



19 April 2011

Our ref: ICAEW Rep 48/11

Your ref:

Jason Pope
Conduct Policy Division
Financial Services Authority
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Dear Mr Pope

Discussion Paper 11/1 Product Intervention

ICAEW is pleased to respond to your request for comments on Discussion Paper 11/1 *Product Intervention*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

DISCUSSION PAPER 11/1 *PRODUCT INTERVENTION*

Memorandum of comment submitted in April 2011 by ICAEW, in response to Financial Services Authority discussion paper published in January 2011.

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INTRODUCTION

1. We welcome the opportunity to comment on the Discussion Paper 11/1 *Product Intervention* (DP11/1) published by the Financial Services Authority.

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure these skills are constantly developed, recognised and valued.
4. The ICAEW Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest. It draws together professionals from across the financial services sector. This includes those working for regulated firms, in professional service firms, intermediaries and regulators.

GENERAL COMMENTS

5. We believe the discussion paper generally presents a representative analysis of the nature of the problems that have characterised the retail financial services sector and support its objective of addressing market failures and providing better protection to consumers. However, the efficient implementation of the existing regulatory framework and the implementation of the Retail Distribution Review (RDR) should be capable of addressing the issues you have identified in this discussion paper. The emphasis for delivering better regulation should primarily therefore focuss on ensuring existing principles and rules are effectively implemented on a consistent and timely basis.
6. There is a danger that greater levels of product intervention will restrict choice and raise costs, with little or no real long term benefit. However, we believe that there is a case for developing a taxonomy for classifying retail financial products according to their underlying purpose, complexity, counterparty risk, charges, and general nature and level of the risks involved. This approach would help consumers understand the generic nature and purpose of the products that are available thereby making it more attractive for consumers to engage in this market, whilst also helping them assess the relative costs and risks associated with different types of product.
7. Regulation should also encourage the development of straightforward, low-risk products which can be both developed and delivered on a cost effective basis. Clear and simple regulatory guidelines in this connection would help providers develop simplified products that are suitable for the mass market and which could be delivered cost effectively through a simplified advice channel. If this is not done there is a danger that more business will be driven to the non-advised distribution channel, which may not necessarily be in the best long term interest of consumers. In this connection, we support the aims and objectives outlined in HM Treasury Simplified financial products: a consultation, published in December 2010.

RESPONSES TO SPECIFIC QUESTIONS

Q1: What issues should we consider in relation to how our product intervention approach affects equality and diversity?

8. No comment.

Q2: How could we use our focus on products to promote equality and diversity?

9. No comment.

Q3: Do you have any comments on our market failure analysis ?

10. In general terms, we believe the broad thrust of the market analysis provides an accurate representation of the underlying nature of the retail financial services market. The combination of asymmetric information, credence goods whose performance will often not become apparent until many years after the point of sale, low levels of financial capability and the fact that consumers do not necessarily always act in their own long term best interest means the sector has the potential to generate relatively high levels of market failure. Market failures in the sector have been caused by a mixture of factors, including those referred to in your market analysis. However, problems in the sector have often been caused by low standards of ethical behaviour rather than as a consequence of poorly designed products, which is an issue that would not necessarily have been resolved by higher levels of product intervention. We do not believe the retail financial services market is necessarily unique as there are other markets which have some of these issues to contend with, such as the pharmaceuticals industry and the provision of health care.

11. The nature of the economic and financial environment changes over time and it is impossible to predict these changes with any degree of accuracy. This means that even simple and soundly based financial products have the potential to become problematic because they will perform very differently depending upon changes in the external environment. For example, level-payment annuities are generally perceived to offer good value in comparison to their index-linked cousins. However, if inflation was to exceed general market expectations in the longer term conventional wisdom could be turned on its head. If this happened, with the application of hindsight, the widespread sale of level-term annuities in preference to index-linked annuities carries the potential to generate widespread consumer detriment. With-profit policies arguably provide a further example of products that generally delivered positive outcomes over long periods, but which subsequently failed to meet expectations due to changes in the external economic environment. Furthermore, the personal circumstances of individual customers change over time and in ways that could not have reasonably been foreseen. Products that were entirely appropriate at the time of sale would not necessarily therefore meet the individual needs of customers going forward. Product intervention would not resolve the above types of problem. .

Q4: What do you think are the criteria by which we should judge when to intervene further?

12. The effective implementation of the existing regulatory framework should have largely prevented the problems referred to in your market failure analysis. Advised sales should always have been undertaken on the basis of a clear understanding of the facts and suitability, clear disclosure and communication of risks and best execution. The wide scope of treating customers fairly (TCF) should capture issues relating to charges, the development of products and services and their subsequent monitoring over time, and firms are already required to manage outcome risks. For example, TCF Outcome 2 covers the risk that propositions do not properly meet the target market; TCF Outcome 5 covers the risk that the product does not meet the expectations set; and management information and compliance monitoring should be structured to tell management if there is a problem in respect of suitability and longer term performance issues.

13. With the above in mind, we believe the emphasis in respect of addressing market failures should primarily be focussed on ensuring that the existing regulatory framework is more

effectively implemented. If this is done there should be limited need for further regulatory intervention. Furthermore, the implementation of the RDR should address many of the problems associated with product bias and remuneration practices and is intended to generate higher professional and ethical standards. When taken in the round, the existing regulatory framework should be capable of ensuring that products are designed to serve the needs of each customer segment so that the market can deliver affordable, differentiated products and services which are consistent with the long-term best interest of individual customers. Further regulatory interventions should therefore be limited to identifying areas of the market where the implementation of existing principles and rules has not been efficiently executed.

Q5: Are there any other relevant indicators that would help us identify potential problems

14. In general terms, we believe bundled products and wrappers, gearing, the use of derivatives and exposure to counterparty risk all carry a relatively high level of risk of market failure with associated risk for consumer detriment. This principle applies to both advised and non-advised distribution channels. It seems sensible therefore that the regulator uses detailed data of the distribution of products and securities that fall into any of the above categories to monitor the potential for market failure in a way that is consistent with a risk based monitoring and supervisory approach toward earlier interventions.

Q6: Do you have any comments on the supervisory approach we have adopted, or suggestions to help develop it?

We have no further comments to add.

Q7: Should we give further consideration to new rules to prescribe conduct by firms when designing and managing products?

Q8: If so, what should be covered?

15. The more effective implementation of existing regulatory principles and rules should be sufficient to ensure that the design and management of products is consistent with meeting the needs of different segments of consumers. However, it would be beneficial to develop common and straightforward standards to categorise different types of products according to their relative levels of complexity, charges, gearing and counterparty risk. This taxonomy of products would help consumers understand the nature and risks of different product types and what different types of outcomes different products are intended to deliver. This will help all consumers make informed decisions, comparing charges and the risks by having access to standardised simple and consistent information, delivered in a comprehensible format.
16. Simple products need to be developed and made available to consumers both on a simplified advised and non-advised basis. We believe this approach will generally deliver the most effective solution in the mass-market.

Q9: What would be the impact on the market?

17. We believe that a regulatory approach which primarily focuses on the better implementation of existing regulatory principles and rules strikes the correct balance. This approach should help providers to respond to underlying market demand so that they can serve the differentiated needs and interests of all types of consumers, whilst addressing problems associated with asymmetric information, imperfect competition and low levels of financial capability. The combination of developing common standards to categorise products according to simple criteria, with clear regulatory guidelines for developing straightforward lower risk products should deliver the best possible outcome for consumers and society at large. A simplified advice regime could add value here.

Q10: What would the implications be if we consider similar interventions for services as those discussed in this paper?

18. The approach outlined in this paper is equally applicable to the regulation of services such as platforms and discretionary investment management. The sector needs to be conceptualised in terms of an overall system for the delivery of retail financial advice and investment services, rather than in terms of individual components, and regulation of the sector needs to reflect this perspective.

Q11: Do you have any comments on any of the possible additional interventions?

19. We have no further comments to add at this stage.

Q12: Which activities would you define as non-mainstream advice for the purposes of developing additional qualifications?

20. ICAEW do not provide financial services qualifications. However, in general terms we believe the new qualification standards as required under the RDR, when coupled with adequate outcomes focussed CPD, should be sufficient to equip advisers to deal with mainstream activities as outlined in the Training and Competence Sourcebook. Advisers also need specialist knowledge and skills required to provide professional advice on specialist areas such as pension transfers, long-term care, equity release mortgages, securities, derivatives and portfolio management. We believe that there are other areas that require specialist knowledge and which may also pose potentially higher risks, such as structured and complex products. All advisers need to be able to demonstrate they have a thorough understanding of the products and special issues relating to their particular area of work. Specialist examinations, tailored modules and appropriate CPD should all help to ensure that advisers are able to deliver professional advice and to ensure that their knowledge is up-to-date with market developments.

Q14: Are there any other interventions we should consider?

Q15: What would the impact of these specific interventions be on the market?

21. We believe the combination of the more effective implementation of the existing regulatory framework and implementation of the RDR, coupled with the development of taxonomy to classify products and the development of simple products delivered through a simplified advice process should be capable of addressing the problems identified in this discussion paper.

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