

## Product regulation can stop the damage and slash costs

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Product regulation is an inevitable consequence of the retail distribution review. This could be a good outcome or a bad one - it all depends on the approach taken by regulators.

First, regulators need to recognise the reasons why they took a wrong turning in the method of regulation. Then they have to understand what consumers actually need, which is not what providers want to sell them.

Finally they have to work out how to apply outcome-focused regulation to the retail market for financial services - the area where process-based regulation has been and will continue to be a failure for entirely predictable reasons.

If they embrace product regulation now, regulators can make a good fist of it but if they resist the idea they will still end up doing it, but will do it badly.

We have to start by asking why the Financial Services and Markets Act and the FSA regulate everything in financial services except products. We now take this for granted but when you put it like this it does sound odd. Capital, people and processes are regulated. Why not products?

Before the City's Big Bang in 1986, there was no system of financial services regulation. Actuaries looked after life assurance and pensions, while stockbrokers, lawyers and accountants were self-regulating. It was Margaret Thatcher's destruction of the cosy City club that led to a need for regulation.

When thinking about how, the legislators had only one example to turn to - the Takeover Panel. Set up in the late 1960s by the City to fend off a Labour Government's proposed legislation, the panel started as a non-statutory self-regulating body, with the overriding aim of fair treatment for all shareholders.

It worked by consent. The banks agreed that to do mergers and acquisitions in London you played by the panel's rules.

The formidable first chairman of the panel, Lord Shawcross, established a system of principles that was interpreted and applied by practitioners.

A two-year secondment to the panel became a must-have item on investment banker CVs - and banks knew that their secondees would return as better M&A practitioners.

The model worked then and it works now. The Takeover Panel is the most successful example of financial regulation ever created. No wonder the idea of light-touch regulation and delegation to practitioners became the model for the self regulatory organisations of the 1980s - Imro (investment management), Lautro (life assurance), SFA (stocks and derivatives) and Fimbra (advisers).

The problem was that the Takeover Panel model only worked in wholesale markets.

Imro and SFA were reasonably successful in controlling their members - for example, Imro was involved in strong-arming some of its members to contribute to the restitution fund for pensioners whose retirement funds were looted by Robert Maxwell.

But Fimbra and Lautro were disasters. Vested interests overrode public interest. Advisers scammed the public. Lautro conned buyers of life policies with its flawed projection rules.

The Securities and Investment Board, created as a compromise solution, failed to impose public interest as the governing principle.

So in 2000, we got the FSMA and the FSA. At this point, it was reasonable to conclude that the problems were to do with process.

The mortgage endowment and pension misselling scandals could be construed as deriving from flawed sales methods. So the new system was constructed on the basis of regulating process. It was assumed that competition would take care of products.

Since then, though, we have had many instances where it was clearly product that was at fault rather than process.

MPPI, split-capital investment trusts and precipice bonds were all bad products. Their design was inherently flawed to the extent that they would not deliver good outcomes for many buyers.

If that is the problem, the solution is not regulation of the sales process. You cannot regulate car safety by regulating how people sell cars.

The problem of inherently bad products is sure to get worse. Ucits III permits fund managers to do things that can blow up their funds, so it is predictable that a fund will blow up at some point. Faifs are even more likely to produce a disaster. Structured products grow ever more complex - another Lehman, Keydata or worse is not just likely but probable.

So clearly we have a problem of hammers being used when spanners are needed. The FSA adopting a "tougher" or "more intrusive" regulatory stance will not help. If banging your head against the wall does not cure your headache, banging it harder is not an intelligent response.

If we want to understand why financial regulators have refused to regulate products, we have to take a step back into the theoretical framework they use. It is the flawed framework of Economics 101. It shares the assumptions of economic and finance theory - rational consumers try to maximise their utility using perfect information. It assumes consumers can effortlessly calculate lifetime utility and correctly balance the utility to them of a pound today versus a pound tomorrow and that each makes their own decision independently of everyone else. Under the assumptions, many and complex products are not a problem.

Put like this, it is obvious how absurd these assumptions are. But it has taken three decades of behavioural finance to get establishment economists to accept that their models do not reflect reality.

In many situations, we act non-rationally some of the time. Evolutionary biology explains why our limbic system overrides rational calculation when we are under stress - flight or fight reflexes had survival value on the African plains.

We now know that we "hyperbolically discount" (we are hard-wired to act on the bird-in-hand principle), that we are overconfident and that we are very, very bad at estimating probabilities.

These biases in our thinking and behaviour are not irrational (the product of prejudice or mental degeneration) - they are non-rational, determined by factors that may still have survival value and are an essential component of being human. But they trip most people up badly when it comes to financial decisions, especially with complex products.

Recognising this, what is the correct response of financial regulators?

Regulators have got it half-right. The RDR proposals create independent advisers who are responsible solely to the client, like accountants, lawyers and doctors. This model, where it is the advice process that is regulated, is the appropriate one for any professional service.

Process-based regulation aims at defining processes that have good outcomes. But the FSA is wrong to apply this model to the retail marketplace.

In this consumer market, the correct principle is not to prescribe good outcomes but to limit harm - the same principle used in food and drug regulation and consumer products generally. And this requires the outlawing of harmful products or product features.

Behavioural finance tells us that what consumers need are simple products. This does not necessarily mean simple to construct, but products for which a narrow range of outcomes is predictable and which can be simply explained. These products will not arise through unfettered competition. They can only be regulated into existence.

The regulators are edging towards this with the discovery that if they want simplified advice, it has to come with simplified products sold using decision trees. They need to go further and limit retail sales (anything other than independent advice) to these simplified products.

How can we have a two-tier market in which IFAs can recommend anything they like but banks and salespeople have only a narrow product range to sell?

You can find an example on every high street. It is a pharmacy. It sells only medicines that have a long history, whose side-effects are well known and for which following simple instructions can avoid harm. You can kill yourself with codeine and even aspirin but we assume you will read the leaflet and live. If you need statins or steroids, though, you consult a doctor.

Nobody complains that this two-tier market is unworkable, unfair or uncompetitive. Both makers of prescription drugs and over the counter medicines make healthy profits, so do pharmacists.

By regulating financial products for the mass market (the detailed regulation of product will necessarily be delegated to bodies dominated by practitioners), most of the process regulation in this sector can be removed, to cut the cost of regulation by upwards of £5bn a year (a cost ultimately paid by consumers).

The other reason for making a decisive switch to product regulation now is that we can be absolutely certain that under the present RDR regime, restricted-advice chains will devise ways of selling high-charge, complex products to far more people, creating consumer abuse on a much bigger scale than we have seen over the past decade.

This really is an oncoming train and if regulators do not stop it now they will be among those who get flattened. Either way, product regulation will happen, because it is the only effective way of limiting harm to consumers, just as it is with cars, drugs and food.