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Product regulation: the new standard in financial services?

Demand for more direct regulation of financial products has been gathering pace both in the UK and worldwide as one response to the financial crisis. This article sheds light on the discussion of product regulation by drawing on comparisons with other sectors where such interventions are more commonplace

The recent financial crisis has caused regulators worldwide to reassess their approaches to the regulation of both the wholesale and retail financial services markets. Like financial regulators in other countries, the Financial Services Authority (FSA) in the UK has, in the past, followed a regulatory philosophy based on firms (providers) being subject to prudential regulation, to ensure their financial soundness, combined with conduct of business regulation to ensure that consumers were treated fairly and were given sufficient information on the characteristics of the products they were being offered so that they could make an informed choice. In addition, in the retail market, the sales process itself was regulated to reduce the incidence of the consumer ending up with the 'wrong' product, and ensure that suitable products were being recommended.

The Turner review of financial services regulation in the UK re-emphasised the validity of this approach, but also recommended the consideration of more direct approaches to the regulation of financial products themselves, which might include the prohibition of the sale of certain types of product to anyone (or certain types of consumer), or closer monitoring of product design features.[1]

In addition, the recent Treasury consultation paper on reforming financial markets invited responses to proposals to change labelling requirements for financial products with a view to improving consumers' understanding of product risks and returns, possibly drawing on the experiences of the other FSA in the UK, namely the Food Standards Agency.[2]

Although this represents a notable change in financial regulatory philosophy in the UK, it mirrors changes taking place elsewhere in financial regulation worldwide. In the USA, there have been suggestions that a new regulatory body, the Consumer Financial Protection Agency, should be created to oversee product regulation,[3] in much the same way as the Food and Drug Administration in the USA oversees drug approvals in addition to product safety and labelling requirements.

Many of these proposals are at an early stage of development. The FSA, initially, indicated that its review of the regulatory framework for mortgages in the UK might contain various suggestions for product regulation, such as caps on loan-to-value or loan-to-income ratios (mortgages above these ratios would not be permitted). In the end, it decided not to propose these caps and only to introduce one particular measure of product regulation: a ban on self-certified mortgages.

Although product regulation in financial services is often perceived as a recent initiative, elements of it are already in place. Collective investment schemes must already be authorised by the FSA and, in order to achieve this authorisation, they must satisfy certain structural requirements. At the European level, retail investment funds are also subject to such regulation in accordance with the Undertakings for Collective Investment in Transferable Securities (UCITS) Directives. However, in other areas further progression along this route has, in the past, been resisted due to perceived adverse impacts of reduced consumer choice and a perceived chilling effect on incentives to provide new and innovative products.

The current regulatory philosophy

As noted, financial services regulation in the UK combines prudential regulation with conduct of business regulation. Most of the latter form is aimed at protecting the retail investor whose financial capability

is assumed to be less than that of professional investors and those working in wholesale markets, where both buyers and sellers are considered sufficiently knowledgeable to deal with any product that they might be offered or asked for.

In the retail market, decisions over the particular characteristics and design of financial products have been left, largely, to the providers, while decisions over the suitability of products for particular consumers have been left to advisers, with appropriate monitoring of this when recommendations are made.

When it has been felt that certain products may not be suitable for all consumers (such as structured products), the FSA has preferred to issue advice of a more general nature, rather than restrict their use directly. In the case of structured products, the FSA provides information for consumers on the types of risk involved and suggests that professional advice be sought due to the products' complexities.

The rationale for this approach is that if consumers have enough information and understand their own needs, their choices will discipline the market to ensure that only good products are produced, and bad products do not survive.

Why product regulation?

The financial crisis has called this assumption into question and has re-ignited the debate around the need for (more) product regulation. There are calls for the outright banning of the production of certain products or product types, or to be more restrictive about what type of consumer can buy a particular product. Relying on market forces operating through informed consumers is seen to be a less effective approach to matching consumers with products.

Despite the increasing attention given to product regulation, it is not always clear what exactly is meant by this term. An examination of the experience in and outside the financial services sector highlights the existence of a number of approaches that can be seen as product regulation. These dimensions are not always mutually exclusive: one group of products being sold to particular consumers may be subject to different types of product regulation.

All of these interventions are designed to make sure consumers end up with the right product, but they vary in how this is to be achieved. In addition, exactly how the market develops in the face of these different regulations may be different, and idiosyncratic to the particular market. Nonetheless, there are patterns that emerge when using the different approaches.

At one end of the spectrum are **voluntary product standards** where the providers agree 'voluntarily' that when products are sold at all, or to certain groups, they will meet some voluntary standard. If all providers sign up to the voluntary standard, the effect is that products that do not meet the standard are not available. However, if there is a significant group of providers who do not sign up to the voluntary standard, the impact on the market may be small. This may be particularly acute if consumers do not understand the implications of the standard, or of buying a product that does not meet the standard.

Compulsory minimum standards aim more directly at ensuring that products with particular characteristics are not offered in the market, and hence consumers cannot buy them. Minimum standards reduce search costs, as consumers can be sure of a certain level of product quality, but they are also likely to impose compliance costs on the industry.

Minimum standards are called *minimum* standards because they prescribe the criteria that products need to meet only at the minimum—firms are still allowed to design products that go beyond these minimum standards. Minimum standards are not necessarily minimal; in practice, they range from very basic standards (eg, safety standards for consumer products) to very detailed rules for specific features of products, potentially resulting in a complete redesign of existing products.

An example of how product regulation can work successfully is the EU Directive standards applied to the UCITS product. UCITS are retail funds authorised by one EU Member State that can be 'passported' across the EU. The regulatory restrictions include rules on the asset classes in which a UCITS can invest, risk-spreading and diversification. There are further operational safeguards such as the need to use an independent custodian and the requirement to perform independent regular valuations of fund assets. Despite the additional costs of complying with these rules, UCITS have grown to become a successful and widely recognised product, also as a global fund vehicle outside Europe.

There may also be a need to **regulate the labelling of products**. These disclosure requirements can take a number of forms and may involve highly prescriptive rules to ensure that labels contain particular information (such as the requirements for disclosure of ingredients on food labels). Labelling can also consist of providing underlying information about the product characteristic, such as the level of the commission received by the adviser or the risk profile of the product.

Further along the spectrum, there is **direct regulation of product prices**. In general, outside industries with natural monopolies, regulators avoid this due to its potential distortionary effects in the market. However, examples do exist, for example in relation to some rail fares. Within more competitive industries, lesser forms of price control do occur, often in relation to a voluntary standard and a labelling intervention, so that some (excessive) prices are ruled out if the product is to be labelled as a 'good' product. The introduction of stakeholder financial products in the UK in 2005 contained an element of price regulation as the government set maximum charges at 1.5% in an attempt to encourage consumers on lower incomes to purchase such products—in particular, pensions.

The aim of price regulation in, for example, the case of stakeholder products was to ensure that products were available to groups of consumers who might not otherwise have been able to afford them. However, in some cases, price regulation may have the exact opposite effect. For example, experiences in the USA with interest rate ceilings for credit products show that it became more difficult for high-risk consumers to obtain access to credit.

Product suitability

An alternative approach is to have regulation applied to advisers, to ensure that the product is bought only by those for whom it is suitable. This form of regulation can only be applied where there is an intermediary (the adviser) and indirectly limits the product availability. One area where this type of regulation is used extensively is in the pharmaceuticals sector, where certain products (prescription products) can only be accessed through the advice of a doctor, and others only through the advice of a pharmacist. In this sector this is (or at least was) the *only* route to these products.[4] However, in addition, this sector is subject to stringent product regulation—only products that pass specific tests are available at all.

In the case of financial products, the 'suitability' approach is a central plank of UK regulation, but, unlike the pharmaceuticals sector, there is little direct regulation of the products themselves. Consumers can, if they really want to, bypass the advisers and deal directly with providers (eg, buying the product through an execution-only channel). Moreover, control of product characteristics through the advice route relies on the advisers not recommending 'unsuitable' products.

If the general suitability, or otherwise, of a product can be influenced by the regulator then unsuitable products may exit the market. One key to the effectiveness of this type of regulation is, therefore, the decisions made by the body that ultimately decides whether the product sold was, indeed, suitable. In the UK, after the event, this is the Financial Services Ombudsman, who rules on suitability disputes. Rather than banning outright, say, mortgages with high loan-to-valuation or loan-to-income ratios, if such mortgages become seen as generally unsuitable, advisers will not recommend them since doing so would put these advisers at financial risk of having to pay compensation if such a loan turned sour.

A coherent system of suitability requirements for financial products would necessitate the regulator determining the risk and return characteristics for the product and then being able to match these (ex ante) with individual consumer profiles. In practice this has proved difficult to achieve. A pattern has emerged of quite significant amounts of specific unsuitable products being sold, followed by compensation claims that apply to all, or nearly all, of the purchasers of the product. Arguably, product regulation has more or less been achieved, but with the flexibility that, for those consumers for whom such a loan is suitable, it can be sold (but with the risk that those for whom it is not suitable can still also buy it by bypassing the adviser).

Financial stability

Product regulation may also have a role in relation to financial stability to address certain negative externalities of the product that could arise, for example, when many consumers (or intermediaries) all hold the same (type of) product.

Arguably, banning the sale of mortgages above a multiple of income could be justified on these grounds. This results from the economy-wide problems that could arise if large numbers of consumers have these mortgages and the economy goes into a downturn. The simultaneous attempted liquidation of defaulting properties, which results from the high gearing on the mortgages, can itself result in further economic damage, in a way that the liquidation of a single high multiple-income mortgage would not. Banning the sale of these products may be the only way to eliminate this risk entirely. However, before proposing such an intervention, further analysis would need to be undertaken to assess whether the risk and potential damage are so significant as to justify intervention.

Unintended negative consequences

Product regulation has a number of practical advantages that can make it a tool that is attractive (and perhaps too convenient) for regulators and politicians. First, regulating the product rather than the provider or the advice process may give the impression that the perceived problem is being addressed head on. You simply ban those products or those product

features that (are perceived to) harm consumers—no beating around the bush. Second, designing a rule that bans certain products or product features may sometimes be easier than trying to prescribe precisely the behaviour of providers or advisers. Third, monitoring compliance with product regulation may also be easier than monitoring compliance with prudential regulation and regulation of the advice process (although this will depend to some extent on the type of product and circumstances).

Product regulation is a direct tool that can be very effective if used appropriately. However, it can also result in unintended adverse effects, including, in particular, distorting competition, stifling innovation and banning products that are not necessarily harmful to at least some consumers. This is a risk in particular when it is used to achieve a particular objective that is only indirectly related to the specific product or product features. Where there is more a direct link between what the regulation is aimed to address and the feature of the product, the risk of unintended consequences is likely to be smaller. Safety regulation is an interesting example of where the ultimate objective is very closely related to the product features—it simply bans certain features that could directly harm consumers, or prescribes features that directly prevent consumers from getting harmed.

Do the benefits outweigh the costs?

In reality, regulation takes on a number of forms concurrently in most parts of the economy. Outside of the financial services sector there are many examples of quite detailed product regulation, particularly in relation to safety, and there are also examples of regulation designed to make the choice process work better (eg, energy efficiency disclosures). Product regulation has been successful in many cases. The safety of many products is ensured by compulsory regulations, which eliminates non-compliant products from the market.

This does not mean that these regulations are always uncontroversial, even in relation to safety. Arguments about the ‘nanny state’ and the exercise of personal choice continually shift the boundaries of product (and services) regulations, so that, for example, cheese made from unpasteurised milk can be sold in some countries, but not others.

In financial services there is some, but rather limited, direct product regulation along the lines of ‘*that product cannot be sold*’. There is much regulation that is, however, designed to produce, indirectly, an outcome whereby *that product is not sold,* or more often *that product should not be sold to that person*.

Before the financial crisis, the UK was already tentatively going down this route with partial product regulation—eg, stakeholder products and CAT (reasonable Charges, easy Access, and fair Terms)—and in the soon-to-be-introduced National Pensions Saving Scheme in the UK the government took a leading role in designing the product, although the core activities of the scheme will be outsourced to the private sector.

It will be interesting to see how the financial services sector embraces (or not!) much more regulation that directly addresses and controls the characteristics of the product being sold.

It should not be forgotten that product regulation is only one of many regulatory tools. All forms of regulation require a clear set of objectives and desired outcomes to be established before the need for intervention has been agreed. These should be combined with an assessment of the likely mechanisms through which the proposed regulations will give rise to these desired outcomes.

In this respect product regulation should be no different. The costs and benefits of product regulation will always depend on the specific circumstances. Although it may be a convenient tool for regulators and politicians, for it to be effective, there needs to be a clear assessment of desired market outcomes and the mechanisms for achieving them. In addition to determining the direct effects of such regulation on consumers, this includes analysing the mechanisms through which it might adversely affect competition and innovation.

[1] Financial Services Authority (2009), ‘The Turner Review: A Regulatory Response to the Global Banking Crisis’, March.
[2] HM Treasury (2009), ‘Reforming Financial Markets’, Cm 7667, July.
[3] House of Representatives Financial Services Committee (2009), ‘Regulatory Restructuring: Enhancing Consumer Financial Products Regulation’, June 24th.
[4] The Internet and cross-border sales of pharmaceuticals have to some extent allowed consumers to bypass the advisers and deal directly with suppliers.

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