

Financial Services Authority

# Treating customers fairly after the point of sale

June 2001



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The FSA would welcome comments on this discussion paper. Comments should reach us by 28th September 2001.

Please send comments by electronic submission using the e-mail address : [treatingcustomersfairlyteam@fsa.gov.uk](mailto:treatingcustomersfairlyteam@fsa.gov.uk)

Alternatively, comments may be sent in writing to:

Consumer Protection Department  
The Financial Services Authority  
25 The North Colonnade  
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London E14 5HS

**It is the FSA's policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise.**

# 1 Executive summary

- 1.1 The Financial Services and Markets Act ('FSMA') will provide the FSA with four statutory objectives. These are: maintaining market confidence, promoting public awareness, protecting consumers and reducing financial crime. The FSA is also required to have regard to a number of principles set out in the FSMA, including the need to use its resources efficiently and economically, to be proportionate in its actions and to minimise adverse effects on competition and innovation.
- 1.2 The FSA is developing a new risk based approach to regulation, based on its statutory objectives and the principles of good regulation. In 'A New Regulator for the New Millennium',<sup>1</sup> the FSA said "Our goal is to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal". We are also establishing a number of high level principles which will apply to all the firms it will regulate. One of these requires firms to pay due regard to customers' interests and treat them fairly.
- 1.3 The existing regime for financial products aimed at retail consumers is more developed in some areas than others. It focuses principally on the circumstances leading up to the purchase of a product but the consumer protection objective which the FSMA will place on the FSA does not make a distinction between events before and after the point of sale in delivering consumer protection. **Therefore the FSA has been examining what a fair deal for retail customers after the point of sale means and in that context:**
  - what the FSA interprets the basic principles of 'fairness' to be;
  - where and how 'unfairnesses' after the point of sale may arise and why;
  - what work is already going on to deal with these unfairnesses; and
  - what powers the FSA has to take any necessary further action.

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- 1.5 We have taken into account that there are a number of important regulatory, industry and consumer initiatives already in hand in this area. Examples are outlined in Annex C. In the light of these, the project's objective has been to establish priorities for further, more detailed work by the FSA. We have looked at issues arising across the retail financial services industry but have not aimed to investigate individual products or propose definitive solutions. Any further work, which proposes formal rules or guidance, will involve appropriate consultative processes.
- 1.5 This work is one of the industry wide thematic projects announced as part of the New Regulator for the New Millennium initiative. The work undertaken has been based on assessing what issues pose a significant risk to the FSA's statutory objectives and how the FSA can allocate its resources most effectively to mitigate on the risks which matter most.
- 1.6 This project has looked at general issues and trends arising across the financial services industry, and the work has included talking to a variety of industry experts and commentators, practitioners, consumer bodies, financial journalists, the Financial Ombudsman Service and other regulators, including non-financial services regulators.
- 1.7 We began by identifying examples of alleged unfairness to consumers through structured brainstorming, review of research findings and consultative meetings. We then classified the 200 or so examples by type, and evaluated them in terms of the risk posed to the FSA's consumer protection and public awareness objectives. Our conclusions are set out below, **and we welcome comment on them.**

### **Summary conclusions:**

- 1.8 Fair treatment of customers should maintain and raise customer confidence. This has to be good for customers and for firms.
- 1.9 But fairness is not a concrete or finite test. It is an established legal concept which gives the FSA and firms a set of values to work with in making business and regulatory decisions, taking into account the relevant circumstances. In the course of our work we have examined concepts such as policyholders' reasonable expectations and legal interpretations of what 'fair' means. **We have identified what we believe 'treating retail customers fairly' should include and explain what we think this means in this paper.**
- 1.10 The FSA sees part of its role as helping consumers to get a fair deal. It believes that this part of its role includes trying to ensure that financial products and services deliver what they are supposed to, that firms deliver what they say they will and that firms do not take unfair advantage of any asymmetry of

power and information that exists between them and their retail customers. But the FSA cannot guarantee fair deals for consumers.

- 1.11 We recognise that some ‘unfairness’ problems, which emerge after the point of sale, may be caused by events before the point of sale. So what happens before the point of sale is very important in setting up and defining how the longer-term relationship between a customer and a firm will run.
- 1.12 The FSA has wide powers under the FSMA in relation to the fair treatment of consumers. These include formal rules and guidance, consumer education, raising standards, and raising public and industry awareness. We also gained important powers to take action on across the retail financial services sector under the Unfair Contract Terms Regulations.<sup>2</sup>
- 1.13 We have identified significant areas where unfairness to retail customers can arise. These are:

- **Some products and information are difficult for consumers to understand**

*Some products lack transparency, are virtually impossible for most consumers to understand and are structured in a way that is liable to give rise to consumer detriment (including high up front charges, hidden penalties, and taking unfair advantage of one sided discretion).*

- **Customers are not kept appropriately informed after the point of sale**

*Customers are not always kept informed of how a product or service is performing or of other products/services now available that might be more suitable for them.*

- **Products and firms don’t always deliver what consumers are led to expect**

*Financial promotion and the sales process can create expectations among consumers which are unlikely to be met, often with unpleasant surprises further down the track.*

- **Customers are discouraged from changing products and product providers**

*In some areas there are financial penalties unrelated to the costs of changing product or provider and in others the ‘hassle factor’ can deter people from changing to better value services and products.*

- **Customers cannot always get their complaints dealt with fairly**

*Practice varies but many firms don’t give adequate priority to the effective handling of their customers’ queries and complaints and this is reflected in systems, resources, cultures and outcomes.*

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2 Statutory Instrument 1999 No. 2083

1.14 The FSA, industry, consumer organisations and Government are already tackling many of these problems through existing work or work already planned. For example:

- we have started work on a Review of With-Profits products which will include examining how products which have relied on the exercise of a very wide discretion can be made more transparent to consumers;
- on mortgage endowments, the industry will in future provide policyholders with re-projections every two years in addition to any contractual reviews, and major firms have taken steps to improve the charging structure of endowment products;
- the Association of British Insurers has established the Raising Standards quality mark scheme, enabling brands which meet specified standards to use a mark granted by an independent Accreditation Board; and
- the Government has introduced CAT standards (charges, access and terms) and encouraged the industry to adopt those voluntary benchmark standards for ISAs and mortgages. The Government is consulting on the possible extension of such an approach.

1.15 But there are areas where the FSA believes it should take some further initiatives. So we propose a programme of work as follows:

## **Further Work**

We intend to carry out a further programme of work on the areas discussed in this paper. The programme will start tackling the gaps we have identified in the light of initiatives already in hand.

## **1. Making products and information easier for consumers to understand**

The FSA intends to:

- use its rules on financial promotions and advertising, and its new Unfair Contract Terms powers, to promote the use of plain language and discourage unnecessary jargon in retail financial services consumer material.
  - ensuring that our current review of financial promotions<sup>3</sup> targets jargon and unclear language;

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<sup>3</sup> The FSA expects to consult on its conclusions from this review during autumn 2001.

- raising standards by publicising examples of good practice, and ‘naming and shaming’ where there is poor practice;
- reviewing policy documents and other consumer contracts and seek to remove clauses that are unclear and not understandable;
- publishing a paper setting out our approach to Unfair Contract Terms later in 2001;
- researching into how much reliance customers place on written as opposed to oral communications.
- **consider whether in addition to existing regulatory requirements relating to the sale of products to retail customers, there are products which, because of their inherent complexity or opacity, are unsuitable for sale to mass market retail customers.**
  - analysing the suitability of certain products for sale to mass market retail customers;
  - assessing the regulatory options including risk warnings, marketing restrictions or prohibitions on sale.

## **2. Keeping customers appropriately informed after the point of sale**

The FSA intends to:

- **review what mandatory information should be provided to retail customers after the point of sale and what the relevant costs and benefits might be, with a view to further consultation on any rules and guidance.**
  - taking stock of what information consumers currently receive in different market sectors;
  - analysing what information consumers need about types of different products and services after the point of sale;
  - increasing the frequency of review of regulatory projection rates for investment performance.



### **3. Reducing the gap between what consumers are led to expect and what is delivered**

The FSA intends to:

- **progress its review of how to use its powers on financial promotions, with a view to minimising the risk that consumers have unrealistic expectations of what they're buying based on marketing material.**
  - considering the scope of our powers from N2;
  - determining the extent to which we should be proactive in this area in order to provide appropriate customer protection, promote public understanding and set fair standards in the market place;
  - publishing a Consultative Paper on our proposed policy stance on financial promotions in the autumn.

### **4. Removing unfair barriers to customer mobility**

The FSA intends to:

- **review where barriers to switching exist, and whether they are disproportionate or unfair, and what action might be needed as a consequence.**
  - researching into why customers do not change products and product providers;
  - analysing individual products to help identify product features (such as front-ended charges, low surrender values, etc) that might prohibit changing product or provider;
  - considering whether such charges are disproportionate or unfair;
  - taking action as appropriate using unfair contract terms or other powers;
- **promoting consumers' understanding of the choices available to them through:**
  - use of comparative information tables;
  - other consumer education.

## **5. Ensuring that consumers can get their complaints dealt with fairly**

The FSA intends to:

- **reinforce the introduction of the new regulatory regime relating to complaints with focused action on compliance with the new rules.**
  - identifying problem areas and trends through the gathering of information received from firms on complaints, information from the Financial Ombudsman Service and other sources;
  - taking action when problems have been identified which might include targeted compliance visits to relevant firms, follow up with customers and possible enforcement action if appropriate;
  - focusing on the extent to which the treatment of complainants is uneven;
- **take forward work on the Cruickshank Report's<sup>4</sup> recommendation that the FSA should compile and publish comparative tables on complaints from retail customers received by firms.**
  - considering what indicators of how firms handle complaints would be most useful;
  - considering how data on firm's handling of complaints should be presented and explained;
  - considering the best way of incentivising firms to improve standards of complaint handling whether by means of publishing comparable data, or whether by providing firms with their own data benchmarked against their peers;
  - publishing a consultation paper in 2002.

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4 Cruickshank, D., "Competition in UK Banking", February 2000

# 2 Introduction and background

- 2.1 In the second half of 2001, the Financial Services Authority (the 'FSA') will become the single financial services regulator for the UK, when the Financial Services and Markets Act (FSMA) is implemented. The FSMA will provide the FSA with four statutory objectives (protecting consumers, maintaining market confidence, promoting public awareness and reducing financial crime).
- 2.2 The FSMA gives the FSA wide powers in relation to the supervision and regulation of firms carrying on regulated activities. These include powers to make rules governing the way firms conduct business with consumers; to issue guidance of a general kind directed at consumers and the public generally; and to produce guidance directed at firms as to the standards which they are expected to achieve when complying with rules. Annex B to this paper sets out in more detail what the FSA's powers will be.
- 2.3 The FSA is developing a new risk based approach to regulation, explained in 'A New Regulator for the new Millennium',<sup>5</sup> based on its statutory objectives and the principles of good regulation. Under this approach, the FSA sees its goal as **maintaining efficient, orderly and clean financial markets and helping retail consumers achieve a fair deal**. We have also set out a number of high level Principles which the firms it regulates must observe, which include paying due regard to the interests of customers and treating them fairly. Much - although not all - of the existing regime focuses principally up to and including the point of sale, but less so after the point of sale. However, the consumer protection objective, which the FSMA will place on us, does not make a distinction between concepts of before or after the point of sale.
- 2.4 Therefore the aim of this work has been to examine what a fair deal for retail customers may mean and what treating them fairly involves. This work is one of the industry wide thematic projects announced as part of the New Regulator for the New Millennium initiative and which forms part of the FSA's new risk based supervisory approach. Accordingly, the work undertaken has been based on assessing what developments or issues pose a significant

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risk to the statutory objectives and how the FSA can allocate its resources most effectively to mitigate them.

- 2.5 **Our objective has been to identify areas where unfairnesses may arise for retail customers which may require specific attention by the FSA.** This project has therefore been aimed at fact-finding and looking at issues arising across the retail financial services industry at a generic level. We did not aim to investigate individual products or to propose definitive solutions. Issues raised will be taken forward as part of a more formal policy making process with appropriate consultation.
- 2.6 The project has therefore involved looking at general issues and trends arising across the financial services industry, and has included talking to a variety of industry experts and commentators, practitioners, consumer bodies, financial journalists, the Financial Ombudsman Service and other regulators, including non financial services regulators.
- 2.7 We began our work in August 2000 by identifying practical examples of alleged unfairnesses to consumers, on the basis of a combination of structured brainstorming, research, and meetings with a wide variety of consumer and industry bodies, the Financial Ombudsman Service, and regulators.
- 2.8 The process produced over 200 examples. We examined these examples for common themes, causes and problems and used a variety of informal discussions with external bodies to identify key areas for further research and internal discussion.
- 2.9 Our work included a review of existing research and literature, either commissioned by the FSA or from external sources. Because of the topicality of the issues we were examining, we concentrated mainly on material published within the last 3 years and reviewed some 25 surveys,<sup>6</sup> reports and reviews,

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6 Cruickshank, D., "Competition in UK Banking", February 2000DTI Report on Switching Suppliers: July 2000  
James, Kevin R., "The Price of Retail Investing in the UK", FSA Occasional Paper #6, February 2000  
PIA: 1998 Disclosure Report.  
OFT Research Paper 11: Consumer Detriment under conditions of Imperfect Information (August 1997)  
FSA Consumer Research 1: Better informed consumers (April 2000)  
FSA Consumer Research 2: Stakeholder Pension Decision Trees (June 2000)  
FSA Occasional Paper Series 11: CAT standards and stakeholders; their role in financial regulation (September 2000)  
PIA Consumer Panel: Consumers' use of post-sale information  
FSA Helpline Satisfaction Survey  
FSA Cost-benefit analysis of statutory regulation of mortgage advice (October 1999)  
Qci Customer Management: The customer management scorecard; State of the Nation (2000)  
PIA Sixth Survey of Persistency of Life and Personal Pension Policies  
Which? Survey on Complaints (2001)  
FSA Occasional Paper Series 9: Past Imperfect? The performance of UK Equity Managed Funds (2000)  
TMI for the Institute of Customer Services: National Complaints Culture Survey 2000  
Financial Services Consumer Panel Annual Report (1999 and 2000)  
Theories about money- implications for policy: Jan Pahl at University of Kent at Canterbury  
Fate, hope and uncertainty: Future Orientation and forward planning (Kate Rowlinson for the Joseph Rowntree Foundation)  
The Retail Investment Funds Attitudinal survey by Deloitte & Touche and Autif  
Consultation Paper 70: Mortgage Regulation: The FSA's High Level approach (November 2000)  
Response to Consultation Paper 28: Comparative Information for Financial Services (June 2000)  
Consultation Paper 53: The Regulation of Approved Persons: Controlled Functions (June 2000)  
FSA Research into Regulatory Status Disclosure  
Consultation Paper 49: Complaints Handling arrangements: feedback statement on CP33 and draft rules (May 2000)

including the Cruickshank Review of Competition in UK Banking, consumer behaviour surveys commissioned by the Financial Services Consumer Panel, the Department of Trade and Industry (the 'DTI'), the Office of Fair Trading (the 'OFT') and Government reports, and research and consumer groups' reports.

- 2.10 In parallel with this, and still refraining from making any judgement about how 'fair' or 'unfair' these examples were, we carried out legal analysis of what 'fairness' is, including concepts such as policyholders' reasonable expectations, and what the FSA's powers are in this area. The results of this work are described in Section 3 and Annex A of this paper.
- 2.11 We then consolidated the outputs of this work and proceeded to identify the key risks to achieving our consumer protection and public awareness objectives.
- 2.12 This consolidation identified five main areas where we believe unfairnesses may arise for consumers. These are where:
- some products and information are difficult for consumers to understand;
  - customers are not kept appropriately informed after the point of sale;
  - products and firms do not always deliver what customers are led to expect;
  - customers are discouraged from changing products and product providers; and
  - customers cannot always get their complaints dealt with fairly.
- 2.13 We then examined what work is already in hand by the FSA and other bodies which should contribute to the fair treatment of retail customers and what the industry's approach is in this area. The conclusions we reached are set out in Section 4.
- 2.14 Finally, we undertook a gap analysis to identify what work might need to be done in relation to the five areas of potential unfairness we had identified. This analysis, together with the lists of proposed actions by the FSA is set out in Section 5.
- 2.15 Throughout this work, we encountered an extraordinary similarity in the issues raised and the messages received, albeit often from different viewpoints. This commonality of themes is reflected in this paper, along with the various perspectives examined.
- 2.16 We bore in mind what consumers' expectations may be of the FSA as a regulator. It is difficult to quantify expectations at this point. While recognition levels of the FSA are still low they are rising, although we will need to be careful to distinguish ourselves from other regulatory bodies and will need to recognise that consumers are unclear about what the FSA regulates. Accordingly, if we are to contribute effectively to getting a fair deal for retail customers, it is important that consumers and their representatives understand what the FSA's role is in this. We hope that this paper will contribute to promoting such understanding.

# 3 What 'treating retail customers fairly' means

## What is 'fairness'?

- 3.1 'Fair' is a term we all use. We all feel we know subjectively what it is, even if we cannot specify exactly what it means. We began our work on this project by examining what 'fairness' is, and what it means, to inform our subsequent work on what sort of 'unfairnesses' may exist between firms and consumers.
- 3.2 We examined a wide variety of judicial pronouncements, statutory interpretations and fiduciary duties, as well as interpretations by other regulators and relevant organisations, including regulators of the privatised utilities, the OFT and the Financial Ombudsman Service. We also compared these with European equivalents of 'fairness'.
- 3.3 We concluded that 'fairness' is not a definitive concept. Instead it represents a series of values, which help us to decide how to behave and treat others. For a regulator, such as the FSA, it helps to illuminate the kinds of behaviour and outcomes for consumers which should be or might be of concern for the FSA but it does not deliver answers to policy issues.
- 3.4 We outline our conclusions from this work in more detail in Annex A to this paper. But a summary of what we concluded as being 'fair' includes:
  - honesty, openness and transparency;
  - disclosure, as necessary on an on-going basis, to the customer of material information;
  - honouring of representations, assurances, and guarantees where this leads to a legitimate expectation in the mind of the customer;
  - treating like situations alike and differentiating appropriately between different situations;
  - acting impartially and reasonably, having regard only to relevant issues and not taking into account irrelevant issues;

- acting with integrity and in good faith;
- acting with reasonable competence and diligence;
- refraining from exploiting customers or acting capriciously; and
- being reasonable about putting right things for which one is responsible and which have gone wrong.

3.5 This is not an exclusive check-list. ‘Fairness’ is a flexible, dynamic and time sensitive concept. It is not one sided, and its operation is dependent on the circumstances of the issue or case in question. It is therefore a relative and, to a certain extent, subjective concept. So, for example, in the financial services context, what is ‘fair’ might depend on what the relationship is supposed to be between the customer and the firm and whether it relates to a single transaction or relates to a financial service which is ongoing and relationship based, such as investment management, stockbroking or custody services.

## **What might ‘good practice’ to deliver fair treatment look like?**

### *Standards already applying*

- 3.6 In order to consider what good practice to deliver fair treatment might look like, we started by considering what kinds of standards firms already apply. Obviously this depends to a considerable extent on how far a sector is subject to statutory regulation, how far an industry code applies, and what a firm’s own internal standards and attitudes are - much of which will depend on which part of the market the firm operates in and what its customer profile is like.
- 3.7 The kinds of standards used in the financial services industry vary from sector to sector. We examined the FSA’s own regulations as well as a limited number of industry codes, including the Association of British Insurers’ (the ‘ABI’) Claims Code, the Banking Code, the General Insurance Standards Council Code, the Mortgage Code and the ABI’s Raising Standards initiative.<sup>7</sup>
- 3.8 We concluded that there are a number of principles which are common across the industry codes and which bear comparison with our analysis of what being ‘fair’ is, including:
- acting fairly and reasonably;
  - providing clear and accurate information to customers;
  - being transparent in dealings with customers;
  - providing customers with help and assistance to understand relevant products and services;

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<sup>7</sup> This is a voluntary quality mark scheme. The scheme aims to raise standards in the long term savings and risk sector and thereby increase consumer confidence and the level of financial provision consumers make for their future welfare.



- acting in accordance with the spirit as well as the letter of the relevant rule or clause in a code and standing by any implied meaning; and
- maintaining clear and simple procedures - especially those relating to complaints processes.

3.9 We noted however that the treatment of retail customers is not always fair. We concluded that:

- as codes tend to be principles based, rather than prescriptive, it is important that firms comply with their spirit; however in practice that often makes the codes subject to interpretation, and in some firms the provisions within the codes may be reinterpreted by compliance departments as a ‘rule’ or defence for the firm and applied as such; the ‘spirit’ of the code may therefore become secondary or even lost; and
- whether requirements are statutory and compulsory, or non statutory and voluntary, how they feed through to the treatment of customers will depend a great deal on the attitudes of a firm, its staff (senior through to front line staff) and the processes and systems which it uses.

3.10 Treating customers fairly is therefore as much about attitudes and behaviours as it is about requirements. Consequently the kinds of principles and values, which we have outlined above in our conclusions of what ‘fairness’ is, become very important in measuring and changing behaviours.

*Comparison with other industries’ standards*

3.11 We also examined standards and attitudes in other industries, to see how they measure up to those in financial services. We undertook some preliminary research into the retail food and non-food industries, gas and electricity, telecommunications, and manufacturing industries.

3.12 We found that the standards adopted by different industry sectors vary significantly and accordingly it has only been possible to make broad, high level comparisons. Within each sector there are a very large number of obligatory standards. Indeed, there are at least 1,300 different applicable pieces of legislation which set relevant consumer protection standards across these industries, together with a range of standards that may be adopted by different market participants based on their own risk management and customer care priorities.

3.13 In general, the industries reviewed operate more on the basis of prescriptive manufacturing and service quality standards than does the financial services industry, despite the development of CAT standards in financial services. Many non-financial services standards are largely defined by legal product liability responsibilities and risk exposures relating to tangible products, arising from health and safety concerns.



## Conclusion

- 3.14 In the course of making this comparison, we examined what a cumulative list of types of standard applying to retail financial and non-financial services industries would look like. We found that the list we derived could amount to a good description of the kind of cradle-to-grave standards which might be needed to deliver fair treatment throughout the life of a financial service or product.
- 3.15 This model therefore includes:
- **product quality standards** - products should be transparent and jargon-free;
  - **advertising and promotion standards** - the delivered messages should be clear, fair and not misleading;
  - **selling and advisory services** - minimum standards of practice should be set which should be strictly controlled and effectively monitored/enforced;
  - **ongoing service standards** - minimum standards should be established, communicated and effectively monitored and enforced;
  - **standards for complaints handling and establishment of redress mechanisms** - again, minimum standards should be established and controlled to ensure that consumers are treated fairly and receive adequate protection; and
  - **standards for compliance** with statutory/non-statutory requirements.
- 3.16 This is the model which we have applied to assist us in identifying how and where the FSA may need to act in relation to the fair treatment of customers and the problems which customers face.

# 4 What are the fairness issues?

4.1 As a result of the work done during this project, we believe there are five key areas where unfairness can arise. In this section we examine how and why these issues occur so that we can then identify what action we believe the FSA may need to take in response to these areas. They are:

- some products and information are difficult for consumers to understand;
- customers are not kept appropriately informed after the point of sale;
- products and firms don't always deliver what customers are led to expect;
- customers are discouraged from changing products and product providers; and
- customers cannot always get their complaints dealt with fairly.

4.2 In examining these areas, we reached two conclusions which we think it is important to mention at the outset:

- **many post sale 'unfairnesses' originate before the point of sale;** we have found that many of the things which 'go wrong' after the point of sale, have their root in the pre-sale process, often via advertising which leads the customer to form expectations about what they are buying and how they will be treated; and
- **there is an interplay of factors contributing to 'unfairness';** for example, consumer behaviour and low levels of understanding can play a significant and complex part.

## The consumer perspective

4.3 In normal circumstances, a consumer buying goods, such as a washing machine, will know what they want it to do, and how much they are prepared to pay for it. They will be able to use it virtually immediately, so that if it does

not work they will be able to spot that it doesn't and will have a manufacturer's guarantee to rely on.

- 4.4 But financial services products are different. They are intangible, often involving the performance of a service by someone else who is much more expert, with a benefit for the consumer some time in the future and an expectation of something being delivered, with an element of risk and a future value and cost which may be difficult to foresee, especially for the consumer.
- 4.5 Financial services therefore inherently involve an imbalance of power and knowledge between the firm and the retail customer. This means that retail customers are not well placed to counteract any unfairnesses they face and it is important that firms take account of this positively in their dealings with customers. This is a particular problem with complex products and information. Consumer understanding of financial matters varies enormously, but in general it remains low and research consistently bears this out.<sup>8</sup> Moreover, basic skills such as reading and arithmetic underpinning this knowledge, can be low.<sup>9</sup>
- 4.6 Few consumers are confident or knowledgeable about financial products and many feel that firms and advisers may not explain things well. In a survey of over 1,200 consumers conducted for the Financial Services Consumer Panel by MORI<sup>10</sup> it was found that:
- few consumers shop around for investment products - one third of people in the survey looked at only one product provider;
  - around one in five financial advisers did not explain charges and commission levels well;
  - almost one in three consumers did not feel confident about trusting banks and insurance companies with their long-term savings; and
  - 40% of consumers in lower social classes believe banks are the best place to go for independent advice,<sup>11</sup> even though at the time of the survey, banks could not provide such advice.
- 4.7 This lack of understanding also extends to complaints processes,<sup>12</sup> how investment returns can rise and fall and the current low inflation/low interest rate environment. The FSA is undertaking separate work on the implications of the economic environment and its conclusions are published in a Discussion Paper.<sup>13</sup>

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8 Examples include: Mori's poll 'Compulsory Pensions For All' (15/02/00) ; Department of Education and Employment (1999)

9 MORI, survey on numeracy for the BBC, MORI: 'Motivating Adult Learners' (12/00)

10 Survey by MORI financial services for the Consumer Panel, 1,252 face-to-face interviews were carried out with adults who identified themselves as 'financial decision-makers'.

11 FSA Occasional Paper Series 11: CAT standards and stakeholders; their role in financial regulation (09/00).

12 NOP Survey: FSA Complaints Research (06/99): while two thirds of people claim to have heard of the term 'Ombudsman', only a third of those correctly identified what the Ombudsman's role is .

13 Low Inflation: Implications for the FSA: FSA, April 2001

- 4.8 Consumers have to be reasonably financially astute to question whether they are getting a good deal and to be able to do something about it, such as switch products, if they are not. For a start, the number of different varieties of the same product can be confusing. For example, a common estimate of the different types of mortgage in the UK is 4000 to 5000.<sup>14</sup> In addition, consumers need the information and understanding to be able to think through their options. For example, TESSA customers querying comparability with ISA rates had first to be aware that rates on their accounts had fallen, then had to know what their options were to get an improved rate including the potential to switch suppliers; and any terms and conditions on their account which might prevent them doing so. This highlights a problem when consumers' poor levels of understanding make them doubly reliant on institutions for information.
- 4.9 But consumer psychology also plays a part, particularly in relation to priorities and expectations. For example, FSA's research on persistency of life and personal pension policies<sup>15</sup> shows that when entering into transactions and relationships, consumers may not consider sufficiently what changes may occur in their personal circumstances before taking financial decisions. Indeed other research<sup>16</sup> suggests that consumers sometimes deliberately do not consider future negative events on the grounds of 'not tempting fate'.
- 4.10 There can be a real expectation gap between the consumer's and the firm's perception of their relationship, particularly where customers have long standing relationships with a firm,<sup>17</sup> and therefore they assume an element of the personal into their relationship which the firm does not reciprocate. But firms often feed this misperception. The focus of many firms on recruiting new customers, often with strong brand focus and follow up telephone calls, misleads customers into assuming that they will get the same level of personal attention once they have signed on the dotted line. Moreover, consumers may equate service with personal service and therefore new technology, installed with the aim of improving service, may ironically frustrate customers who are looking for someone to take personal responsibility for them.
- 4.11 Financial services are an important part, if not a conscious part, of most consumers' lives. Around 80% of UK households have a current account. Two-thirds of households have some kind of bank savings or investment product.<sup>18</sup> But financial services are not necessarily a high priority for most people and research<sup>19</sup> shows that finance is a low ranking decision for many people. Consumer culture is still generally marked by financial inertia where people

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14 DTI Report on Switching Suppliers: July 2000

15 PIA's Sixth Survey of Persistency of Life and Personal Pension Policies: (12/00)

16 'Fate, hope and insecurity: Future orientation and forward planning' (Karen Rowlinson), published for the Joseph Rowntree Foundation by the Policy Studies Institute, May 2000

17 Cruickshank, D., "Competition in UK Banking", February 2000. The average length of time a current account is held for is 11.1 years, savings accounts for 9.9 years, and mortgage accounts for 7.5 years.

18 Source: 'In or Out' FSA July 2000.

19 DTI report on Switching Suppliers: July 2000

would rather not spend time and energy shopping around and remain attached to recognised brands. A recent survey for the FSA Consumer Panel showed that for recent purchases of all products to be regulated by FSA, two-thirds of people only used one information source.<sup>20</sup> Other research shows that 50% of people surveyed agreed that ‘life is too short to worry about saving a few pounds here or there’.<sup>21</sup> This means that getting the best deal will often not be the most important factor for consumers and they may even feel they are acting rationally in balancing the cost to their time and energy against the saving they will make.

## **The industry and competition perspective**

- 4.12 The extent and form of competition in retail financial services is affected, amongst other things, by the long-term nature of the contracts and information asymmetries between buyers and sellers. These interact with the industry structure and consumers’ general understanding of financial services and result in low levels of moving between products and providers, lack of transparency, and (product) complexity. As a result competition in retail financial services is not as effective as it could be.
- 4.13 Existing customers often lose out at the benefit of new customers as firms focus their attentions<sup>22</sup> on attracting new customers rather than retaining existing business. Although the cost of attracting new customers is higher than keeping existing customers,<sup>23</sup> low levels of customer mobility combined with possible barriers to changing product and provider mean that existing customer bases remain relatively stable, leaving firms to concentrate on competing for new customers, albeit to the benefit of those customers.
- 4.14 In addition, where the focus of competition is on new customers, there can be less incentive for time consuming explanations of complex provisions such as use of discretion, beyond complying with regulatory requirements, while urging consumers to consider negative life events such as redundancy, sickness or death can appear as depressing and risks putting the consumer off the purchase.
- 4.15 But commercial pressures on firms are beginning to cause changes in the way they treat their existing customers. Firms claim an increased recognition of the importance of retaining satisfied customers (and often cross selling other products to them) as against spending large sums to acquire new customers and taking their existing customers for granted.

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20 FSA Consumer Panel 2000 Annual Report

21 Research by FDS International Limited (05/00) for the DTI report on Switching

22 For example, existing lenders seem to compete for new business offering sizeable discounts, etc. at the expense of existing customers who do not benefit from these, (FSA, “Cost-benefit analysis of statutory regulation of mortgage advice”, October 1999), though recent developments suggest that this might change in the future. Similarly, the Cruickshank review suggested that about 50% of those interviewed had the current mortgage for more than five years (Cruickshank, D., “Competition in UK Banking”, February 2000).

23 For example, a recent study of service industries finds that the cost of attracting new customers is between two and twenty times as great as the cost of keeping existing ones, Goodman, O’Brien and Segal, 2000.

## Problems faced by customers

**Problem 1: Some products and information are difficult for consumers to understand.**

### *Complex products*

- 4.16 Financial services products and services vary in complexity and transparency, from a fairly straightforward bank current account to a more complex investment product or service. How far a consumer understands a product depends on how complex or transparent the product or service is, how clear and simple any relevant information is, how financially sophisticated the customer is and how good an explanation is provided where advice is sought.
- 4.17 Even fairly straightforward products may involve unfamiliar or complex concepts which can be difficult to understand or explain. For example, few borrowers understand terms such as ‘variable rate’. The Cruickshank Report found that only a quarter of people correctly understood that variable rate means the interest rate varies at the lender’s discretion.<sup>24</sup>
- 4.18 Unfairness can arise where products are unnecessarily or unreasonably complicated or opaque, or where customers do not understand sufficiently the key consequences of what they have bought. For example, a customer does need to understand exactly how an authorised unit trust works, but they do need to be told that as a consequence of how it works its price can go down as well as up; however because it invests in a spread of shares it is safer than buying an individual stock. Problems can therefore arise if customers have not understood what they were told or what they bought and if they cannot spot when things go wrong and get the problem sorted out.
- 4.19 There may be some products which, because of a high or unnecessary degree of complexity, are inappropriate for sale to mass market retail customers. Some parts of the regulatory regime already apply restrictions to the way certain risky products can be sold.

### *Complex information*

- 4.20 The quality of information available varies enormously in the financial services industry. Some is very good, but much is unclear or complex, using jargon and technical language, such as ‘capital units’, ‘bid/offer spread’, ‘minimum sum assured’ and ‘reversionary bonus’. Complex and legalistic terms and explanations can be off-putting for consumers, such as where returns on investments or loss of capital are dependent upon specific percentage movements in a number of stock markets. Other information is insufficiently explicit. For example, some firms have issued mortgage offers where the actual offer does not explain what type of mortgage is being

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24 Cruickshank, D., “Competition in UK Banking”, February 2000

offered. In some cases, customers believe they have effected an interest only mortgage whereas in actual fact they have a repayment mortgage or vice versa, with long term implications for their need for additional life cover and the repayment of the mortgage.

- 4.21 Vital product information hidden in small print<sup>25</sup> can deter consumers from reading important information. Firms may also present important information in obscure or confusing ways. For example, some banks and building societies have written to savers with maturing accounts, carefully detailing the reinvestment options open to customers but referring to their right to withdraw funds either obliquely or in smaller print as a postscript.
- 4.22 Contract and product information can be drafted defensively and in legalistic language. Instead of acting to inform the consumer, its prime purpose can become to protect the firm in the event that things go wrong. In some of the examples which we examined, seasoned financial services professionals declared that they found information difficult to understand and in some cases could not understand why they were being provided with it in the first place.

#### *Role of advice*

- 4.23 Where consumers do not understand products or information, financial advice can have an important role to play. The customer relies on the adviser to take account of their circumstances, requirements and objectives before making recommendations and giving suitable advice. The customer must expect to pay reasonable costs for such advice, which are either built in to the cost of the product or charged as an up-front fee. One of the key roles of the adviser is to help customers understand the product they are considering and explain the risks, charges and benefits involved. Yet research for the FSA's Consumer Panel suggests that one in eight people who sought financial advice did not think their adviser had fully understood their circumstances. However many consumers are still reluctant to make their own decisions and are happy to accept advisers' recommendations without further shopping around.

#### *Discretion and opacity*

- 4.24 Some products involve the use of discretion by a firm, for example, in the investment management of a unit trust or in the allocation of bonuses in a with profits life product. Where discretion is a key part of the product or service it is important that the consumer understands how it will operate and what its role is, particularly as it will be difficult otherwise for policyholders to understand or anticipate how contractual discretion will operate. Though it may be difficult to explain comprehensively the factors which will be likely to

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25 But notably, under criminal law enforced by the Trading Standards Service, small print is not always a defence where it attempts to disclaim a message that a consumer relied upon.



influence how discretion will be exercised it need not be impossible, and customers can benefit from its use by firms.<sup>26</sup> Consumer representatives have suggested to us that consumers tend to think of themselves as unfairly treated whenever they are ‘surprised’ by an event or decision. Firms who use discretion without informing customers adequately of how they might use it risk delivering just such ‘nasty’ surprises as opaque products or processes potentially create a vacuum for the development of unsustainable consumer expectations or assumptions.

### *Charging*

- 4.25 Charging structures are often difficult for consumers to understand.<sup>27</sup> The FSA Consumer Panel 2000 Annual Report shows that 47% of people agree it is difficult to understand charges for pensions and 53% for investment products. Where front end loaded charges are used, consumers often fail to appreciate that some products, such as endowments and personal pensions, may need to be held for ten years or more in order to break even. If a customer is making regular contributions to a unit trust, the effect of the initial charges is to add, on average, about 1% to the annual management charge.<sup>28</sup>
- 4.26 In addition, if customers let these products lapse they can find themselves taking a significant financial loss and often end up feeling that they have been treated unfairly when they did not realise that this could happen, either because it was not made clear to them, or they did not understand that it was a feature of the product.
- 4.27 In some areas, the real amount of charges can be obscure. For example, investment funds need not disclose certain types of charges – principally, those incurred when trading the underlying assets in a fund’s portfolio – to investors. These implicit charges can be extremely significant. To illustrate, FSA research indicates that the true total charges of investing through an actively managed UK equity unit trust can be, on average, almost twice as high as disclosed charges alone would indicate.<sup>29</sup>
- 4.28 The quality of information provided by firms on the kind of charges referred to above varies across the financial services industry. In some areas it can be difficult for consumers to understand information, leaving them unsure of the charges they are liable to pay and in others, they do not seem to realise that they are liable until the charge has been incurred. Where consumers are able to access information, it can be difficult to translate into cash terms and to

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26 In this context, the FSA is undertaking a separate review of with profits products.

27 FSA Consumer Panel 2000 Annual Report shows that 47% of people agree it is difficult to understand charges for pensions and 53% for investment products.

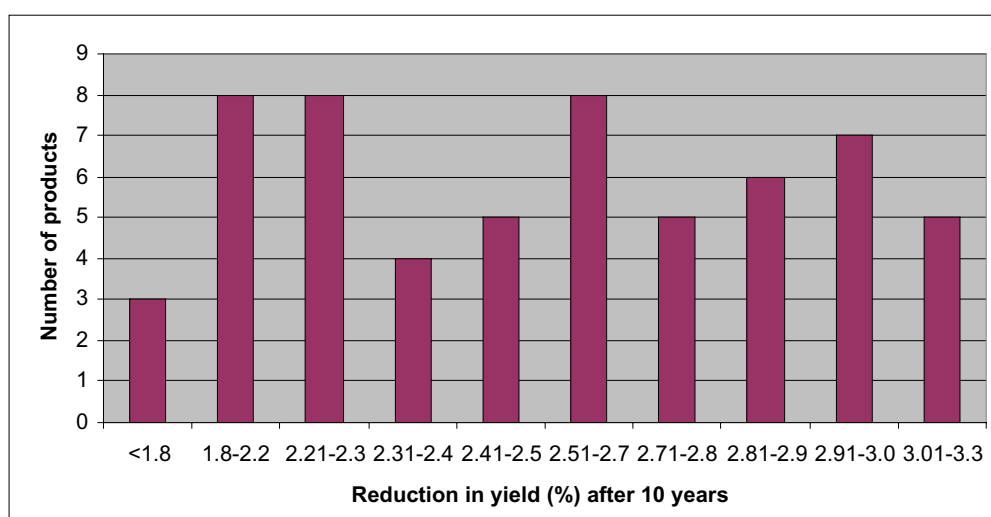
28 If a consumer contributes £60 per month to a unit trust or OEIC UK equity (non Tracker) fund, which charges a spread (or other initial charge) and an annual management charge, with a 6% growth rate, we can calculate the reduction in yield which results from the combination of the initial and on-going charges. The effect of the initial charge - about 5% of the contribution - is to add, on average, about 1.1% to the annual management charge, resulting in a reduction in yield of about 2.5%. These figures are based on material from the PIA: 1999 Disclosure Report.

29 James, Kevin R., “The Price of Retail Investing in the UK”, FSA Occasional Paper #6, February 2000



make comparisons with other providers. A survey for the FSA Consumer Panel found that 62% people agreed that it was difficult to compare the cost of different mortgages. Complexity and lack of comparability of information can act as a barrier to shopping around.

- 4.29 One other result of complexity is that because consumers find it difficult to determine the price of what they are buying, prices may become excessively dispersed. On the basis of the unit trust example used above, price dispersion (excluding currently non-disclosed charges) is considerable, as shown in the table below. Such price dispersion suggests that competition is not working effectively.



**Problem 2: Customers are not kept appropriately informed after the point of sale.**

- 4.30 The primary focus of many financial services relationships is on selling the product or service. Firms, therefore, concentrate on giving information to the future customer so that they can make an appropriate and informed financial decision. But many are less adept at providing customers with information after the point of sale. Such information is necessary to help manage consumer expectations and enable customers to manage their finances effectively.

*Information on product or service performance*

- 4.31 Where firms do provide information to customers on the performance of their products or services, the information can be presented in a way that is difficult for the consumer to understand, for example, by using terminology which is unfamiliar to the consumer.
- 4.32 Sometimes, part of the information which the customer needs could include information on a better deal. There can be real advantages in informing the customer when a product is superseded, has become less advantageous or something else might be more suitable. Unfortunately, as demonstrated by low interest rates on some savings accounts, customers with low performing

products are often the more profitable for firms, who may therefore be reluctant to inform customers about other products.

**Problem 3: Products and firms don't always deliver what customers are led to expect.**

- 4.33 Our research suggests that consumers may be led to have unrealistic expectations of the products they have purchased or the level of service they will receive, and that their propensity to have these expectations is often what firms exploit in order to sell products and services. This can lead consumers to regret making a financial purchase. The consequences can be serious if people lapse policies and face detriment. Persistency rates show that nearly a third of all life policies have lapsed by the end of their fourth year.<sup>30</sup>

*The sales and marketing process*

- 4.34 Any pre-sale process which does not accurately inform the customer is likely to lead to some 'unfairness' emerging after the point of sale, as the customer may then proceed on the basis of inaccurate information and with false expectations. The potential benefits of a product are often illustrated without equal prominence being given to the associated risks and without adequate and clear explanation of the features of the product.<sup>31</sup> Much of advertising today is about communicating 'messages' - you only have to watch television advertisements to see this. But in reality consumers often treat these as part of the information on which they base their expectations. In addition salesmen can be tempted to overstate the potential of a product in order to secure a sale. Under existing regulatory rules, the onus is on firms to show that financial promotions are fair, clear and not misleading, and that advice is suitable.
- 4.35 Past performance figures and awards gained by firms for the performance of their funds or products are commonly used in advertisements. But past performance is not a definitive indicator of future performance<sup>32</sup> and while firms may use such advertising to reinforce messages about the professionalism and security which they can offer, in reality it draws the consumer into overestimating the extent to which the firm – often operating in a volume driven commercial environment – has his or her best interests at heart.

**Problem 4: Customers are discouraged from changing products and providers.**

- 4.36 In a market where the customer is not satisfied, under normal circumstances, the customer would exercise choice and either buy something else next time or move her custom elsewhere. But the financial services market does not always

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30 FSA Consumer Panel 2000 Annual Report

31 PIA mystery shopping exercises relating to ISAs and personal pensions: PIA Regulatory Update 84, February 2001

32 Occasional Paper (Series 9): Past Imperfect? The Performance of UK Equity Managed Funds - Mark Rhodes (2000)

operate in this way, mainly because of a variety of barriers that prevent consumers from changing their product or the provider of that product.

*Barriers to customers changing products and providers*

- 4.37 Some financial products have penalties and lock-ins which may act as barriers to customers changing products. Some penalties are applied in exchange for benefits for the customer. For example, discounted rate mortgages provide a low rate of interest provided the borrower stays with the lender for a set period of time.
- 4.38 Charging can act as a barrier to changing products and providers and to getting a better deal. Mortgage redemption penalties and initial charges are examples of such barriers. The cost of changing mortgage lenders can be significant for some consumers and, coupled with administrative procedures and legal expenses, can be perceived by them to outweigh any benefits. Research shows that, for society as a whole, the cost of changing mortgages can be as much as £281 million (1998).<sup>33</sup> However, mortgage providers are coming under increased pressure to remove these penalties after the period of discount, which should enhance competition and encourage existing borrowers to shop around for a better deal from other lenders. This may create a new issue for firms about the stability of their customer base. Some firms are already creating new strategies to retain customers who have a greater freedom to switch lenders.
- 4.39 Charging structures can also have the effect of locking in existing customers. Some long-term products are sold on the basis of front loaded charges, where the majority of the first few years' premiums may be taken in charges. This means that where a policy lapses, consumers have to accept they will get back less than they have invested, or they have to stay with the product and the provider even if the product is less than optimal in order to break even and then get a return. Where the penalties to switching are not cost-related and proportionate, they may act to serve as a barrier to effective competition.
- 4.40 Details of penalties and charges are often contained within the terms and conditions of the contract, which are sometimes presented in small print. Consumers may therefore not spot them or they may be presented in legal language, which may be difficult for consumers to understand.
- 4.41 A further barrier is lack of information for customers. Firms often do not provide their customers with sufficient information on more advantageous products or arrangements, for example, so that they can switch from superseded products, even where there is provision for this in relevant industry codes. Examples include:

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33 Annex to A Cost-Benefit Analysis of Statutory Regulation of Mortgage Advice: FSA (10/99)

- banks and building societies failing to give information about discontinued products and opportunities to switch to more attractive products; and
- life companies failing to explain fully to personal pension customers their options for purchase of annuities.

4.42 Administrative burdens in moving product can also deter consumers from moving products and providers. The hassle factor can be significant. Some banks and insurance companies are making efforts to assist customers in moving firm. But efforts to date in relation to helping customers switch current accounts have been disappointing.

4.43 All this comes at a cost to consumers. A recent report by McKinsey<sup>34</sup> estimates the cost to American consumers of not managing their finances rationally. They conclude that American households could save an average of \$530 a year if they managed their borrowing and saving more skilfully. A further \$950 could be saved by buying financial services from the most competitive provider. While there are no statistics for the cost to British consumers, there is no indication that the situation would be substantially different in the UK.

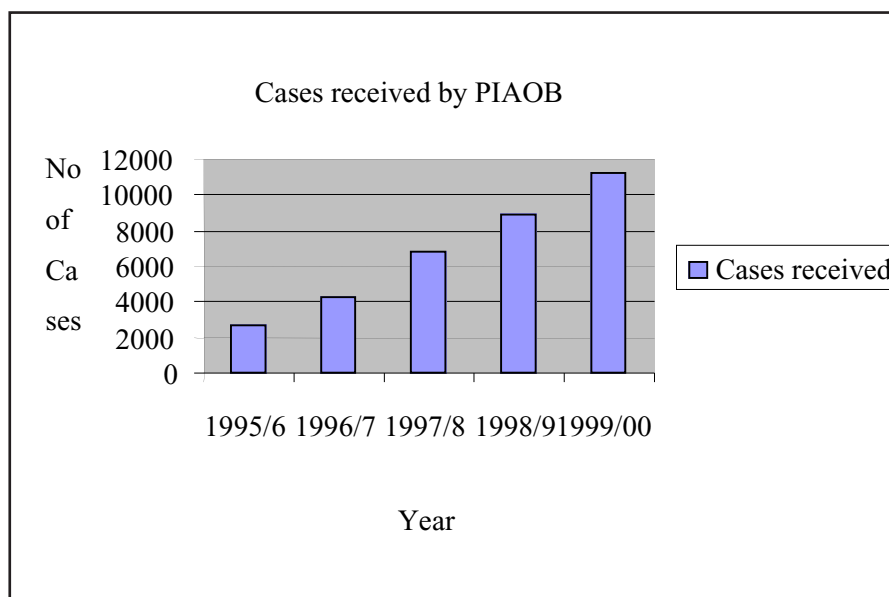
**Problem 5: Customers cannot always get their complaints dealt with fairly.**

4.44 The handling of customer complaints has a dual significance for fair treatment. Firstly, the complaints process is an opportunity to sort out something which may have gone wrong, but secondly it can also become the subject of customer dissatisfaction itself. This dissatisfaction is significant. In research conducted by the FSA in 1999,<sup>35</sup> 23% of respondents said they had a problem with a financial services firm. In addition, the volume of customer complaints is rising. In the five years to March 2000, the PIA Ombudsman saw a 417% increase in the volume of complaints it received.

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34 McKinsey Quarterly 2000 No 3

35 NOP Survey FSA Complaints Research (06/99)



4.45 Practice varies from firm to firm but the annual reports of the various financial services ombudsmen, combined with numerous reported cases in the press and feedback to the FSA's own consumer helpline, all suggest that the general standards of complaints handling in the retail financial services sector are low.

4.46 Although consumers' willingness to complain is generally perceived as rising,<sup>36</sup> the level of complaints currently made is likely only to be the tip of the iceberg as far as dissatisfied customers are concerned. Only 10% of complainants who are dissatisfied with the way their complaint has been dealt with by a firm take the matter further<sup>37</sup> to the Ombudsman.

*Firms do not collate information on complaints received, or act on problem areas.*

4.47 The Financial Ombudsman Service's experience is that where firms receive a significant number of complaints about a specific product feature or issue, some firms simply deal with each complaint on an individual basis rather than considering whether a general problem needs to be resolved. The project team has, for example, seen letters from building societies and banks advising the customer that their complaint about a low TESSA interest rate is unique, when it is publicly acknowledged that this was a common concern.

4.48 A recent survey on complaints cultures<sup>38</sup> concluded that while many of the firms (of which a quarter were financial services firms) intellectually understood the importance of complaints handling, this was not backed up in practice. Although complaints were monitored, the information was often not used to improve service standards. In another recent cross-industry survey in which 50% of firms

<sup>36</sup> Indeed, our willingness to complain also appears to increase with age: TMI for the Institute of Customer Services: National Complaints Culture Survey 2000

<sup>37</sup> NOP Survey FSA Complaints Research (06/99)

<sup>38</sup> TMI for the Institute of Customer Services: National Complaints Culture Survey 2000

surveyed were a financial services sample,<sup>39</sup> only 25% of firms had a culture that encouraged reporting of complaints as a means to **improve** standards.

#### *Firms put up obstacles to complainants*

- 4.49 Customers who try to complain, can encounter a variety of obstacles in getting their complaint heard and investigated effectively. Some find that making complaints via call centres can be problematic where staff are not well briefed or empowered, work to a script, and may not recognise when they should escalate a complaint. Others who complain in writing can find they get a standard response rather than one which answers their specific concerns.
- 4.50 The FSA has observed that some firms require complainants to submit product documentation that was provided to them at or before the point of sale and to complete 'fact finds' as a prerequisite to investigating a complaint. While this may be justified in certain circumstances, it should not be a pre-requisite to investigation.

#### *Lengthy complaints process*

- 4.51 A complainant who pursues a complaint right through to an Ombudsman's decision can find that the process takes a long time. Clearly firms, and the Ombudsman, must be given sufficient time properly to investigate a complaint. However, complainants can find disputes outstanding for up to two years, and sometimes longer. In some cases complainants find real difficulty getting a final letter of response from a firm so that they can then take their complaint to the Ombudsman. A number of financial journalists have told us that this problem features up to half of their correspondence.
- 4.52 When the FSMA is implemented, the FSA will introduce complaints rules requiring<sup>40</sup> a firm to advise a complainant of his right to refer the matter to the Ombudsman after 8 weeks (see below). But a '2 months' rule already applies to firms regulated by the Personal Investment Authority, and in practice firms often take 'as long as it takes' to complete investigations.
- 4.53 The new FSA complaints rules will also enable the Ombudsman to specify what information he requires from firms and the time limits within which the information must be provided.<sup>41</sup> They will also require firms to report twice yearly to the FSA on, amongst other things, the number of complaints which are resolved within the time limits specified and the number which are not.<sup>42</sup>

#### *Variation in treatment of customers who complain*

- 4.54 Quality of complaints handling varies widely across the industry, within complex groups with common ownership and even within firms. The structure of the complaint process, the resources allocated to it and the authority levels

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39 QCi Customer Management: The Customer Management Scorecard: State of the Nation (2000)

40 DISP 1.4R and 1.4.5R

41 DISP 3.5R and 3.6R

42 DISP 1.5.4R

given to staff will all affect the customer experience of making a complaint, or indeed its outcome. Customers with identical or very similar problems then find themselves being treated differently. On the other hand the attitude of customers can drive differential outcomes: customers who are determined to pursue their rights, who threaten referral to the Ombudsman or to instruct solicitors often receive outcomes that are not afforded to customers who are less persistent.

## Conclusions

- 4.55 Consumers of financial services seem to be in a fundamentally different position from consumers of most other retail goods and services. Admittedly, the characteristics of a financial product do create a different set of problems from, for example, a washing machine. But when purchasing anything, particularly something with long term consequences, and future liabilities, customer ought to be able to:
- understand key features of what it is they are buying;
  - expect to get what the product is supposed to deliver;
  - get any problems which might arise sorted out;
  - get any further information which they need; and
  - change the product or switch provider without paying a disproportionate (time or money) cost.
- 4.56 Most firms would probably say they are working hard to improve customer care. But while senior executives may be committed, financial journalists and complaints bodies find that what often happens to consumers tells a different story.
- 4.57 The role of senior management is crucial in determining a firm's attitude towards its customers since their philosophy and approach determines the attitudes of those with day-to-day customer contact. The consistent message we have received from practitioners is that for a firm to achieve fair treatment for its customers the will has to come from the top, and then it has to be communicated through the organisation.
- 4.58 The competence of customer facing staff and the adequacy of training are key to fair treatment of customers, since it is these individuals who end up shaping customers' perceptions of how they are treated. Where staff within firms are well-trained, properly incentivised, adequately briefed and empowered, and have clear and fair customer relationship strategies to follow, the firm's relationship with the customer is likely to be enhanced.
- 4.59 All this should be good for the customer, and generally also good for the firm's business.<sup>43</sup> Fair treatment should raise customer confidence and that has to be in the overall interests of the financial services industry.

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43 'Companies that manage customers well using sensible, observable, well-implemented business practices are very likely to be good business performers. Conversely, companies that do not set up good customer management practices are likely to be poorer business performers' - Business Intelligence 2000.



# 5 Gap analysis and report recommendations

## Introduction

- 5.1 In the course of our work we have looked at:
- what ‘unfairness’ problems exist - these are set out in the previous section;
  - what current initiatives are underway - these are outlined in Annex C and
  - what powers the FSA has to act in this area.
- 5.2 The purpose of this section of the paper is to draw together this work and, in relation to the problems earlier identified, to summarise:
- what risks to the FSA’s statutory objectives we have identified;
  - how initiatives in hand relate to these; and
  - what options for further action by the FSA may be.
- 5.3 This summary is set out below in a series of tables which identify a range of possible future actions. We do not propose to take all of these actions forward. Instead, we intend to focus on those we believe will be most effective, bearing in mind that tackling the problems we have examined may be a long term process.



## Summary of risks and options for action

**Problem 1: Some products and information are difficult for consumers to understand.**

**Why is it a risk?**

Some products lack transparency, are impossible for most consumers to understand and are structured in a way that is liable to give rise to consumer detriment. (including high up front charges, hidden penalties, and taking unfair advantage of one sided discretion). This is compounded by the fact that consumers fundamentally do not understand the products that they have bought.

Work underway:	<ul style="list-style-type: none"> <li>• Development and use of CAT standards for identified products.</li> <li>• Range of consumer education initiatives, including consumer helpline, consumer alerts and the FSA website, carrying up-to-date information on relevant products.</li> <li>• Review by the FSA of with-profits products focussing on use of discretion, expectations, disclosure and transparency.</li> <li>• Development of a new disclosure regime at the point of sale.</li> <li>• Supervisory visits on areas of concern and enforcement of relevant rules.</li> <li>• Mystery shopping to identify and check areas of concern.</li> <li>• Industry Raising Standards initiative to simplify certain aspects of life products.</li> </ul>
Gap:	<p>Work currently underway tends to be reactive rather than preventative. There is room for further work on removing jargon, encouraging use of plain language and standardising some information provided to customers. There may be room for the introduction and use of simple products that are easier to understand rather than focusing on providing more information which consumers may still not understand. There may also be scope for prohibiting the sale of certain products to potential mass market customers due to their inherent complexity or opacity.</p>
Options for possible action:	<ul style="list-style-type: none"> <li>• Use the the FSA's powers to actively target opacity and make product information focus on the essential and readable.</li> <li>• Make firms explain clearly how they exercise discretion and ensure it is used in a way which meets customers' reasonable expectations.</li> <li>• Work to help develop more basic financial products meeting basic consumer needs including voluntary kite-marking systems on complexity and transparency or products/services.</li> <li>• Introduction of an FSA 'Health warning' for opaque or complex products identifying that consumers should seek financial advice for relevant products.</li> </ul>

**Problem 2: Customers are not kept appropriately informed after the point of sale.**

**Why is it a risk?**

Consumers are not always kept informed of how a product or service is performing or of other products/services now available that might be more suitable for them. The way in which firms administer products and customer relationships can cause consumer detriment.

**Work underway:**

- Development of regulatory regime for mortgage provision and associated post-sale disclosure requirements.
- Existing rules require periodic reporting of investment performance to unit trust and investment management customers.
- Application of industry codes, although subscription to them is currently voluntary.
- Range of consumer education initiatives.
- Guidance to product providers to advise policyholders considering surrender of a life policy that they may be able to trade the policy instead ( PIA Regulatory Update 85).

**Gap:**

The ongoing relationship between a firm and a consumer is often neglected as the firm focuses efforts on attracting new sales. The consideration of ongoing relationships by the FSA is set to change with clearer powers under FSMA to look at regulation beyond the point of sale. There are currently limited regulatory requirements on firms to keep customers informed after the point of sale.

**Options for possible action:**

- The FSA could consider making firms responsible for keeping retail consumers informed after the point of sale and stating up front the nature of the after sales relationship.
- The FSA could provide consumers with standard questions to ask when going into a long term contact.
- FSA could provide information on switching products, how consumers go about this and what the costs and benefits are.

### Problem 3: Products and firms don't always deliver what consumers are led to expect.

#### Why is it a risk?

Financial promotion and the sales process can create expectations among consumers which are unlikely to be met, often with unpleasant surprises further down the track.

Work underway:	<ul style="list-style-type: none"><li>• FSA provision of comparative information covering certain financial products.</li><li>• Development of a new disclosure regime at the point of sale.</li><li>• FSA Task Force on past performance in advertising.</li><li>• FSA review of financial promotion.</li><li>• Routine supervisory visits and thematic visits carrying out targeted reviews.</li><li>• FSA website and factsheets, providing material on products, what they can deliver and topical issues.</li><li>• Mystery shopping.</li></ul>
Gap:	<p>The current regulatory approach tends to focus on financial promotions which are untruthful, even though rules also state that material should be fair, clear and not misleading. The FSA may therefore need to review its approach. The FSA may need to consider undertaking an analysis of the expectations generated during the sales process.</p>
Options for possible action:	<ul style="list-style-type: none"><li>• Internal review of financial promotions policy and standards could lead to a more proactive stance and a toughening of approach to 'fair, clear and not misleading'.</li><li>• Ensure via the FSA's review of the Disclosure regime that the key pros and cons of products, including the costs, penalties and the risk of not getting your money back are set out in key features documents.</li><li>• Supervisory and enforcement focus on misleading and unclear advertising, and the advice process.</li><li>• Consumer education initiatives to remind consumers to look through and read the advertising, small print and the Key Features documents.</li><li>• Liaison with industry bodies to encourage firms to treat their customers fairly.</li></ul>

<b>Problem 4: Customers are discouraged from changing products.</b>	
<b>Why is it a risk?</b>	
<b>In some areas there are financial penalties unrelated to the costs of changing product or provider and in others the ‘hassle factor’ can deter moving to better value products.</b>	
Work underway:	<ul style="list-style-type: none"> <li>• FSA development of comparative information tables covering relevant products.</li> <li>• Range of consumer education initiatives including the FSA website and consumer helpline.</li> <li>• Research into the cost of moving product or provider.</li> <li>• Development of regulatory regime for mortgage provision and associated post-sale disclosure requirements.</li> <li>• Use of industry codes and related monitoring e.g. the Banking Code.</li> <li>• Use of supervisory tools.</li> <li>• Use of enforcement powers.</li> <li>• Use of Unfair Contract Terms powers.</li> </ul>
Gap:	The current regulatory focus is on disclosure rather than dealing with barriers. Information is not generally available to consumers regarding benefits and costs of moving products and product providers, or to enable them easily to make comparisons between products/services. Minimal research has been done into barriers to moving products and product providers and the effect this has on consumer behaviour.
Options for possible action:	<ul style="list-style-type: none"> <li>• Use powers under the Unfair Contract Terms Regulations and new regulatory disclosure regime to: <ul style="list-style-type: none"> <li>– crack down on unreasonable terms and conditions preventing consumers moving products and product providers;</li> <li>– require firms to disclose what barriers to moving products and product providers exist, before the point of sale;</li> <li>– identify and publicise costs to consumers of unfair barriers e.g. by extension of comparative information tables;</li> <li>– continued consumer education including information on the implications of entering into a long-term relationship with a firm, and what potential problems might exist;</li> <li>– further research into the relationship between customer inertia and barriers to moving products;</li> <li>– encourage enforcement of industry codes regime; and</li> <li>– consider what effect greater mobility of customers and lowering of barriers may have on the market place.</li> </ul> </li> </ul>

**Problem 5: Customers cannot always get their complaints dealt with fairly.**

**Why is it a risk?**

**Practice varies but many firms don't give the effective handling of their customers' queries and complaints adequate priority, and this is reflected in standards of administration, systems, resources, cultures and outcomes.**

Work underway:	<ul style="list-style-type: none"><li>• Rule making: new FSA complaints rules to take effect from the implementation of the FSMA.</li><li>• Establishment of a single Financial Ombudsman Scheme with which the FSA will liaise on complaints.</li><li>• New single compensation scheme.</li><li>• Examination of complaints records during routine supervisory visits.</li><li>• Provision of FSA publications on 'How to complain'.</li><li>• Use of consumer helpline to guide complainants to appropriate agency e.g. Insurance Ombudsman, Banking Ombudsman.</li><li>• Liaison and co-operation with other consumer bodies.</li></ul>
Gap:	Although new FSA complaints rules will be in place, it is essential that the FSA ensures a high level of industry compliance in order to make the new rules fully effective. Customers have little comparative information available to them regarding complaints.
Options for possible action:	<ul style="list-style-type: none"><li>• Supervisory focus on compliance with the new complaints rules, including themed visits and follow up with customers.</li><li>• Active enforcement of new FSA rules which require firms to clear up persisting or underlying problems giving rise to complaints.</li><li>• Internal training for FSA staff on complaints handling so that staff are better informed.</li><li>• Liaison with consumer organisations e.g. the Consumers Association, National Consumer Council to educate consumers about the complaints process.</li><li>• Liaise with the Financial Ombudsman Scheme, particularly to exchange information about problem products and firms.</li><li>• Publication of complaints comparative tables using data obtained from firms under the FSA's new complaints rules.</li></ul>

## Recommendations

The FSA is required by the FSMA to have regard to a number of principles, including the need to use its resources efficiently and economically, to be proportionate in its actions and to minimise adverse effects on competition. In the light of these principles, the problems identified in this paper and the need for further action, we intend to take the following actions.

We anticipate that these actions will represent a clearer focus to the FSA's work, rather than entailing additional costs. The full extent of any eventual costs will depend on how these recommended actions are implemented and how other FSA priorities are adjusted. In carrying forward work as a result of this work programme, the FSA anticipates that it will conduct more detailed cost benefit analysis as appropriate.

The work involved will be long term in nature and in delivering results. It will be important to keep the results under review, bearing in mind any developments or problems which may emerge, as well as any other actions, continuing measures of effectiveness and costs and benefits which may be required.

## Further Work

We intend to carry out a further programme of work on the areas discussed in this paper. The programme will start tackling the gaps we have identified in the light of initiatives already in hand.

### 1. Making products and information easier for consumers to understand

The FSA intends to:

- use its rules on financial promotions and advertising, and its new Unfair Contract Terms powers, to promote the use of plain language and discourage unnecessary jargon in retail financial services consumer material.
  - ensuring that our current review of financial promotions<sup>44</sup> targets jargon and unclear language;
  - raising standards by publicising examples of good practice, and 'naming and shaming' where there is poor practice;
  - reviewing policy documents and other consumer contracts and seek to remove clauses that are unclear and not understandable;

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44 The FSA expects to consult on its conclusions from this review during autumn 2001.

- publishing a paper setting out our approach to Unfair Contract Terms later in 2001;
- researching into how much reliance customers place on written as opposed to oral communications.
- **consider whether in addition to existing regulatory requirements relating to the sale of products to retail customers, there are products which, because of their inherent complexity or opacity, are unsuitable for sale to mass market retail customers.**
  - analysing the suitability of certain products for sale to mass market retail customers;
  - assessing the regulatory options including risk warnings, marketing restrictions or prohibitions on sale.

## **2. Keeping customers appropriately informed after the point of sale**

The FSA intends to:

- **review what mandatory information should be provided to retail customers after the point of sale and what the relevant costs and benefits might be, with a view to further consultation on any rules and guidance.**
  - taking stock of what information consumers currently receive in different market sectors;
  - analysing what information consumers need about types of different products and services after the point of sale;
  - increasing the frequency of review of regulatory projection rates for investment performance.

## **3. Reducing the gap between what consumers are led to expect and what is delivered**

The FSA intends to:

- **progress its review of how to use its powers on financial promotions, with a view to minimising the risk that consumers have unrealistic expectations of what they're buying based on marketing material.**
  - considering the scope of our powers from N2;

- determining the extent to which we should be proactive in this area in order to provide appropriate customer protection, promote public understanding and set fair standards in the market place;
- publishing a Consultative Paper on our proposed policy stance on financial promotions in the autumn.

## **4. Removing unfair barriers to customer mobility**

The FSA intends to:

- **review where barriers to switching exist, and whether they are disproportionate or unfair, and what action might be needed as a consequence.**
  - researching into why customers do not change products and product providers;
  - analysing individual products to help identify product features (such as front-ended charges, low surrender values, etc) that might prohibit changing product or provider;
  - considering whether such charges are disproportionate or unfair;
  - taking action as appropriate using unfair contract terms or other powers;
- **promoting consumers' understanding of the choices available to them through:**
  - use of comparative information tables;
  - other consumer education.

## **5. Ensuring that consumers can get their complaints dealt with fairly**

The FSA intends to:

- **reinforce the introduction of the new regulatory regime relating to complaints with focused action on compliance with the new rules.**
  - identifying problem areas and trends through the gathering of information received from firms on complaints, information from the Financial Ombudsman Service and other sources;



- taking action when problems have been identified which might include targeted compliance visits to relevant firms, follow up with customers and possible enforcement action if appropriate;
- focusing on the extent to which the treatment of complainants is uneven;
- **take forward work on the Cruickshank Report's<sup>45</sup> recommendation that the FSA should compile and publish comparative tables on complaints from retail customers received by firms.**
  - considering what indicators of how firms handle complaints would be most useful;
  - considering how data on firm's handling of complaints should be presented and explained;
  - considering the best way of incentivising firms to improve standards of complaint handling whether by means of publishing comparable data, or whether by providing firms with their own data benchmarked against their peers;
  - publishing a consultation paper in 2002.

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45 Cruickshank, D., "Competition in UK Banking", February 2000

# The meaning of ‘fairness’

## What is ‘fairness’?

- A.1 We have examined concepts such as policyholders’ reasonable expectations, a wide variety of judicial pronouncements, statutory interpretations and fiduciary duties, as well as interpretations by other regulators and relevant organisations, including regulators of the privatised utilities, the Office of Fair Trading (the ‘OFT’) and the Financial Ombudsman Service. Case law was the richest source of material.
- A.2 What is clear from a consideration of a broad range of material is that ‘fairness’ still correlates to natural justice or morality, and is rather similar to ‘equity.’ It is also clear that although ‘fairness’ is not a principle of English law in the sense that it can be enforced in the courts by a person who believes himself merely to have been treated unfairly, ‘fairness’ is a point of reference and something which will inform and guide the way in which courts reach decisions. It might even be said that ‘fairness’ forms part of the judicial toolkit enabling the court to achieve a just result in circumstances where unfairness is apparent.
- A.3 The use of ‘fairness’ in this way has a very long history in English law, going back centuries to principles of conscience and ‘equity’. Today, it is a concept which appears in one form or other in legislation, for example, in the Sale of Goods Act 1979, the Control of Misleading Advertising Regulations 1988,<sup>46</sup> the Consumer Credit Act 1974 (which refers to the ‘unconscionable bargain’), the Unfair Contract Terms Act 1977 (as a result of which some clauses are deemed ineffective and others are subjected to a test of reasonableness) and, most notably, the Unfair Terms in Consumer Contracts Regulations 1999 (which impose a number of controls on the grounds of unfairness and which apply to any contractual term (not just exclusion clauses) that has not been individually negotiated). Under the FSMA, the new Financial Ombudsman Service which has been established is required to make decisions on complaints on the basis of what in the Ombudsman’s opinion would be fair and reasonable in all the circumstances of the case.

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46 SI No. 915

## **‘Fairness’ overseas**

- A.4 Because of the relationship between European and UK law, we examined what ‘fairness’ is in European laws. In non-English speaking countries the word ‘fairness’ does not have a direct, one word, translation. But there are concepts which equate to it. Consequently, most European legal systems do not include a definition of ‘fairness’ applicable specifically to financial services and instead use concepts based on ‘good faith’ which tend to be well understood and enforceable in the courts.
- A.5 So, although there is not an identical equivalent to ‘fairness’ in other EU countries, the concepts used which equate to ‘fairness’ represent major principles that govern the contractual relationship between customers and service providers. French legislation on financial services talks of ‘transparency’. German laws insist on the idea of ‘protecting the customers’ interests’. Italian contractual law is based on the principles of ‘fairness, good faith and diligence of a good paterfamilias’. In the Netherlands ‘reasonableness and fairness’ are very important concepts of private law and in Sweden insurance companies have to conduct business according to ‘good insurance standards’.
- A.6 Therefore, ‘fairness’ and European concepts of ‘good faith’ have a lot in common, particularly in what they try to achieve, by providing courts with a framework to work with when interpreting unclear contracts and in providing consumers with protection against abuse of power by sellers of goods and services.

## **What ‘fairness means’**

- A.7 ‘Fairness’ has not been exhaustively defined by the courts and continues to be a flexible concept. However, the essence of ‘fairness’ draws on common elements of natural justice, ethics and morality.
- A.8 Because ‘fairness’ is and has to be a flexible and dynamic concept, its operation is dependent on the circumstances of the case. Consequently, it is a relative and, to a certain extent, subjective concept. For example, in the financial services context, what is ‘fair’ might depend on what the relationship is supposed to be between the customer and the firm and whether it relates to a single transaction or relates to a financial service which is ongoing and relationship based, such as investment management, stockbroking or custody services.
- A.9 ‘Fairness’ is also time sensitive. What is deemed to be ‘fair’ can change over time, as circumstances, knowledge and expectations change. It is often easier to judge with hindsight what is fair and unfair, as hindsight often enables greater possession of the facts on which to make a judgment and therefore there is a risk in applying standards of fairness retrospectively. Accordingly the standard

of fairness applied should be that of the time of the process or event being judged and it would be unreasonable for any authority retrospectively to impose standards, and as such, could be an abuse of process.

- A.10 ‘Fairness’ is not necessarily a one sided concept. For example, when considering questions concerning the adequacy of information provided to consumers, it is necessary to think about what obligation a consumer has to take action to look after his own interests in the light of the information provided, or any further enquiries which it is reasonable to expect him to undertake. Care needs to be taken, however, to ensure that ‘caveat emptor’ or ‘buyer beware’ is not indiscriminately applied, particularly where consumers have been effectively lulled into acquiescence and inaction. Under the FSMA, the FSA is required to have regard to the general principle that consumers should take responsibility for their own decisions.<sup>47</sup> Equally, the FSMA requires the FSA to have regard to differing degrees of experience and expertise which consumers may have<sup>48</sup> and differing degrees of risk involved in different types of transaction.<sup>49</sup> Accordingly, the FSA has distinguished the different levels of protection required for different types of customer in the application of its rules.
- A.11 While all this means that it is difficult to define ‘fairness’ concretely, it is also what goes to make it a flexible and dynamic concept, and therefore one which we all still use in our daily lives.
- A.12 But it is possible to identify a number of elements which go to make up what is ‘fair’, and types of conduct which are indicative of acting fairly. These elements are set out below and the list is not exhaustive. Many overlap and many underpin the FSA’s high level Principles for Business and FSA’s regulatory rules. In the context of financial services, we think that these include:
- honesty;
  - openness;
  - transparency, which includes the use of plain and intelligible language in customer contracts so that the meaning and purpose is clear, capable of being understood by the customer, and onerous clauses are obvious, with the result that there will be no unreasonable surprises for the customer;
  - disclosure, as necessary on an on-going basis, to the customer of material information;
  - honouring of representations, assurances, and guarantees where this leads to a legitimate expectation in the mind of the customer;

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47 FSMA S5(2)(d)

48 FSMA S5(2)(b)

49 FSMA S5(2)(a)

- acting in accordance with the contract or otherwise in accordance with the obvious intention of the parties or the spirit of the contract, even where this conflicts with the “small print”;<sup>50</sup>
- treating like situations alike and differentiating appropriately between different situations;
- acting impartially and reasonably, having regard only to relevant issues and not taking into account irrelevant issues;
- acting with integrity;
- acting with reasonable competence and diligence;<sup>51</sup>
- acting in good faith;
- refraining from exploiting customers, for example imposing manifestly harsh and disadvantageous terms, taking advantage of the “poor, ignorant and needy” and generally writing contracts which cause a significant imbalance in the parties’ rights and obligations arising under the contract to the detriment of the customer;
- refraining from acting capriciously, including going back on an established course of action without prior notification setting out the reasons;
- maintaining the confidence and trust of the customer;
- acting in accordance with relevant codes of practice, rules and the law;<sup>52</sup>
- being reasonable about putting right things for which one is responsible and which have gone wrong;
- being accessible to customers, for example, so that customers can contact the firm, know where and how to do so and when they do make contact, customers will receive a meaningful response.

A.13 But fairness is not just about process, it is also about **outcome**. Research suggests that consumers believe an outcome is unfair where it is significantly different from what they understand the core or fundamentals, of a transaction or contract to have been.<sup>53</sup> Put another way, they tend to think themselves unfairly treated where, in the course of an ongoing relationship or contract, something comes as a ‘nasty surprise’. This can be because, the consumer:

- did not adequately understand and have sufficient information on the transaction in the first place; this then undermines the extent to which

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50 ICS v West Bromwich Building Society (1 All ER 1998) Director General of Fair Trading v First National Bank plc (2 All ER 2000)

51 Used by the Financial Ombudsman Service

52 Used by the Financial Ombudsman Service

53 Referred to in page 29 of Jolls et. al. “A behavioural approach to law and economics”, University of Chicago, Working Paper, No. 55, May 1998.

there is a mutually ‘agreed’ transaction and this in turn can give rise to a perception of unfair treatment after the point of sale;

- did understand adequately and have sufficient information but another party has used some contractual discretion to affect the outcome - either by doing, or not doing something - and thus change what the consumer had anticipated would happen.

A.14 But the future is inherently impossible to predict, so we need to distinguish what is ‘unfair’ from what is simply unexpected. A fair process which leads to an unexpected outcome can nevertheless constitute fair treatment of the customer.

### **Would guidance on the meaning of ‘fairness’ be useful?**

A.15 We have considered whether regulatory guidance on the meaning of fairness would be useful. We concluded that because fairness is such a flexible and relative concept, and because the FSA’s rules already significantly reflect the elements of fairness which we have found, generic guidance would not be helpful. We concluded that product or situation specific guidance is more helpful. This sort of regulatory guidance is already provided. So the FSA will continue to keep developments which benefit from further guidance under review and issue it where appropriate.

### **Conclusion**

A.16 We used the concepts of ‘fairness’ illustrated above as useful starting points in assessing the specific issues which are important to consumers after the point of sale. Given its flexible and open ended quality, ‘fairness’ does not necessarily point to or produce clear policy decisions or outcomes but it does provide a useful overall framework in which to set the analysis of possible options. But as we have explained in this paper, the way in which the FSA uses its powers is something which must satisfy the FSA’s general statutory duties and in particular the principles of regulation set out in the FSMA. For this purpose, the FSA will also apply the disciplines derived from the FSA’s risk based approach to regulation, which it has separately described in its publications, ‘New Regulator for the new Millennium’,<sup>54</sup> and ‘Building the New Regulator; Progress Report 1’.<sup>55</sup>

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<sup>54</sup> January 2000

<sup>55</sup> December 2000



# The FSA's powers

## What the FSA will regulate

- B.1 The FSA will have powers under the FSMA to authorise and regulate persons who, by way of a business, carry on regulated activities. It is the responsibility of HM Treasury to specify, in secondary legislation, the activities which fall within the scope of the Act. The Order<sup>56</sup> [currently before Parliament] brings the following kinds of business within the scope of the Act:
- investment business;
  - deposit taking;
  - carrying on insurance business;
  - lending on mortgages.
- B.2 The Order also stipulates what kinds of activities carried on in relation to such business are within the scope of the Act. For example, advising on, dealing in and managing all kinds of investments are included as regulated activities. In the case of general insurance business and deposit taking, the scope is more limited, for example advisory activities are not included. It will be important for the FSA to develop ways of informing consumers about the scope of its responsibilities.

## The FSA's powers to make rules and issue guidance

- B.3 The FSMA gives the FSA wide powers in relation to the supervision and regulation of firms carrying on regulated activities. These include powers to make rules governing the way firms conduct business with consumers and to issue guidance of a general kind directed at consumers and the public generally as well as guidance directed at firms as to the standards which they are expected to achieve when complying with rules.

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56 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.



B.4 The FSA's rule making powers are widely drawn. The FSMA provides that the FSA may make rules applying to regulated firms in relation to:

- the carrying on of regulated activities;
- the carrying on of non-regulated activities;

as appear to be necessary or expedient for the purpose of protecting the interests of consumers.<sup>57</sup> For this purpose 'consumer' includes any person who uses, has used, or who may be contemplating using, any services provided by authorised persons and persons who have rights or interests which are derived from the use of any such services.

B.5 The rule making power is not therefore restricted to issuing rules with regard to regulated activities but may extend to any other activities where there is a sufficient connection between a particular activity and persons who use or who may have used the services of an authorised person in carrying on the activity. The powers could, for example, be used in relation to consumers' dealings with firms after the purchase of a product or service or in relating to an aspect of advice or administration concerning deposit or general insurance business where there is a need to protect the interests of consumers.

B.6 In exercising powers to make rules and issue guidance the FSA is subject to its general duties as set out in section 2 of the FSMA. This requires the FSA, in exercising its general functions, so far as is reasonably practicable, to act in a way which is compatible with the regulatory objectives<sup>58</sup> and which the FSA considers most appropriate for the purpose of meeting those objectives. In discharging its general functions the FSA is required to have regard to the principles of good regulation set out in section 3 of the FSMA. In addition the FSA must normally before making rules or issuing guidance directed at regulated firms publish its proposals for consultation (including, if necessary, a cost benefit analysis).

## **Activities carried on before and after the point of sale**

B.7 Therefore, it can be seen that, subject to it acting in accordance with its general duties, the FSA has rule making powers which are not confined to any particular aspect of a financial services activity. The way in which firms communicate and deal with consumers after a contract has been sold or an account set up are matters which the FSA may consider including within requirements and standards established by way of rules and guidance.

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<sup>57</sup> Section 138 FSMA.

<sup>58</sup> The regulatory objectives are:

- market confidence
- public awareness
- the protection of consumers
- the reduction of financial crime.

## **Distinctions in the regulation of different types of business**

- B.8 In practice, the kinds of rules likely to deal with the fair treatment of consumers will relate to the way in which financial services business is conducted and products are structured. The FSMA does not generally distinguish between different types of rules - so-called 'conduct of business', 'prudential' or product focussed rules. But, with the exception of requirements relating to financial promotions and the need for firms to establish complaints handling systems, the FSA's current approach does not involve setting rules governing the way firms conduct their business for deposit taking and non-life insurance. Each of these areas will principally be subject to prudential regulation, such as relating to their financial soundness.
- B.9 The FSA has set out a number of Principles for Businesses<sup>59</sup> which all the firms it regulates should observe in carrying on their business, using its powers under the FSMA. These include principles such as using integrity, and paying due regard to customers' interests and treating them fairly.
- B.10 Whilst the Principles will apply to all authorised firms, the FSA has said that they do not represent any extension of conduct of business regulation to deposit taking and general insurance and that we have no plans for such an extension at this stage.<sup>60</sup> Nevertheless the FSA may in its capacity as prudential supervisor take action if any firm falls significantly short of the standards set by the Principles in its treatment of customers, for example where reputational risk was causing prudential concern or where conduct of business requirements already do exist and are broken.
- B.11 Although, issues arising from the unfair treatment of private customers are likely to relate to the conduct of a firm's business, they could as noted above relate to the prudential supervision of a firm. For example, the Threshold Conditions set out in Schedule 6 of the FSMA, require a firm to have adequate resources in relation to any regulated activity which it carries on. Accordingly, regulatory action could be taken where a firm behaves in a way which impacts on its ability to meet the threshold conditions. For example, this could relate to the way in which insurance companies administer policies or pay out distributions, or the way in which a particular firm handles redemptions or whether it has the resources to handle the volume of complaints it receives. Clearly not all inadequacies as to the amount or quality of resources will impact upon a firm's ability to continue to satisfy the threshold conditions for authorisation. The FSA will need, in each case, to form a view as to the materiality of a shortfall and its impact upon the firm.

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<sup>59</sup> The Principles are a general statement of the fundamental obligations of firms under the regulatory regime. They derive authority from the FSA's rule making power in s138 and reflect the FSA's regulatory objectives under the Act.

<sup>60</sup> The FSA's Principles for Business, CP13.

## **The FSA's other powers**

- B.12 Under its general rule making power<sup>61</sup> the FSA can also make rules relating to the handling of complaints by firms. The FSMA also provides specific power<sup>62</sup> to make rules in relation to the establishment of a single independent ombudsman scheme to resolve disputes between retail complainants and authorised firms quickly and with the minimum of formality.
- B.13 The Financial Ombudsman Scheme (the “FOS”) will cover all the existing financial services ombudsmen and arbitration schemes and will extend to all authorised firms and most regulated activities. The FSA may extend the FOS to cover other activities of authorised firms that are not regulated activities and with FSA approval, the FOS can also provide a service for any other financial services complaints for firms that wish to use it. This applies to all firms whether authorised or not.
- B.14 The FSA also has other powers which are generally subject to their own limitations as set out in the relevant parts of the FSMA. For example, the FSA's investigatory powers, depending on the particular one to be used, carry different triggers and different persons who are subject to their requirements.

## **The Unfair Terms in Consumer Contracts Regulations 1999 and the Injunctions Directive**

- B.15 In April the FSA became a qualifying body under the Unfair Terms in Consumer Contracts Regulations 1999.<sup>63</sup> These powers will enable the FSA to take action on behalf of consumers who have entered contracts which contain standard terms and conditions which are unfair according to the Regulations.
- B.16 The aim of the Regulations is to protect consumers against unfair standard terms and conditions in contracts entered into with firms. The FSA plans to publish its proposals for exercising its powers under the regulations in the summer 2001.
- B.17 From April 2001 until the Financial Services and Markets Act is implemented (N2) FSA's scope for the purposes of enforcing the regulations will be “investment business” as defined under Schedule 1 of the Financial Services Act, 1986. FSA's scope at N2 is still to be determined but is likely to be extended to cover retail banking and general insurance.
- B.18 FSA will gain further powers at N2 under the Injunctions Directive.<sup>64</sup> This will allow FSA to apply for injunctions across European Community borders

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61 FSMA S 138

62 See Part XVI of the Act.

63 Statutory Instrument 1999 No. 2083

64 Council Directive 98/217/EC

to prevent infringement of certain European consumer protection directives, chiefly the Unfair Terms in Consumer Contracts Regulations and both the Misleading and Comparative Advertising Directives.

## **Conclusion**

- B.19 The FSA therefore has a wide range of powers under the FSMA, both to make regulatory rules and to issue guidance and information. Although, the FSA does not propose to use all its rule making powers in relation to deposit taking and general insurance, it can still undertake substantial industry liaison, complaints, consumer education and information work in these areas.
- B.20 The FSA is also gaining important new powers in relation to unfair terms used in financial services contracts and this will take the FSA into new regulatory territory. The FSA is currently considering how it will use these powers and will publish proposals on this during summer 2001.
- B.21 Earlier in this paper, we examine what current problems of ‘unfairness’ exist for consumers and what issues these raise. Having examined the FSA’s powers, we conclude that the FSA has the power to deal with most, if not all, of these issues. But we also recognise that other bodies have relevant powers in these areas and that therefore the FSA should bear in mind the need to work with them.



# Current initiatives

## Introduction

- C.1 Throughout our work on this project, we have taken account of the wide range of initiatives already in hand. Many of these initiatives reflect public and Government concern about the increasing need for individual planning by consumers and the demands this creates for a fairer society,<sup>65</sup> clearer standards (giving rise to CAT standards) and products and information to meet consumer needs.
- C.2 The creation of the FSA as the UK's single financial services regulator, with a statutory consumer protection objective, reflects these concerns and the desire to enhance the regulatory system to the benefit of firms and consumers. This has informed the further work which the FSA is doing.

## FSA initiatives delivering fair treatment

- C.3 Regulatory requirements which assist in the delivery of fair treatment of consumers include:
- ensuring that any firms or individuals undertaking financial services business are fit and proper and have appropriate resources and skills to undertake that business; this will include overseeing that all firms have appropriate systems and controls for their business;
  - requiring that senior management responsibilities in all firms are clear and that the business affairs of the firm can be adequately monitored and controlled by its senior managers;
  - setting high level obligations through a set of Principles, which provide a yardstick by which regulated firms should order their business;

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65 A speech delivered by the Chancellor of the Exchequer on 27/05/99 to the Institute of Fiscal Studies

- monitoring how firms which undertake investment, life assurance and pensions business conduct that business with customers;
- undertaking the regulation of certain financial products (unit trusts and open ended investment companies);
- ensuring that where a firm ‘outsources’ some of its functions which involve the service company coming into contact with a firm’s customers, the firm must be aware of the impact this will have and manage the situation appropriately;
- establishing a **single** compensation scheme to provide appropriate redress to customers when firms go bust.

## **Requirements on how firms conduct their business with customers**

C.4 The existing regulatory regime applying to investment and life insurance business sets out rules for how firms conduct business with their customers. The FSA will continue with this approach, on the basis of ensuring :

- common **minimum** standards; and
- proportionate levels of customer protection.

C.5 The FSA’s consumer protection objective requires it to distinguish between different types of risk and transaction and differing degrees of experience and expertise - in a sense, ‘fair’ levels of protection. Accordingly, the FSA’s rules will distinguish between different levels of customer protection, with the highest level of protection provided to private, retail customers. The FSA’s requirements will include provisions to ensure firms:

- classify customers into the appropriate category of protection;
- are clear, fair and not misleading in financial promotions and communications to customers;
- provide clear information on charges and commission and their effect on savings returns;

and where they provide advice, that they:

- adequately investigate the financial circumstances of a customer before recommending an investment;
- make investment recommendations that are suitable for the customer’s needs;
- provide a range of suitable risk warnings when they sell certain investments.

- C.6 Requirements specifically applying after the point of sale are more limited but will include requiring firms to:
- confirm transactions to customers immediately after the event;
  - provide information on rights to cancel or not proceed with the transaction;
  - have appropriate arrangements in place where they hold investments or money on behalf of their customers; and
  - report regularly to customers where they manage investments for them or hold investments or money on their behalf.

## **Financial promotion and advertising**

- C.7 Three legislative regimes for the marketing of deposits, insurance and other investments exist under the Financial Services Act 1986, the Banking Act 1987, and the Insurance Companies Act 1982 .
- C.8 Under the FSA's new regime, new FSA Financial Promotion rules will apply to all regulated firms but have limited application to financial promotions for deposits, general insurance contracts and pure protection contracts. Mortgages and pre-payments for funerals will be covered by the rules under the FSMA.
- C.9 The current terminology of 'advertisement' and 'unsolicited call' will be removed. Financial Promotion will be 'media neutral' covering communications made in any medium, for example, brochures, mail-shots, telemarketing and solicited/unsolicited calls. There is a distinction between 'real time' communications (for example, personal visits, telephone conversations), other interactive dialogue and non 'real time' communications (for example, e-mail) such as letters and brochures etc.
- C.10 The FSA is also undertaking a review of how it should operate these powers, in particular in the light of their potential to act preventatively and to reduce the risk to consumers caused by inadequate understanding of the products they might buy and unrealistic expectations of what they might end up with. The FSA intends to consult on the conclusions of this review during autumn 2001.

## **Disclosure of information to consumers before the point of sale**

- C.11 The existing regulatory regime requires anyone providing investment advice to a consumer to disclose certain key information before the point of sale in what is known as a Key Features Document. But research commissioned by FSA on consumers' understanding of key features documents suggests that these have achieved a mixed degree of success and may not always be meeting



their objectives of describing products in clear and comprehensible terms. The FSA has been consulting on proposals to improve the product disclosure regime for ‘packaged products’ and is currently testing new proposals for Key Features Documents in the light of responses to the consultation.<sup>66</sup>

## **Requirements on how complaints are handled**

- C.12 Access for retail consumers to mechanisms for dealing with complaints about financial services firms is a key part of the new regulatory regime. The FSMA gives the FSA the power to make rules relating to the handling of complaints by authorised firms. It also provides for the establishment by the FSA of an independent dispute resolution mechanism to resolve complaints which firms cannot resolve quickly and with the minimum formality. The rules, which will come into force at N2, when the FSMA is implemented, have been specifically designed to address the perceived weaknesses in the current complaints arrangements and to deliver a fairer deal for consumers.
- C.13 The Financial Ombudsman Scheme (the ‘FOS’) will be a new single Ombudsman scheme which will bring together the current with different schemes.<sup>67</sup> It will provide a free, accessible and informal alternative to the courts for private retail customers. Awards will, for the first time, be made on a consistent basis across the whole of the financial industry and “hybrid” complaints spanning different sectors of the industry will be handled in a co-ordinated way by a single Ombudsman.
- C.14 Firms will be required to have effective complaints procedures, and the rules introduce a common (and wide) definition of “complaint” for this purpose. All authorised firms will be subject to standard time limits, record-keeping and reporting requirements and to requirements designed to improve the accessibility of their complaint procedures. Consumers will have a statutory right to take their complaint to the FOS if the firm fails to resolve it to their satisfaction within eight weeks. Firms will be under a duty to inform complainants of this right. (A consumer’s right to complain to the FOS will remain even after a firm’s authorisation has ceased and an award will be enforceable in the courts.)
- C.15 Under the new rules, the FSA will receive, on a regular basis, detailed complaints data from firms and from the FOS, which will be logged on a central complaints database. This will enable us to identify early warnings of problems in firms, products, rules etc, at an early stage and to take appropriate action where necessary to protect consumers.

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<sup>66</sup> FSA Discussion Paper: Informing Consumers: A Review of Product Information at the Point of Sale (11/00)

<sup>67</sup> The FSA Direct Regulation Unit and Independent Investigator; The Investment Ombudsman; The PIA Ombudsman Bureau; The Personal Insurance Arbitration Service and The SFA Complaints Bureau The Banking Ombudsman; The Building Societies Ombudsman and The Insurance Ombudsman

## **Review of with-profits products**

- C.16 The FSA has announced it will undertake a wide-ranging review of some features of with-profits business to look at the prospects for change in four main areas:
- the extent of discretion available to management over the operation of with-profits funds and how that discretion is exercised;
  - improvements in the transparency of the published information about with-profits funds;
  - better information for policyholders about the progress of their investments, including the language used to describe returns, and greater clarity about investment strategies and the way in which terminal bonuses are determined; and
  - the principles which underpin the “reasonable expectations” policyholders may have in relation to their pooled investments.
- C.17 This will involve close consultation with consumer groups, the industry and relevant professional bodies. The review will take place during the course of 2001.

## **Regulation of mortgage provision**

- C.18 The FSA is currently preparing to regulate mortgages, with the new regime expected to take effect around nine months after the implementation of FSMA. The FSA expects to regulate loans, including equity release and flexible mortgages, which are taken out on or after the commencement of regulation and which are first charges over residential property in the UK, with at least 40% of the property being occupied by the borrower or his/her dependants or immediate family. This type of borrowing often represents the biggest financial commitment many consumers will make.
- C.19 The FSA will not regulate advice or second charges and buy-to-let mortgages which will continue to be regulated by the OFT under Consumer Credit Act regulations.
- C.20 Under these new powers, the FSA will regulate lenders but not mortgage intermediaries (although some intermediaries will be authorised because they conduct investment business). All intermediaries will, however, be affected by the new proposals - certainly by the new legislative framework on financial promotions, and possibly by the FSA’s proposals on the provision of standardised information to consumers.
- C.21 The FSA is developing the detailed proposals for mortgage regulation and draft Rules and Guidance will be issued for consultation at the end of May.

## Consumer education

- C.22 The FSA is working to help people acquire the knowledge, aptitude and skills necessary to become questioning and informed consumers of financial services so that they can manage their finances more effectively after the point of sale. FSA will continue with work streams established by existing investment business regulators and will also undertake more widespread work covering consumers of most financial services. This is a long term task and we recognise that the benefits may not be apparent for some time.
- C.23 Some of this work is directly linked to current consumer protection issues, such as those relating to endowment policyholders. Other work requires a range of consumer education tools, both for immediate consumer protection issues and for longer-term educational work. These include use of:
- **the FSA's Website** - provides easy-to-understand, up to date, independent information;
  - **publications** - over a million FSA consumer factsheets and booklets including guides to financial advice and complaints, have been distributed to date either free or by paid-for distribution through the industry;
  - **promoting the FSA's services** - during March 2001, the FSA ran a pilot advertising campaign in two regions using local radio and press, to test how effective this might be as a means of raising awareness;
  - **Adult Learning Programme** - the FSA is developing an interactive web-based financial services learning programme for adults part-funded by the EU in collaboration with the DTI and with involvement of the two National Training Organisations, the Qualifications and Curriculum Authority and the University for Industry;
  - **Consumer Helpline** - this telephone service is available to take orders for FSA consumer publications, and answer general personal finance questions including checking whether a firm is properly authorised, and explaining the procedure for making a complaint;
  - **Comparative Information** - the FSA will launch a new Comparative Information Service in September 2001, providing an on-line service to consumers to compare the features of long term investment products such as personal pensions, investment bonds, unit trusts and open ended investment companies;
  - **work with schools** - the FSA has already worked with the Department for Education and Employment (DfEE) and other educational authorities to ensure that personal finance is firmly embedded in the revised Curriculum; it has also helped produce educational material for schools, including funding a series of schools programmes with a soap format on the

personal finance curriculum, and is helping the educational charity pfeg (the Personal Finance Education Group) raise funds from the financial services sector for a multi-million pound project to give a kick-start to personal finance education in schools.

## **Training and competence**

- C.24 The main aim of the FSA's requirements is to ensure a minimum level of competence amongst employees of regulated firms, undertaking or associated with regulated activities. The FSA's philosophy is that a competent workforce should be able to deal with customers more fairly after the point of sale and be aware of the actions they should be taking.
- C.25 Various training and competence regimes already apply to investment firms. The new regime will apply requirements to the sales process and to the administration of investment products after the point of sale at various points throughout the life of these products.
- C.26 This new regime will also apply guidance to all regulated firms including deposit takers and general insurers and will require firms to ensure that relevant employees are suitably competent, appropriately supervised and that their competence is reviewed.
- C.27 One other means of enhancing the competence of firms, and thereby their ability to treat customers fairly, is to provide education on the FSA's requirements. The FSA does this to help firms apply the requirements better by giving them a greater understanding of why they exist, what the context is, and the practical application of the requirements.

## **Industry and Government initiatives**

- C.28 A number of these initiatives are concerned with reviewing and enhancing the content, monitoring and effectiveness of financial services consumer codes of practice:
  - **HM Treasury's review of financial services consumer codes of practice:** the review was chaired by DeAnne Julius of the Bank of England and reported to Ministers at the end of May. The codes reviewed included the Banking Code, Mortgage Code, the Banking Code for Small Businesses, and the Statement of Principles of Business Banking.
  - **The Government's 1999 Consumer White Paper:** this outlined proposed Government policy on codes of practice. The proposals included an enhancement of the OFT's role with 'express powers to approve codes; to allow members of approved codes to use a logo denoting his approval, to

market the benefits to consumers of using businesses that comply with effective codes which display the logo, to monitor the operation of the codes; and, to remove approval from those which are not effectively enforced.”<sup>68</sup>

- **OFT approval scheme of voluntary codes of practice:** in February 2001, the Director General of Fair Trading announced<sup>69</sup> that the OFT is adopting a more rigorous approval scheme for voluntary codes of practice governing business dealings with consumers. The new approach has two linked stages. At stage one the OFT will encourage codes that actually promise to deliver. At stage two, the OFT will give a ‘better trader’ logo to codes that prove they can deliver. A consultation paper has been published, in which the OFT proposes, on a preliminary basis, that a number of sectors should be targeted as a priority in this new regime, including, from the financial services perspective, credit and direct marketing.
- **SALTR<sup>70</sup> initiative:** the life insurance industry, led by the Association of British Insurers, is aiming to raise standards and improve disclosure through making key promises to consumers which include clarity and comparability of information, appropriateness of products purchased and customer service.
- **Banking Code:** the industry is making efforts to enhance general disclosure and this is reflected in provisions in the Banking Code. A new Banking Code came into effect in January 2001, which contained some enhancements of the previous code.

C.29 Further initiatives include:

- **Current Account Transfer Scheme (CATS):** this scheme is being piloted by the Association of Payment Clearing Services (APACS) and aims to ensure that a bank will be able to transfer all information, including direct debits and standing orders, via an automated system. The pilot scheme involves a number of the major banking institutions. It is hoped that by the end of 2001 most banks should be participating.
- **Myners Review of institutional investment:** this report commissioned by HM Treasury looks at many aspects of the way investment management is carried on. The Review recommendations are intended to be implemented voluntarily by the industry, but a statutory backstop is suggested if compliance is not effective voluntarily after two years.
- **Competition Commission’s Small Business Report:** this report resulted from Cruickshank Report on Competition in UK Banking which concluded that small and medium-sized firms were not, generally,

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68 DTI Press Release 28.03.00

69 OFT Press Notice 09/01, 27 February 2001: OFT announces new approach to Fair Trading

70 SALTR = Savings and Long Term Risk

receiving fair treatment from banks. The Commission's report examines the effect of the current level of competition within the banking community on fair treatment of this sector of consumers.

- C.30 We are also conscious that there are a number of relevant European Union initiatives. These include amendments to the existing UCITS directives which would require managers of unit trust and OEICS to use a simplified prospectus, providing consumer friendly standardised information, and early work on possible legislation setting out a duty to trade fairly and a co-regulatory framework to operate this.

### **How industry codes relate to the unfairnesses which we have examined**

- C.31 Industry codes cover areas of unfairness which we discuss in this paper, and we list a sample for illustrative purposes, based on the ABI Claims Code, the Banking Code, the General Insurance Code, the Mortgage Code and the ABI's SALTR initiative (the 'Codes'):

- **products and information are difficult for consumers to understand:**
  - all the Codes require information to customers to be provided in plain language;
  - all commit to helping the consumer understand the products/services offered.
- **consumers cannot get their complaints dealt with effectively:**
  - all the Codes require firms to have an internal complaints process and to handle complaints speedily;
  - SALTR requires firms to measure customer satisfaction with regard to the handling of complaints.
- **products and firms do not deliver what customers think they will:**
  - all the Codes require firms to help customers to understand features of products.
- **consumers are discouraged from changing products or product providers:**
  - the Banking Code requires banks to transfer accounts as efficiently as possible.

- **customers are not kept informed after the point of sale:**
  - the Banking Code, Mortgage Code and GISC code commit to notifying customers if charges, terms or conditions change after the point of sale;
  - SALTR requires firms to provide yearly statements to customers with investment products.

## **Developments in monitoring of the codes**

- C.32 Subscription to the Codes is currently voluntary. Until recently, there was limited or no monitoring or enforcement of the Codes. The ABI Claims Code benchmarks subscribers' compliance with the code and relies on peer pressure to encourage compliance. The remaining Codes are monitored and enforced by independent bodies, some of which have only recently been established, including the Banking Code Standards Board, the General Insurance Standards Council and the Pensions Protection Accreditation Board (which monitors SALTR). With the exception of the ABI Claims Code, those responsible for enforcing the Codes have a variety of sanctions and actions they can use, including involuntary withdrawal of membership of the code, imposition of fines, and censure via the press.

## **Conclusion**

- C.33 Significant work is already being done by the FSA and other bodies which should contribute to the protection of consumers and the fair treatment of retail customers after the point of sale. However, it has been clear to us in conducting our research that there are significant unfairnesses to consumers, which are not covered by this work and that there are therefore gaps on which the FSA needs to take action. We look at these gaps in Section 6 of this paper.
- C.34 The establishment of these bodies is encouraging change within the industry and our understanding from discussions with the code bodies, practitioner firms and industry experts is that firms are beginning to alter their behaviour which should in turn result in increased compliance with the Codes.

**ISBN: 0117042862**

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