies set premiums and sold the capabilities of 'smoothing' were major contributors to negligence. No wonder the underwriters feel like suckers.

An unfolding with-profits crisis also makes it inevitable eventually that the FSA will regulate the design and description of products. Millions of with-profits investors are discovering that their investment policy is no longer based on their needs, consistent with some mix of assets suitable for long term return objectives, but is directed to remaining 'technically solvent'. In the process, policyholders are being dealt out of the equity market after it has fallen and have little prospect of being dealt back in until after it has recovered. Unfortunately, the contract terms do not include the right to switch to direct investment alternatives at fair value, based on their underlying asset share.

Yet again, the FSA will be blamed for not anticipating problems and for delaying action at the first signs of a blow-up. Sir Howard Davies will once again be cast in the role of 'the man who followed the Lord Mayor's show with a shovel and a bucket' – his words, not ours. But dealing with the fault line is a political not personal process. It is for the Treasury to set it in motion.