Feasibility (Pty) Ltd

Clarity & Strategy Through Economic Research

Treating customers fairly

A discussion paper prepared for the
Financial Services Board

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1. Concise report

1.1 Setting the scene

The regulatory authority in the non-banking financial services industry, the Financial Services Board (FSB), is interested in pursuing a Treating Customers Fairly (TCF) programme similar to that currently being implemented in the UK.

This discussion paper examines the elements of the TCF programme and considers its application in South Africa.

Issues concerning the fair treatment of customers arise as a combination of factors and include those related to market failures, firm incentives and consumer behaviour. One of the key market failures is that market participants do not possess perfect information. The system may be confronted with the problem of asymmetric information where certain market participants (the suppliers of financial services) possess information that others (consumers) do not possess. This may lead to consumers being treated unfairly and possibly suffering considerable financial losses in the process.

The TCF programme is a regulatory initiative by which firms are required to consider their treatment of customers at all the stages of the product life-cycle, including the design, marketing, advice, point-of-sale and after-sale stages. By encouraging firms to re-evaluate their company culture and to inculcate the attitude of treating customers fairly, the outcome is likely to result in a more optimal one from the perspective of the regulators, consumers and ultimately, firms.

1.2 Regulating the financial services industry

Financial services tend to fall in the category of services whose quality can be ascertained only at considerable cost, typically some time after purchase or perhaps only when disaster occurs. For example, it may be left to the heirs of a customer to find out if the insurance policy under consideration was a fair one. The costs concerned include not only the actual costs, but the benefits foregone, should a certain alternative have been chosen.

While regulators can do much to educate consumers as to the nature of financial contracts, and to inform them of the responsibilities associated with undertaking such contracts, the nature of financial services suggests that such education is not enough in itself.

For as long as they have existed, regulators have grappled with how best to ensure that firms treat customers fairly. Typically, they set out principles and rules by which firms should operate. While the TCF programme of the Financial Services Authority (FSA) in the UK was initially expressed as a principle-based approach, it is clear that any set of regulatory norms require both broad principles and detailed rules. Over time, the FSA has come to describe its approach as an outcomes-focussed approach, rather than as a principle-based approach.

For the regulatory norms to succeed in their aim of fair outcomes for customers, there must be incentives in place to encourage firms to comply. Together with the incentives, there need to be legal and political structures in place. Incentives can be both positive (such as receiving recognition) and negative (such as being fined).

The FSB is a statutory body established by the Financial Services Board Act, 1990, with the objective to promote and maintain a sound financial investment environment in South Africa. Its mission is to promote:[1]

- Fair treatment of consumers of financial services and products
- Financial soundness of financial institutions
- Systemic stability of financial industries
- Integrity of financial markets and institutions.

The TCF programme is accordingly well within its mandate. The statutory FAIS Ombudsman and the Pension Fund Adjudicator, as well as the voluntary industry ombudsmen also have a role to play in ensuring ultimate fairness to consumers.

In terms of the implementation of a TCF programme, the UK experience suggests that however well-worded the principles and rules may be, there are additional factors affecting successful implementation. This includes a **change of mindset amongst firm leadership**. Successful adopters of the TCF programme were those where the CEO or managing director of the firm had typically endorsed the programme, spelt it out for middle management and employees and received regular data on consumer complaints and redress. Moreover, TCF measures were used to influence performance appraisal and incentive structures in the firm. The least successful firms were those that left it all to their compliance department (or an outside consultancy) to design a programme but whose feedback was neither presented nor understood at board level.

[1] FSB Annual Report 2009

Another key lesson has to do with the **clarity of expectations.** Firms need to understand what the regulator expects of them.

Over recent decades, more and more low-income consumers have entered into sophisticated financial contracts, without understanding the implications thereof or their concomitant responsibilities. Another lesson is **the need for better education of consumers** so that they could be responsible counterparties to financial providers.

The FSA in the UK has come to see **pre-emptive and intensive supervision** as key to the success of the TCF programme. Supervision is pre-emptive in that analysis is conducted with the aim of identifying and addressing conduct risks in the industry and at firm level at an early stage. Intensive supervision refers to the systematic assessment of firms' business model and culture as well as its product development and design activities, product marketing, distribution and post-sales handling. The intensive supervisory approach includes mystery shopping and collecting evidence from the shop front, and does not merely include boardroom activity.

The importance of **enforcement through credible deterrence** in order to ensure compliance was another key lesson. While firms and industry bodies might be co-operative, this would only translate into change in the industry if firms knew from the outset that their culture, strategies and behaviour would be tested, and that they would face negative consequences if their performance was found wanting. Such consequences could include fines, de-registration and even prosecution. Achievable deadlines for compliance should be published and enforced, in order to establish credibility. The threat of publishing the names of non-compliant firms is effective as firms do not want to be seen as lagging behind their peers. The FSA has forced firms to publish data about complaints should the numbers exceed a certain threshold.

1.3 Approaches to treating customers fairly

Since the TCF programme has been articulated and initiated by the FSA, it is not surprising that the FSA approach is strongly associated with the TCF programme.

The FSA expects senior management to be aware of the TCF programme and lays responsibility for treating customers fairly squarely at the door of senior management. The FSA wants to encourage firms to treat customers fairly without relying on too many rules and in particular wishes to avoid laying down a huge raft of new rules. Its approach is to focus on the six outcomes of the TCF programme:

- **Outcome 1:** Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture. This outcome is the consequence of Outcomes 2 to 6.
- **Outcome 2:** Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3:** Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4:** Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5:** Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and what they have been led to expect.
- **Outcome 6:** Consumers do not face unreasonable post-sale barriers to changing product, switching provider, submitting a claim or making a complaint.

In order to achieve these outcomes, cultural and operational aspects of the firm may need to change. Moreover, the firm needs to consider what the TCF programme means for each phase of the product life cycle.

For example, the product life-cycle can be seen to involve the following stages: product design, marketing and promotion, advice, point-of-sale, information post point-of-sale and complaint- and claims-handling. The concept of treating customers fairly needs to be considered at each stage:

- **New Product design:** Products are designed and developed for specific target markets, based on a clear understanding of the likely needs and financial capability of each customer group.
- **Promotion and marketing:** Products are marketed to specific target groups, through clear and fair communications that are not misleading.
- **Advice:** Firms need to make clear what they have to offer and need to balance the commercial objective of increasing sales with the objective of TCF.
- **Point-of-sale:** Firms need to provide clear and fair information and need to make charges transparent. Being clear to customers about what the products and services offer and balancing the commercial objective of increasing sales with the objective of TCF.
- **Information after point-of-sale:** Firms need to monitor and respond to changes in the wider environment that may affect products and impact on particular classes of new or existing customers.
- **Complaints and claims handling:** Firms need to honour representations, assurances and promises.

Box 1 Complementarity and TCF

Suppose that you wanted to build a brick wall. As a binding agent you use a mixture of cement and sand. Somebody advises you that cement is by far the most important ingredient, and taken to its extreme, the argument might suggest that you concentrate on cement alone. On the other hand there might be those who suggest that you use as little cement as possible. Once again, the extreme case would amount to using sand alone.

The sensible way to build is surely to take into account that sand and cement are complements in the building process. In much the same way, it is not sensible to argue in favour of a regulatory policy that emphasizes **either** rules **or** principles. The two are not substitutes. We need a regulatory policy that makes use of principles **and** rules. The two complement each other.

What we mean by a TCF policy

As the above discussion on complementarity indicated, the TCF concept is not confined (as far as regulation is concerned) to the *principle* of treating customers fairly. The concept should also not be confined to the *rules* involved. As our notes on complementarity have made clear, a policy that emphasizes either $TCF_{principles}$ or TCF_{rules} will come short. As the word indicates, the rules and the principles are complements. You can't have one without the other.

In order to emphasize the necessity of the complementarity concept, we could, of course, always write $TCF_{principles\ \&\ rules}$. That would, however, be unnecessarily cumbersome. We nevertheless wish to emphasize that when we talk about the appropriate TCF policy, we mean a policy that reflects the notion of $TCF_{principles\ \&\ rules}$.

Moreover, as has become clear from the UK experience, a successful TCF policy requires enforcement. The use of the term enforcement also raises the question of who is doing the enforcing. As will become clear, enforcement involves both intensive supervision and credible deterence, from the regulator. Market discipline also contributes if the right incentive structures are put in place. Moreover, the ombudsmen have a role to play. Strictly speaking, then, when we talk about TCF, we mean $TCF_{principles\ \&\ rules\ \&\ enforcement}$.

Moreover, the leadership of the firm needs to consider what management information is needed to measure the firm's TCF performance in each of these stages. While TCF should not imply that innovation is inhibited, firms must identify the riskiness of new products, and build in appropriate controls to ensure that customers are treated fairly and not exposed to unsuitable or unidentified risks.

TCF is not the same as being nice to customers, nor does it amount to creating satisfied customers even though these are the likely outcomes of TCF. For instance, the complexity of many products, combined with the low level of consumer understanding, means there could be occasions when customers are satisfied because they do not realise that they have not been fairly treated. Likewise, customers with unrealistic expectations might feel dissatisfied even though the firm has treated them fairly.

For the TCF outcomes to eventuate, and for the principles to be effected in each of the life-cycle stages, firms need to embrace the TCF principles at various levels:

- **Leadership:** The Board, senior and middle management need to provide direction and monitor the delivery of TCF behaviour and outcomes. The importance of TCF must not only be understood - it must also be implemented in all business areas.
- **Strategy:** The TCF aims should not merely be part of a firm's vision and values. They also need to be carried through to implementation. Moreover, the TCF approach should be built into any plans (or changes in plans) developed by senior management.
- **Decision-making:** All decisions that impact on consumers should be subject to the challenge implicit in the TCF strategy of the company. For staff to feel they can evaluate and challenge decisions from the TCF perspective - without repercussion - it may be necessary to set processes in place or to create a conducive environment.
- **Controls:** The monitoring of the success of a firm's TCF strategy requires that management information (MI) be identified, collected and evaluated.
- **Performance management:** The recruitment of appropriate staff and agents (trained to deliver appropriate TCF outcomes) is necessary. Moreover, staff should be evaluated in terms of performance in TCF competence and expectations.
- **Reward:** While firms will establish targets related to the growth of firms and the growth of profits, incentive schemes need to take cognisance of fair consumer outcomes. Hence reward structures may need to be reviewed in terms of quality issues and firms need to consider ways of rewarding good outcomes in terms of TCF.

1.4 "Conduct unbecoming" examples in South Africa

There are a number of areas where unfair outcomes have been experienced by South African consumers. While by no means an exhaustive list, a few illustrative examples are provided:

Product design phase:

- In some cases, the product design defeats the apparent purpose of the product. An example is where high and layered fee structures are imposed on investment policies, making the likelihood of a positive return improbable. Even if these fees are disclosed, the consumer may not understand the implication of such fees.
- In other cases, the contractual wording may be highly restrictive, and while the consumers may believe they have cover, the likelihood of a successful claim is very small. For example, in the case of health policies, the conditions covered may be highly obscure, while more common diseases and conditions

are excluded. This type of product has the effect of creating a very small claims ratio, as most claims are rejected.

Promotion phase:

- The marketing material makes misleading promises. For example, a promise is made to pay the claim within 48 hours, even although there are no structures to ensure such a turnaround time.
- Consumers feel misled as promotion material focuses only on good reasons to buy products, but fails to inform about the key risks of the product or the extent of exclusions or limitations.
- Church, work or community groups are used as broad-based distribution channels; however, they are inadequately trained and cannot adequately explain the nature of the product, or its exclusions. Customers may later feel hoodwinked.

Advice phase:

- The upfront commission structure in long-term insurance leads to over-eagerness to sell inappropriate policies – such as where a client clearly cannot sustain the premium contributions. In other cases, an alternative non-insurance product might be more suitable, but is not sold because it would result in less up-front remuneration for the intermediary.
- The financial firm – such as a bank - directs all business to an associated insurance company, with the client unaware of whether or not the associated company offers value for money. The client may also be unaware that he (she) may be allowed to choose an alternate supplier.

Point-of-sale:

- Bundling occurs so that the different components of the product (and its associated premium or fee) are not brought to the attention of the consumer. This means that the consumer may not be aware of the extent or nature of the insurance, or its value or the ability to opt out.
- Clear and simple language may be absent. The terms used in point-of-sale material and by the sales person or broker may not be adequately defined. This potentially confuses the consumer.
- In the case of telemarketing, consumers are sometimes misled by the apparent ease of the process, and may not pay attention to the need to provide follow-up or additional information. For example, the ID numbers and licence numbers of additional drivers may be requested. However, the importance of submitting this information may not be emphasised. In this case, consumers run the risk that claims involving such additional drivers will be rejected.

After point-of-sale:

- Consumers are sometimes surprised by charges that come into effect when a policy is called into use. In many cases, these charges are not explained at the point-of-sale, but the client experiences the effect of these charges after the sale. While charges on withdrawals and surrenders from contractual savings products of insurers, for example, may be incorporated into the design of the product in order to encourage long-term savings, the quality of the advice given prior to the point-of-sale may mean that the consumer has appreciated neither the nature of the contract nor his or her responsibility in undertaking it. Moreover, the contractual arrangements may not be at all suited to the financial position of the client. In these cases, the client's after-sale experience of the contract is likely to be negative.

Complaints and claims handling:

- Firms may assign considerable resources to the repudiation of claims, rather than ensuring that adequate information is provided to consumers upfront. For example, after a claim is made, much effort may be put into proving there was inadequate disclosure by the policyholder, or that a condition pre-existed. At the time the contract was signed, however, little or no effort was made to extract sufficient information or explain the consequences of pre-existing conditions.
- In some cases, payouts of retirement annuities are delayed by administrative inefficiencies for months on end, leaving the consumer out of pocket and unable to take advantage of specific investment opportunities.

A new approach that involves principles of fairness embedded in the cultural behaviour of firms seems called for rather than *ad hoc* regulatory fixes.

1.5 TCF in South Africa – the way forward

The appropriate regulatory regime to facilitate the successful implementation of a TCF programme in South Africa requires elements that:

- Ensure clarity of regulatory expectations through legislative revision, regulatory change and provision of guidance notes to the industry.
- Monitor the programme through pro-active and intensive supervision.
- Ensure compliance through enforcement with appropriate incentives and sanctions.
- Encourage consumer responsibility through education.
- Facilitate ultimate fairness by working with the statutory and voluntary ombudsmen and adjudicators.

Each of these key elements is interrelated and its success is dependent on the other elements. Failure to implement any one of these is likely to retard or scupper the success of the others.

The FSB has published this discussion document with a view to clarifying what is meant by treating customers fairly in South Africa. In the process it seeks to obtain views on the matter from industry and consumers.

The aim is not necessarily to rework the document, but to stimulate comment and debate. It is intended that written submissions be made on the concepts set out in this document and that a workshop be convened to discuss the comments.

Following this process, the FSB will set out its TCF vision and the programme for the next stages.

2. Introduction

In South Africa, the regulatory authority in the non-banking financial services industry is the Financial Services Board (FSB). Feasibility (Pty) Ltd has produced the current discussion paper for the FSB on the Treating Customers Fairly (TCF) programme currently being implemented in the UK and on its possible application in South Africa.

Issues concerning the fair treatment of customers arise from the fact that market participants do not possess perfect information. In particular, the system may be confronted with the problem of asymmetric information where certain market participants (the suppliers of financial services) possess information that others (consumers) do not possess. This may lead to consumers being treated unfairly and possibly suffering considerable financial losses in the process. If consumers could somehow be provided with better information so that they could make responsible decisions, society should benefit.

In general terms, the subject matter of this inquiry centres on the provision of adequate information by firms in the form of a TCF approach. Such provision is not, of course, the only avenue whereby consumers could acquire information. With or without the assistance of firms, consumers could be offered educational programs to enhance financial literacy. From the viewpoint of a regulator, a two-pronged approach is the way to go. An educational program promoting financial literacy should be complementary to a TCF program providing information. Firms should not be led to believe that they are absolved from the responsibility of treating customers fairly if consumers are well educated.

Another way of viewing the TCF issue is to acknowledge that there are costs associated with not treating customers fairly. The TCF approach can be viewed as an attempt to make such costs explicit. If the costs remain hidden, the system may be incapable of reaching an optimum position. This is best illustrated by another example of making implicit costs explicit.

The example has to do with pollution. A factory manufactures steel and in the process ejects poisonous waste into a river which kills the fish. The non-optimum position arises because the cost curves of the firm do not include the costs of pollution. If the regulatory authorities could introduce some way of making the (initially) hidden costs of pollution explicit, society may move to a more optimum solution. The solution lies in incorporating the cost of pollution into the cost curves of polluters.

The principles involved in this example can now be applied to the TCF programme. If consumers are not treated fairly, the system under consideration may arrive at a non-optimum position. Part of the solution lies in making it expensive for firms to hoodwink customers – in the same way that the solution to the pollution problem lies in making it expensive for firms to pollute. As we have indicated, this policy of discouraging hoodwinkers is only part of the solution – the other half of the solution lies in educating those who may be hoodwinked.

The theory of treating customers fairly has something in common with the theory of the economics of crime. One of the ways of reducing crime is to make it more expensive to supply crime. From a risk-based point of view, the more certain a potential criminal is of being caught, the more expensive it is for him or her to engage in criminal activities.

The more certain a firm is of getting caught for treating customers unfairly, the more expensive it is for that firm to engage in unfair activities. From a regulatory perspective, unfairness must be combated by making it expensive for firms to supply toxic financial services where by this we mean financial services tainted with unfairness.

In Section 3 we investigate the issues involved in regulating the financial services industry. This includes having a closer look at the nature of financial services (Section 3.1). Financial services tend to fall in the category of services whose quality can be ascertained only at considerable cost, typically some time after purchase or perhaps only when disaster occurs. The costs concerned include not only the actual costs, but the benefits foregone, should some alternative have been chosen. We also discuss the trend towards principles-based regulation and the need for a combination of rules and principles to guide regulation and compliance (Section 3.2). Implementation issues, related in part to compliance and the need for incentives are discussed in Section 3.3.

Section 4 examines country experience and possible lessons. Specifically, the UK experience where the TCF approach is currently being used and the Australian experience, where it is not, provide a useful frame of reference for the South African scene.

Section 5 investigates a number of examples of the kind of unfair behaviour that have arisen in South Africa. If such "conduct unbecoming" examples are to be eliminated, one needs to consider the type of regulatory regime that needs to be in place.

Section 6 considers some of the key elements that a regulatory regime requires for the successful implementation of a TCF programme in South Africa.

3. Regulating the financial services industry

3.1 Regulation of financial services and the nature of the service

Regulation of financial services is complicated by the nature of the beast. Some examples should help to make this clear. A distinction is usually made between *search, experience* and *credence goods* and *services*.

In the case of *search* goods, quality and price can be ascertained at low cost prior to purchase or where a credible warranty is attached. Selection of a shirt, for example, typically involves an evaluation of the fit, style and price prior to purchase.

By contrast, *experience*-goods are those whose quality can be ascertained at low cost through use, though not prior to purchase. So for example, evaluation of a vacuum cleaner is typically made after purchase. Moreover, a faulty vacuum cleaner can be returned and a replacement obtained at relatively low cost to the consumer. While the element of uncertainty at the point of purchase is clearly higher than in the case of search goods, the degree of uncertainty is bounded. Many services tend to fall into the experience category, as it is only after the laundry has been done, or the haircut performed, that the consumer may evaluate the quality.

Credence goods and services, on the other hand, are those where quality can be ascertained only at some cost after purchase. A frequent characteristic of these goods and services is that the value of the purchase is either spread over a long period of time, or emerges only after a considerable lapse of time. Reversal of such a purchase usually involves considerable loss, both in terms of actual costs and benefits foregone of selecting some alternative.

Financial services tend to fall in the category of credence services. The value of many such services can often only be determined once the disaster befalls. For example, it may be left to the heirs of a customer to find out if the insurance policy under consideration was a fair one. It is in the nature of many financial transactions that they involve *incomplete contracts*, in that their value is determined in large part by the behaviour of the seller/supplier after the point of purchase, or even by the behaviour of other firms in the industry. For example, an investment manager may turn out to be incompetent or even corrupt, and a financial institution may become insolvent while having fiduciary commitments to its customers, perhaps because of a systemic crisis, such as the sub-prime disaster.

The nature of financial transactions makes the lives of regulators more complex, precisely because it emasculates the disciplinary power of effective competition by rational consumers. In the case of shoes, or vacuum cleaners, or even laundry, consumers can "vote with their feet" and this and other forms of consumer protest are likely to lead to improved quality and even the demise of the unsatisfactory provider. Financial service providers are somewhat immune from competition precisely because informed choice is more elusive and rational behaviour is not self-evident at the time of purchase.

3.1.1 The trend towards principles-based regulation

One of the ways in which financial regulators have sought to deal with both complex services and an evolving regulatory landscape, is by moving towards *principles-based* regulation. In recent years, for example, following the FSA in the UK, financial regulators in the EU and US have made strides in adopting the principles-based approach to regulating financial firms[2].

Among the reasons for this trend is disillusionment with a detailed, rules-based approach, which is seen to encourage process, but not necessarily substantive compliance. Very detailed or specific rules, by their nature are likely to leave gaps in compliance – which in a quickly evolving market place are manipulated by firms - resulting in a regulatory regime that rapidly becomes outdated and typically leaves the regulator playing catch-up.

Adherents to the principles-based approach point out that it allows firms flexibility, innovation and enhanced competitiveness, even while complying with regulation. The benefits for regulators are similar – flexibility and innovation in supervision, durability of the regulatory regime and - as the FSA has been quick to point out - regulatory competitiveness. Consumers and investors benefit from more substantive compliance and better conduct (Black, 2008).

Detractors of the approach point out that there is less certainty and predictability in a principles-based regime. Moreover, since the sub-prime crisis and the failure of Northern Rock, there has also been some association of principles-based regulation with inadequate or slap-dash regulation[3].

It appears that the success of a principles-based approach has much to do with how it is implemented, and the institutional, corporate and consumer culture in which it is placed.

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[2] Black, 2008, p 2. She makes reference to the EU Commission "trumpeting" the benefits of a principles-based approach in 2007, the negative perceptions of authorities in the US to Sarbanes-Oxley and the setting out of a "Blueprint for a modernized financial regulatory structure" in 2007 by Hank Paulson *et al* which calls for a UK style approach to regulating financial markets.

[3] House of Commons Treasury Committee "The Run on the Rock" 2007-8 was highly critical of the FSA.

For expository purposes, the choice of a regulatory system could initially be presented as a choice between either a principles-based approach or a rules-based approach. The options might thereafter be considered as a spectrum, with a pure rules-based system at one extreme and a pure principles-based system at the other and all sorts of combinations in between. The extreme positions of the either-or approach would be viewed as illustrative and unlikely to exist.

The spectrum conception tends to create the impression of a more realistic approach and the possibility of a trade-off. When the FSA in the UK puts forward the case for a more principle-based approach as far as treating customers fairly is concerned, they invariably seem to be arguing that a movement towards something (principles) is simultaneously a movement away from something else (rules). If excessive rules are regarded as a bad thing and principles are regarded as a good thing, the inevitable conclusion appears to be that society will benefit from a movement towards a principles-based approach.

In investigating the paradoxes that can emerge from a movement towards principles-based regulation, Black (2008) points out that a movement towards principles-based regulation may actually lead to more rules. This in itself casts doubt on the trade-off between rules and principles. We shall in fact argue that the spectrum view of the rules and principles debate is a misconception. Before we come to that, however, it will be useful to illustrate that the debate about rules and principles appears in other disciplines as well, and examples are provided in Box 1.

Box 2 Principles and Rules: Examples from other disciplines

Consider, first of all an example that straddles both law and literature. In Shakespeare's play *The Merchant of Venice*, Shylock seeks his revenge in a court of law. He demands his pound of flesh, an expression that through ubiquitous use has migrated from a literal to a figurative sense. In countering his claim, a lawyer (Portia) employs a rules-based argument. Shylock can have his pound of flesh, but it must be exactly that. Not an ounce more and not an ounce less. He is also reminded that the deal does not mention that any blood can be spilt. Portia uses such a rules-based argument as a legal device to protect her client, but elsewhere also reveals a principles-based argument when she notes that the quality of mercy is not strained. The example illustrates that legal philosophy has to deal with particularities (rules) and general principles.

Centuries ago Greek philosophers distinguished between universals and particulars. Nominalistic philosophers argued that reality was confined to particulars. Hence individual cows, individual tomatoes and the like existed, but general or universal terms such as mammals, parenthood or redness – however useful they might be as classificatory devices - existed only in the minds of people using the terms and had no independent existence. As opposed to the nominalists, realist philosophers posited the existence of universals.

In the physical sciences much is made of the distinction between data and theory. Theory is viewed as some sort of short-cut that avoids the tedium of specifying individual items. If we want to know if something will float when thrown into water, we can, of course, make a list of all known substances and put a tick opposite them if they float. Alternatively we can make use of a theory. Theory introduces a term, specific gravity, which is the relationship between the volume of a substance and its weight. The specific gravity of water is one. If something has a specific gravity of more than one it will sink. If it has a specific gravity of less than one it will float. Once again we are considering some or other over-arching principle which appears to side-step the need to concentrate on individual items. In the philosophy of science, debates have raged over whether or not the theoretical concepts (principles) can be viewed as simply an amalgamation of individual data items. So too - as far as regulation in the financial services arena is concerned - it has been argued that principles are themselves nothing more than rules. [4]

The FSA has been arguing in favour of a principles-based approach since at least the turn of the century. One of the eleven principles of the FSA is the TCF or treating-customers-fairly principle. The principles-based approach can be seen as a movement away from a pre-occupation with rules to the specification of what the regulating authority expects firms to do. Senior management are held to be responsible for ensuring that firms comply with the outcomes specified by the regulator. The test of whether or not the TCF campaign is working is to be measured in terms of the outcomes specified by the regulator.

In our brief foray into legal philosophy in Box 2 we intimated that the debate over rules and principles is ingrained in the profession. The law needs principles and the law needs rules. It is hard to imagine a world in which lawyers operate without rules. It would nevertheless be equally hard to conceive of a legal system that operated without concepts of what justice is – in other words without principles. Similar remarks apply to regulation in the financial services industry where regulation requires both rules and principles.

The TCF framework embraces all phases of the product life-cycle – from the time the product is conceived, through the advertising and sales process to after-sales care. Moreover the TCF framework should include matters related to the ease of switching to other products should it transpire that the consumer feels he or she was not fairly treated. The emphasis is on encouraging firms to adopt an approach in which consumers are treated fairly. In a utopian world in which all firms always treated customers fairly there would be no apparent need for explicit recourse to implicit rules and the related legal system. Since we do not live in utopia, we need to maintain a distinction between implicit and explicit presences. When one is developing a principles based argument (the quality of mercy is not strained) explicit reference to rules might not be given, even if the rules are implicitly present. The argument should also be used the other way around. When one is concentrating on the rules (pound of flesh), the apparent absence of principles in the argument does not mean that the principles are not there.

[4] See Black 2008: 13.

The moral of the story is that if rules do not explicitly appear in a principles-based argument, they may very well be implicit. If principles are not explicit in a rules-based argument they may very well be implicit.

We are accordingly arguing that both the either-or approach (rules or principles) and the more nuanced spectrum view (trade-off between rules and principles) are misconceived. If it is to function at all, a regulatory system needs both rules and it needs principles. Hence, rules and principles may be seen as complements rather than substitutes.

A principles-based approach requires rules in order to operate. A rules-based approach requires principles in order to operate. You can’t have one without the other.

Black (2008) suggests that one may think of norms (rules and principles) as having different structures. A norm's structure has three elements: precision, complexity and clarity - variation in these elements gives rise to different types of norms (see Table 1).

Table 1 Norm types and examples

Type 1: Bright line rule	Type 2: Principle	Type 3: Complex/detailed rule
A firm must execute all orders of under 10 000 securities within one business day	A firm must pay due regard to the interests of its customers and treat them fairly	A firm must execute all orders for customers within one business day in the following circumstances [definition of customer, definition of order; restriction as to whether discretionary dealing or execution only; circumstances where orders may be worked over a longer period, etc]

Source: Black, 2008, p15

Type 1 rule is a "bright line" rule that sets a simple requirement, typically set out in quantitative terms. While it is clear and straightforward, such a rule may fail to capture the essence, and indeed may completely miss the point, of what is required to achieve fairness, for example. It is also typically relatively easy to manipulate such rules.

In the case of the Type 2 Principle, the aim is set out. The certainty of the rule and its clarity depends on whether or not there is a similar interpretation by both regulator and firm as to what is meant by "paying due regard" and "treating customers fairly". The wording is deceptively simple, as compliance will require consideration and adaptation of a number of factors, which will make it complex and layered.

The Type 3 complex rule may be more easily aligned with policy objectives and relevant than the Type 1 rule, but that will of course depend on whether or not the criteria set out are appropriate. It may even be seen to have the consistency of a principle, but provide more certainty than the principle, as it provides more elaboration. However, in the elaboration, there is greater scope for gaps and manipulation, and hence uncertainty.

Hence Black makes the point that while it is tempting to presume that certainty comes with the structure of the rule or principle per se, in reality the certainty of the norm depends on the interpretation it receives. Hence certainty depends on whether or not regulators and the regulated entities share a common understanding. While development of a shared understanding of a principle may require the formulation of fairly precise rules, as the rules become overly precise, uncertainty may creep in.

The recent experience of the FSA, particularly as it relates to TCF, is illustrative. Initially, (the first TCF paper was published in June 2001), the approach was seen as a part of its principle-based approach to regulation, with a view to encourage the spirit of fairness - with as much emphasis on influencing attitudes and behaviour as on meeting certain requirements[5]. Gradually, however, as the project gained momentum, there appears to have been a growing awareness of the need for shared interpretation of what is meant by treating customers fairly. Subsequent reports on the responsibilities of providers and firms, product design, measuring success and management information were published. Emphasis was increasingly placed on desired or expected outcomes, indeed, the FSA now chooses to describe its TCF programme as an outcomes-based approach. This may be an implicit acceptance that while a regulator may prefer to describe its approach as based on principles, rules become essential in helping to formulate shared interpretation.

With this all in mind, we shall attempt in what follows to do away with the rules or principles conception, or a rules versus principles conception in favour of a rules **and** principles conception. This also enables us to adopt a less entangled view of the compliance issue.

Over and above rules and principles, account must be taken of enforcement (compliance) issues. It is sometimes remarked that South Africa has a wonderful and modern constitution. A wonderful and modern constitution is of little use unless there are also in place the means whereby the articles in the constitution can be enforced. So too with the debate about rules and principles. Issues of fairness might be ingrained into the legal system, and reflected in a comprehensive set of rules, but unless there are adequate legal institutions (and

[5] FSA, 2001 June, p 15.

incorruptible officers) to enforce the law, the law might be flouted. The penal system must also be taken into account. What is the point of sending offenders to jail if the penal system is open to corruption and abuse?

It is perhaps no co-incidence that - in parallel with the evolution of the FSA language on TCF from principle-based to outcomes-based - there has been a more explicit focus on compliance. Initially, the FSA may have been said to pride itself on its "light touch" regulatory style[6]. Indeed, it is this approach that led to the FSA being labelled as is a "toothless watchdog" – with "substantial failure of regulation" - in the analysis of the failure of Northern Rock, a mortgage lender, in August and September 2007[7]. Since then, as shall be documented further in section 4, the FSA has appeared to have hardened its stance on enforcement, with more transparent and punitive fines and sanctions.

The art of moral suasion has some bearing on the notion of principles and rules. A regulatory authority may from time to time urge firms to certain behaviour by appealing to moral standards (principles). Whether or not such moral suasion is effective or not depends in part on the existence of explicit rules and depends in part on matters of compliance. What is often implicit in the moral suasion approach is the threat that if financial institutions do not listen to the good advice being given, more insidious forms of coercion could well be applied. Here too, it is the threat of stricter action to come that may get the desired result. Once again, however, there is a compliance issue. Unless the regulatory body has the teeth to enforce the issue, appeals to a moral code will be of little import.

The canons of a good tax system are illustrative. Nobody really wants to pay taxes, so the populace will presumably have to accept a tax system based on other considerations, such as (for example) the equity principle, on whether or not the system is easy to administer and on whether or not it is efficient.

A good regulatory regime requires principles, rules and compliance. Particular issues that need to be considered are issues related to efficiency, equity, and ease of administration.

3.1.2 The incentive issue

Unless we believe that firms are by nature philanthropic institutions that treat customers fairly, incentives have to be built into the system to encourage firms to do so.

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[6] References to this are many. The *FSA Annual Report 1999/2000* refers to a “light touch” approach for professional bodies, page 27/132; *FSA Better regulation 2005* – again reference to “light touch” approach for professional bodies and *FSA Annual Report 2000/01*, p 75 “*This is a light touch regime that encourages firms to excercise discretion, but it ...”*

[7] House of Commons, Treasury Select Committee, 2008.

What would such incentives look like? A closely related question would be: What would the institutional set up have to look like in order for the firms to want to treat customers fairly? Here we shall of necessity have to consider the issue of whether or not free market capitalism generates the kind of institutions necessary for the maintenance of free market capitalism.

Box 3 Dogmatic and pragmatic free market views

Those of a free market persuasion advocate the view that the government that governs the best governs the least and that the best way to ensure efficient allocation of resources is to ensure that markets are free of government interference. However, markets are delicate mechanisms that need to be supported by institutions such as the legal system. Does a free market develop the kind of institutions that it needs in order to survive? Those who argue that the answer to such a question is yes, can be classified as dogmatic free marketeers. Those who say that the answer is no, but who in general support free market policies, can be classified as pragmatic free marketeers.[8]

Another way of illustrating the arguments involved is to use the invisible hand metaphor. Since the appearance of Adam Smith's *Wealth of Nations* in 1776, economists have employed the invisible hand argument to describe the actions of (free) markets in generating an efficient allocation of resources and thereby ensuring that society benefits. Smith argued that it was not through the benevolence of individual market participants that such a solution emerged. Individuals guided by self-interest (read "greed" if you like) would somehow be led, as if by an invisible hand, to benefit society, even though this was no part of their intentions. In the current context, the question that we are seeking an answer to is the following:

Is the hand behind the invisible hand also invisible? If your answer is yes, you can be characterised as a dogmatic free marketeer. If you answer is no, you can be seen as a pragmatic free marketeer. Pragmatic free marketeers thus argue that the kind of institutions that free markets require in order to operate do not emerge spontaneously through market forces. Such institutions (including legal structures) have to be purposefully created in order to fulfil that function. There must be a visible hand (of appropriate legal institutions) behind the invisible hand in order for it to operate efficiently.

In Smith's view, the forces driving economic behaviour – which are also the forces that will benefit society as a whole – are the forces of self-interest (greed) – not benevolence. Smith is not saying, let's call the butcher and the baker together and appeal to their benevolence (so that society may benefit). What he is saying is that if the butcher and the baker pursue - in a selfish way – their self interests, society as a whole will benefit.

Smith wrote the Wealth of Nations in 1776. He had, in 1759, published another book. The theory of moral sentiments, in which he argued that human behaviour was governed by feelings of sympathy for others. The juxtaposition of his 1776 and 1759 views gave rise what later became known (by German philosophers) as Das Adam Smith problem. How was it possible, asked the Germans, for a man to write not only a book in which the guiding motive behind human behaviour was sympathy for others, but also a book in which the guiding motive behind human behaviour was self-interest or greed?

Consider the following two scenarios, the first of which we term the benevolence or sympathy scenario. Suppose it were possible to summon all senior management persons in the financial services industry into a large hall. The

[8] Mittermaier, 1986

regulator then exhorts them to treat their customers fairly. Appeals to their better nature are made. The regulator points out that if firms treat their customers fairly and sympathetically, society as a whole will benefit. The regulator adds that, by the way, there is a system of laws in place and firms and persons who do not treat their fellow citizens fairly can be punished. The general approach, however, is to encourage people to be good, rather than to punish them if they are bad.

In the second scenario, the regulator relies on the self-interest approach. The regulator assumes that the firms are going to act in their own self-interest – and maximize their profits - in response to the institutional incentives and sanctions which influence market behaviour. While the regulator warns firms that if they do not obey the concepts of fairness enshrined in the legal system they will be sanctioned, the regulator also encourages the setting up of "best-practice" approaches in the financial industry. Consumers can find out how their financial provider rates in terms of treating customers fairly. After a time, firms that meet the TCF criteria are claiming fair treatment of consumers as a competitive advantage. Those firms that do not meet the criteria and which are responsible for treating customers unfairly are sanctioned – they are fined and their names are made public. In some cases, where firm behaviour is egregious, firms are prosecuted and their licenses withdrawn. When customers realize that a firm has performed poorly in terms of fairness to customers, they switch away from the firm. Analysts start to evaluate firms on their long-term sustainability related to treating customers fairly, not just their short-term profit.

The issue of compliance arises in both the benevolence and self-interest scenarios. It would be of little use to warn businessmen that they would be punished if they did not obey the law if there is very little in the way of ensuring compliance.

The notice of compliance cannot be viewed independently of incentives. Incentives should be interpreted broadly to include both encouragement and discouragement. We can offer a child a reward to encourage certain behaviour, but we can also promise punishment if he or she acts in a different way. Incentives are being provided in both cases.

At first sight the so-called principles-based approach of the FSA in the UK appears to resort to appeals for benevolence on the part of firms. However, if firms do not so voluntary, the FSA approach boils down to an incentive approach. In between the benevolent and incentive schemes lie other possibilities – such as, for example, naming and shaming erring firms.

The FSA approach thus appeals to businessmen to treat their customers fairly, but at the same time it encourages businessmen to pursue their own interests, within the institutional structures that the FSA is instrumental in forming. Once again it should be noted that while the principles-based approach captures the headlines, it requires rules in order to operate successfully. The FSA approach is a principles **and** rules approach.

The issue of compliance is perhaps the key issue in the debate. For a principles and rules based approach to be successful, there have to be legal and political structures in place in order to ensure compliance. We furthermore need to examine what incentives there are to guide business behaviour in the desired direction.

Incentives should also be viewed in the light of competition. We have already had a look at the life-cycle of financial services. The final stage has to do with barriers to switching. If, after purchase, one is dissatisfied with a particular financial service, how easy is it to switch to another (similar) service? If there is effective competition in the industry, it may be relatively easy to switch. The notion of switching also highlights the importance of competition. There are laws pertaining to competition in the South African legal system. The Competition Commission is there to try to enforce those laws. How well the system works depends in part on the teeth of the Competition Commission. We also need to examine what actually happens in practice. For example, there may be laws in place to ensure certain outcomes, but is compliance effectively enforced?

3.2 Legislative framework in South Africa

3.2.1 The Financial Services Board

The FSB is a statutory body established by the Financial Services Board Act, 1990. Both members of the Board and members of the Executive are appointed by the Minister of Finance (MoF).

The FSB's objective is to promote and maintain a sound financial investment environment in South Africa. In order to achieve its objective, its mission is to promote:[9]

- Fair treatment of consumers of financial services and products
- Financial soundness of financial institutions
- Systemic stability of financial industries
- Integrity of financial markets and institutions.

Although the FSB functions in close liaison with the MoF, it acts independently from Government and is not Government funded. The FSB is mainly funded

[9] FSB Annual Report 2009

through a levy system provided for in the FSB Act. Fees for services rendered provide a secondary source of income.

Section 3 of the FSB Act stipulates the functions of the Board, which involve supervising non-banking financial institutions, advising the MoF and promoting consumer education. Specifically, the functions are:

> *(a) to supervise and enforce compliance with the laws regulating financial institutions and the provision of financial services.*
> *(b) to advise the Minister on matters concerning financial institutions and financial services, either of its own accord or at the request of the Minister; and*
> *(c) to promote programmes and initiatives by financial institutions and bodies representing the financial services industry to inform and educate users and potential users of financial products and services.*

Sections 10(3) and 10A of the Act provide for the establishment of an enforcement committee to be responsible for enforcing compliance with the laws regulating financial institutions and the provision of financial services.

The Dealstream example indicates the necessity of having an enforcement committee.[10] Dealstream was never authorised by the FSB (in terms of the Financial Advisory and Intermediary Services Act, 2002 (FAIS)).

> *The collapse of Dealstream is an example of the many high profile abuses which have plagued the South African financial services industry. … As a response to the abuses, the Financial Services Laws General Amendment Act, 2008 (FSLGA Act), came into effect on November 1 2008.*
>
> *… The amended FSB Act states that the primary function of the FSB is to supervise and enforce compliance with the legislation regulating the financial services industry. This enforcement objective is to be achieved by the newly-created enforcement committee. It will comprise persons with appropriate knowledge and experience in the financial services industry to enable the committee effectively to enforce compliance with the various pieces of legislation governing the industry.*[11]

Section 13 of the FSB Act provides for the appointment of an executive officer, deputy executive officers and a chief actuary appointed by the Minister after consultation with the Board. The executive officer shall, subject to supervision by the FSB, perform the functions entrusted to him by or in terms of the FSB or any other regulatory Acts administered by the FSB. In all those Acts, the Registrar (being the Executive Officer of the FSB) is the regulatory or supervisory authority

[10] Dealstream was an online stockbroker that started running short of cash in September 2008. See http://mybroadband.co.za/news/Telecoms/5363.html.
[11] Colegrave, 2009.

of the financial institution dealt with in each Act. The FSB, therefore, accommodates the office of the Registrar.

The FSB administers the following legislated Acts[12]:

- Collective Investment Schemes Control Act (Act 45 of 2002)
- Financial Services Board Act (Act 97 of 1990)
- Financial Advisory and Intermediaries Services Act (Act 37 of 2002)
- Financial Institutions (Protection of Funds) Act (Act 28 of 2001)
- Financial Supervision of the Road Accident Fund Act (Act 8 of 1993)
- Friendly Societies Act (Act 35 of 1956)
- Inspection of Financial Institutions Act (Act 80 of 1998)
- Long-term insurance Act (Act 52 of 1998)
- Pension Funds Act (Act 24 of 1956)
- Short-term Insurance Act (Act 53 of 1998)
- Supervision of the Financial Institutions Rationalisation Act (Act 32 of 1996)
- The Securities Services Act (Act 36 of 2004).

3.2.2 Statutory Bodies

FSB Appeal Board[13]

The Appeal Board was initially established in terms of Section 26 of the FSB Act but was re-established in expanded form and with amended procedures under the Financial Services Laws General Amendment Act, No 22 of 2008. The latter Act introduced sections 26A and 26B to the FSB Act which now deal with the Appeal Board, its panels and appeal proceedings.

The following persons may appeal:

- Any person aggrieved by a decision of the Executive Officer of the FSB. The Executive Officer of the FSB is also the collective of the different Registrars established by various statutory enactments contained in legislation dealing with the regulation and supervision of financial institutions (other than banks). It follows that an aggrieved person may appeal against a decision by the Registrar.
- Any person aggrieved by a determination of the Ombud for Financial Services Providers (FAIS Ombud) made in terms of section 28 of the Financial Advisory and Intermediary Services Act, No. 37 of 2002 (the

[12] FSB website www.fsb.co.za (legislation)
[13] FSB website www.fsb.co.za (Appeal Board)

FAIS Act) including a determination by the FAIS Ombud in the capacity as the Statutory Ombud referred to in the Financial Services Ombud Schemes Act, No 37 of 2004 ("Statutory Ombud").[14]

- Any person aggrieved by a decision of an exchange, central securities depository and claims officer as contemplated by the Securities Services Act, No 36 of 2004.
- Any other person aggrieved by a decision made under a law which provides for an appeal against that decision to the Appeal Board.

Ombud for Financial Services Providers (FAIS Ombud)

The Financial Services Ombud Schemes Act, 2004 (37 of 2004) provides for the establishment of a FAIS Ombud. Its objective is to resolve disputes relating to the rendering of financial services by providers (on or after 30 September 2004) where they have either failed to comply with the FAIS Act or where as a result of either wilful or negligent conduct by the provider the client has suffered or will potentially suffer prejudice or damage. The primary objectives of the FAIS Act is to ensure consumer protection and the integrity of the financial services industry and is underpinned on principles of contract law as well as equity.[15]

The FAIS Ombud also has the power to act as the Statutory Ombud in terms of the Financial Ombud Schemes Act 2004 (Act No. 37 of 2004) ('FSOS Act'). The existing voluntary ombudsmen, as listed below, are recognised by the FSOS Act, but the Statutory Ombud can adjudicate a complaint where the existing voluntary ombudsmen do not have jurisdiction or where there is uncertainty over jurisdiction. If a case cannot be settled through mediation or conciliation, the FAIS Ombud or the Deputy FAIS Ombud may issue a determination. A determination is deemed to be a judgment of a court.[16]

Pension Funds Adjudicator[17]

The Pension Fund Adjudicator's office investigates and determines complaints of abuse of power, maladministration, disputes of fact or law and employer dereliction of duty in respect of pension funds.

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[14] Any person aggrieved by a determination of the FAIS Ombud or the Statutory Ombud must first obtain leave to appeal from either those Ombuds respectively or, if leave has been refused, from the Chairperson. Once leave to appeal has been granted, a person may lodge a notice of appeal with the Secretary. The procedure for lodging those appeals is set out in rule 12 of the Rules on Proceedings of the Office of the Ombud for Financial Services Providers, 2003 and the regulations promulgated in terms of section 26B(19) of the FSB Act.

[15] http://www.faisombud.co.za/

[16] http://www.faisombud.co.za/index.php?opt=pages&value=about

[17] http://www.pfa.org.za/site/index.asp

3.2.3 Voluntary ombudsmen

Ombudmen were voluntarily established by the insurance and banking industries to provide free services to consumers regarding disputes. Although funded by these industries the Ombuds are independent bodies who report to either an independent Board or Council. They are all recognised by the FSOS Act.

- The role of the Ombudsman for Long-term Insurance is to resolve disputes between long-term insurers and complainants.[18]

- The role of the Ombudsman for Short-term Insurance is to resolve disputes between short-term insurers and policy holders.[19]

- The role of the Ombudsman for Banking Services is to resolve individual complaints about banking services and products.

In addition, the FSOS Act also recognises the Office of the Credit Ombud, which is not further discussed here.

3.2.4 Ultimate fairness

The discussion above which sets out the legislative and regulatory landscape of statutory and voluntary institutions suggests that the hand behind the invisible hand is indeed visible. Moreover, this visible hand plays its role in achieving what we may refer to as ultimate fairness.

The concept suggests that there is a time dimension involved in the fairness principle. We can distinguish between what we can for the moment call immediate fairness and ultimate fairness. The concept of ultimate fairness is there to remind us that in the event of a dispute, both parties have recourse to appeal standards of behaviour (which can be enshrined in the law). A customer who thinks she is being treated unfairly has recourse to complain about the behaviour of the firm concerned. The firm, in turn, has the right to respond to the customer's complaint. An independent authority (which can be the Ombudsman or the court) resolves the dispute. In certain circumstances, a decision of the Ombudsman or court may in turn be appealable. The process may take months or years to sort out and there are costs involved. The concept of fairness has to include a time element:

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[18] http://www.ombud.co.za/
[19] http://www.osti.co.za/

To have the ability to complain when things go wrong is also entirely fair. This TCF Outcome is about firms not putting unreasonable procedural barriers in place which make any of these activities excessively difficult for consumers. These barriers can take many forms. For example tight time limits, long notice periods, onerous information demands, difficulties in communicating or even administrative delays[20].

3.3 Implementation of the TCF programme – the realities

In recent interviews with UK experts and regulators[21], possible lessons regarding the implementation of the TCF programme were probed. The interviews revealed that however well-worded the principles and rules may be, there are additional factors impacting successful implementation.

The following themes from the interviews are explored below:

- A change in mindset of the industry
- Clarity of regulatory expectations
- Education to encourage consumer responsibility
- A supervisory approach that is pre-emptive and intensive
- Enforcement and compliance

3.3.1 A change of mindset in the industry

In all the interviews, a general industry malaise concerning treating customers fairly was raised as a concern. This was expressed as a general lack of ability or willingness to recognise the firm's shortcomings in terms of fairness. Firms would typically argue that since they had been operating for some years and were still in business, they must be treating customers fairly.

As has been suggested above, this approach by firms may suggest that they are equating their services with simple products where consumers can vote with their feet. Switching may, however, be neither easy nor costless. Moreover, if certain practices are typical in an industry, consumers may feel there will be no benefit in switching, even if they believe they are being dealt with unfairly. As the interviewees pointed out, customer satisfaction is not the same thing as fairness, and predatory and unfair practices are typically only brought to light some years on.

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[20] FSA, 2007 (d), p 26

[21] Interviews were held with the FSA, the Financial Services Ombudsman (FOS) and a consultant from *intouch consulting* in November 2009.

Interviewees said that where a firm could show that it was successfully and continually implementing the TCF programme, the CEO or managing director of the firm had typically endorsed the programme, spelt it out for middle management and employees and received regular data on consumer complaints and redress. Moreover, TCF measures were used to influence performance appraisal and incentive structures in the firm. The least successful firms were those that left it all to their compliance department or an outside consultancy to design a programme but whose feedback was neither presented nor understood at board level.

Key to encouraging the change in mindset in industry was clarity of regulatory expectations.

3.3.2 Clarity of regulatory expectations

The FSA began studying the TCF programme in 2000, published its first paper on the subject in 2001, and the programme was officially launched in 2005. Since then, there have been an increasing number of industry studies and engagements by the FSA, and it has published guide notes and toolkits. It is clear that the last decade represents a learning experience for the regulators and industry alike. The key lesson from the experience seems that it is necessary to ensure that the regulator's expectations are clearly spelt out and understood by firms. Firms tend to be more familiar with rules than with principles or outcomes, and they frequently claim that they do not understand what the regulator requires when principles are used.

The example offered as a case in point was the drive to ensure that firms were monitoring and acting on information regarding fairness. As part of the TCF initiative, the Management Information (MI) requirement obliged firms to show that they were monitoring appropriate information on fairness and that they had mechanisms for redress. Feedback from industry, which had its deadline in March 2008, showed widespread lack of compliance. Money had been spent, but firms were not favourably rated. Industry claimed that the wrong things were evaluated by the regulator. The FSA claimed that much of what was reported to them was not necessarily about fairness.

Firms typically measured how many advertisements they had placed, for example. But little, if any, evaluation was given as to whether or not the adverts amounted to marketing, and whether or not educational aspects had been tested, for example. While firms might have given information on the number of policies underwritten, and even on how many policies had not been standard, no thought had apparently been given to the risk that non-standard policies might extract an unfair premium from the consumer, based on the agreed level of cover. In this case, a more appropriate TCF measure would have been an item reporting on how often samples of non-standard policies had been evaluated for their pricing and what the results of such evaluations had been.

It was clear that some firms needed explicit guidance as to what fairness meant in terms of their usual processes.

3.3.3 Education to encourage consumer responsibility

One of the themes emerging from the interviews was the increasing access to financial services by low-income individuals. Such access had traditionally been regarded as the domain of the middle class.

> *…customers of the ombudsman service [are] now more numerous and more diverse in their backgrounds and levels of financial literacy than ever before[22].*

There was a concern that consumers were entering into sophisticated financial contracts without understanding the implications or their concomitant responsibilities. There was hence a need for better education of consumers, with some interesting programmes being mooted[23]. The relative lack of awareness by consumers, together with the rise in "complaints" firms - which solicited consumers to make complaints - had led to a massive increase in complaints being brought to the Financial Ombudsman Service. Ultimately this might result in better consumer responsibility, but the interviewees thought this was a long way from being realised.

A very useful application to educating consumers was the consumer hotline of the Financial Ombudsman Service. They received millions of calls last year - helping to clarify and direct customers on various issues.

From a policy point of view, a drive to promote consumer education and responsibility and a drive to encourage firms to treat customers fairly should be regarded as complimentary. The fact that consumers may become more sophisticated and informed about financial matters does not exempt firms from thinking and acting fairly.

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[22] Financial Ombudsman Service. 2008. Ombudsman welcomes Lord Hunt's report on "Opening up, reaching out and aiming high" April.
http://www.finncial -ombudsman.org.uk/news/updates/LordHunt_Report.html.
[23] For example, trials are being run to educate midwives on basic financial planning, so that they can in turn educate expectant parents on financial responsibilities.

3.3.4 A supervisory approach that is pre-emptive and intensive

Pre-emptive supervision revolves around identifying conduct risks in much the same way that a prudential supervisor may aim to identify the solvency risk of firms and the stability risks of the industry.

The aim is to identify and address conduct risks in the industry and at firm level at an early stage - before they become too large. In 2010, the FSA's *Financial Risk Outlook* had for the first time, a chapter on "retail conduct risks and issues" - together with the more conventional sections on financial stability and market risks. The point of departure of the chapter is that market misconduct arises as a consequence of market failures, firm incentives and consumer behaviour, but that the economic cycle and market context will influence where conduct risks arise, how significant they are, and when consumers suffer.[24]

For example, in an economic downturn, firms may try to increase margins where they can, to the detriment of consumers. Moreover a particular product line may be exceptionally profitable, and the claims ratios may be extraordinarily low.[25] In these instances, the supervisors need to know if these results were achieved with or without due observance of the TCF approach.

In terms of intensive supervision, the FSA's newly created Conduct Risk division will be enforcing the TCF principles through systematic assessment of firms' business model and culture. Analysis of the whole life cycle of products, such as firms' product development and design activities, as well as product marketing, distribution and post-sales handling is included. The intensive supervisory approach includes mystery shopping and collecting evidence from the shop front, not merely considering the matter at board room level[26].

3.3.5 Enforcement and compliance

It is clear that enforcement of the principles and rules of the TCF programme is crucial to the success of the programme.

One interviewee went so far as to say that it was naïve to rely on the goodwill of firms to implement principles and rules. While firms and industry bodies might be co-operative, this would only translate into change in the industry if firms knew from the outset that their culture, strategies and behaviour would be tested, and that if found wanting, firms would face negative consequences.

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[24] FSA, 2010. *Financial Risk Outlook*, London, p 57
[25] FSA, 2010. *Financial Risk Outlook*, p 57-65
[26] FSA, 2010. *Financial Risk Outlook*, London, p 70

This need for testing and evaluation and for taking action represents a departure from the so-called light touch approach employed at the turn of the decade. Increasingly, there is evidence of a new approach to deterrence – involving naming, shaming, higher fines, and even jail.

Historically, both the Financial Ombudsman Service and the FSA have been reluctant to publish names of firms who are regularly the subject of complaints and poor behaviour. However, this seems to have changed. In April 2008, the Financial Ombudsman Service received an independent review on their services[27] and one of the key recommendations was better transparency and more openness on the performance of individual firms. For the first time in September 2009, the Financial Ombudsman Service published the names of firms that had 30 or more new complaints against them. Similarly, for the first time, the FSA is now requiring that firms report to them on the complaints they have received, and that should there be more than 500 complaints in a 6-month period, the firms themselves are required to publish their complaints data[28].

The regulators pointed out that deadlines for compliance must be published so as to help focus the minds of firms on the programme. Furthermore, it is essential that these deadlines are achievable and that they are enforced, in order to establish credibility. The threat of publishing the names of non-compliant firms is effective as firms do not want to be seen as lagging behind their peers.

The apparent sea-change towards more intensive enforcement can be seen in the words of the FSA, as well as in its behaviour.

In November 2009, Hector Sants, the then new head of the FSA, said:

> *Historically, the FSA was, in practice, operating a "twin peaks" system. The oversight of the domestic institutions focused on the "Treating Customers Fairly" programme. However, this focus has not delivered the outcomes that consumers deserve. This is because 'old style' consumer protection regulation is, in my view, largely reactive, not proactive.*[29]

The CEO went on to outline how new supervisory staff had been recruited to conduct (for example) more intensive inspections, and to perform revised risk analysis. In interviews, the regulators pointed out how important it was to adopt new supervisory methods. There was a realisation that simply reviewing returns from firms was no longer adequate. Instead, inspections based on specifically developed toolkits needed to be implemented. Moreover, to get to the heart of the matter, mystery shopping exercises were also necessary, as well as shop floor

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[27] Lord Hunt, 2008.
[28] FSA,2009 (c). and FSA, 2010.
[29] Sants, 2009.

inspections, to deal with the apparent disconnect between head office intentions and shop front behaviour. In the same speech, Sants said that a failure to comply would also lead to prosecution and jail sentences.

The new approach to intensive supervision and greater transparency is also backed up by a new approach to financial sanctions. In July 2009, the FSA published its new policy on the enforcement of financial penalties. The proposals aim to increase transparency in the way the FSA sets penalties, improves consistency in penalty-setting, and increases the level of penalties imposed[30]. The FSA aims to ensure that the firm does not benefit from its unfairness (disgorgement) and seeks to impose discipline on the market. Recent fines (such as that imposed on a mortgage originator GMAC-RFC Ltd of GBP 2.7 million[31]) suggest that this aim is being achieved.

The interviews drive home the point that it is effective compliance that is of importance. If potential wrongdoers are fairly certain of getting caught, this will act as a deterrent.

[30] PLC. 2009.
[31] FSA 2009 (a).

4. Approaches to treating customers fairly

4.1 Introduction

To understand the notion of treating customers fairly, we need to examine the role of the institution that popularised the TCF programme, namely the UK FSA. The four objectives of the FSA are presented, together with the eleven principles that guide its action. The TCF programme is closely associated with number six of these eleven principles.

Section 4.2 examines the role of the FSA in the UK, with the TCF programme coming under the spotlight. The six outcomes that the FSA would like to see (in terms of consumers) are presented. In proposing the fairness principle, the FSA has put forward the view that fairness needs to be taken into account over the entire life-span of the product involved. The six stages of the product life-cycle identified by the FSA are examined, as is the cultural framework, which it believes is essential to achieving its outcomes. The section concludes with a short discussion on enabling and enforcing progress.

Section 4.3 has a look at the Australian situation where the regulator is the Australian Securities and Investments Commission. The ASIC apparently follows a more rules-based approach. We investigate the Australian regulatory framework and have a look at a study which recently considered whether or not Australia should move from its current rules-based towards the principles-based approach of the FSA.

4.2 The UK

The Financial Services Authority (FSA) came into being as a result of the merger of nine regulators, including the Securities and Investments Board (SIB), the Investment Management Regulatory Organisation (IMRO), the Personal Investment Authority (PIA) and Securities and Futures Authority Limited (SFA). Key among these was the SIB, which itself came into existence in 1985, and can be seen as a self-regulator. On 20 May 1997 the then Chancellor of the Exchequer (Gordon Brown) announced that a new regulator was to be formed. He also announced that under the new regulator, banking service supervision and investment services regulation were to be merged.

In 1998 banking supervision became the responsibility of the FSA. It had previously been the responsibility of the Bank of England, however, regulation of Banking Conduct only came into the remit of the FSA in 2009.

The Financial Services and Markets Act (FSMA) of 2000 provides the FSA with its powers. The FSMA was implemented in 2001 and its legislation applies to banks, insurance companies and financial advisers. General (or short-term) insurance regulation was introduced in 2005 and from 2004 the FSA also regulated the mortgage industry.

All in all, therefore, the FSA regulates the behaviour of deposit taking-institutions, insurance companies (short-term & life), investment firms and firms offering financial advice.

In its website, the FSA states:

> *We are an independent body and do not receive any funding from the government. To finance our work, we charge fees to all authorised firms that carry out activities we regulate, as well as other bodies such as recognised investment exchanges.*

The Board of the FSA is appointed by the Treasury. The board consists of a chairman, a CEO, three managing directors and nine non-executive members. According to the FSA website, "This Board sets our overall policy, but day-to-day decisions and management of the staff are the responsibility of the Executive."

While the Board does not contain any direct representatives of consumer groups, it does include those with experience in consumer organisations[32]. It also gets advice on consumer matters from what is called the Financial Services Consumer Panel, whose members are appointed by the FSA. The panel does not see to individual consumer complaints, instead the Financial Ombudsman Services works closely with the FSA.

Although the TCF programme has been popularised by the FSA and has thus come to be associated with it, the principle can be applied by any financial services industry regulator. We nevertheless have to bear in mind that the FSA assumes roles that in other countries may be shared by other institutions, such as, for example, a central bank. In South Africa and Australia, the regulation of banks and the regulation of non-banking firms are the responsibilities of different regulators.

[32] www.fsa.gov.uk/pages/about/who/board/mcateer.shtml

4.2.1 The TCF programme and its outcomes

According to the Handbook of the FSA, the regulatory objectives of the FSA (as described in sections 2(2) and 3 to 6 of the Financial Services and Markets Act 2000) are:

> *(a) market confidence;*
> *(b) public awareness;*
> *(c) the protection of consumers; and*
> *(d) the reduction of financial crime.*

The TCF initiative springs obviously from the third objective, but also has links with the other objectives.

To carry out its mandate, the FSA has laid down various principles that firms should obey. These are set out in Table 2.

For current purposes, the most important of these principles is Principle 6, which sets out the obligation that the financial firms under consideration should treat their customers fairly. The TCF programme has direct links to customer protection but obviously also has links to the other objectives as well.

For example,

> *TCF covers not just our Principle 6 ('a firm must pay due regard to the interests of its customers and treat them fairly') but also several of our other principles for businesses, including: Principle 2 (conducting business with due skill, care and diligence); Principle 3 (taking reasonable care to organise and control affairs responsibly and effectively with adequate risk management systems); Principle 7 (client information needs) and Principle 9 (suitability of its advice and discretionary decisions for customers).* [33]

[33] Speech by Sarah Wilson given at ABI seminar for Non-Executive Directors of insurance companies, 5 February 2009

Table 2 The principles of the FSA

1 Integrity	A firm must conduct its business with integrity.
2 Skill, care and diligence	A firm must conduct its business with due skill, care and diligence.
3 Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A firm must maintain adequate financial resources.
5 Market conduct	A firm must observe proper standards of market conduct.
6 Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7 Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9 Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10 Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11 Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FSA appropriately anything relating to the firm of which the FSA would reasonably expect notice.

Source: FSA Handbook

As discussed above, the FSA has opted for an approach can be seen as both principles-and rules based. The FSA expects senior management to be aware of the principles relating to TCF and lays responsibility for treating customers fairly and squarely at the door of senior management in the firms concerned. The FSA wants to encourage firms to treat customers fairly without relying on too many rules and in particular wishes to avoid laying down a huge raft of new rules.

In a recent discussion paper (March 2009) the FSA noted:

> *Principles-based regulation means, wherever possible, moving away from prescriptive rules to a higher level articulation of what the FSA expects firms to do.*
>
> *This has the major advantage of giving firms greater freedom to decide how best to align their business objectives and processes with the regulatory outcomes the FSA has specified but also emphasises their explicit responsibility to do so and so helps to reinforce the statutory principle that senior management is responsible for firms' compliance.*
>
> *The focus of the FSA's philosophy, however, is not per se the principles but rather on judging the results of the actions of the firms and individuals the FSA supervises, whilst remaining firmly*

> *risk-based and proportionate. Given this philosophy, a better strap line is 'outcomes-focused regulation'.*[34]

To understand the FSA approach we accordingly need to appreciate what these outcomes are. The FSA has six outcomes in mind:[35]

Table 3 Desired outcomes of the TCF programmes

Outcome 1: Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.
Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their needs and circumstances.
Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.
Outcome 6: Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

Source: FSA, 2006

Outcome 1 implies a framework within which the firm operates. This has come to be called the cultural framework. Outcomes 2-6 are the results of Outcome 1 being in place.

The FSA adopted the outcomes-focussed approach out of a belief that the old-style approach to regulation was failing. It seeks to change the behaviour of firms in order to deliver improved outcomes for consumers. At the same time it acknowledges that this will involve time-consuming cultural and behavioural change.

The FSA provides support to firms in terms of (1) explaining what is meant by the product life-cycle, (2) helping firms to establish a culture framework conducive to treating customers fairly and (3) assessing progress and enforcement. These elements are further expanded below.

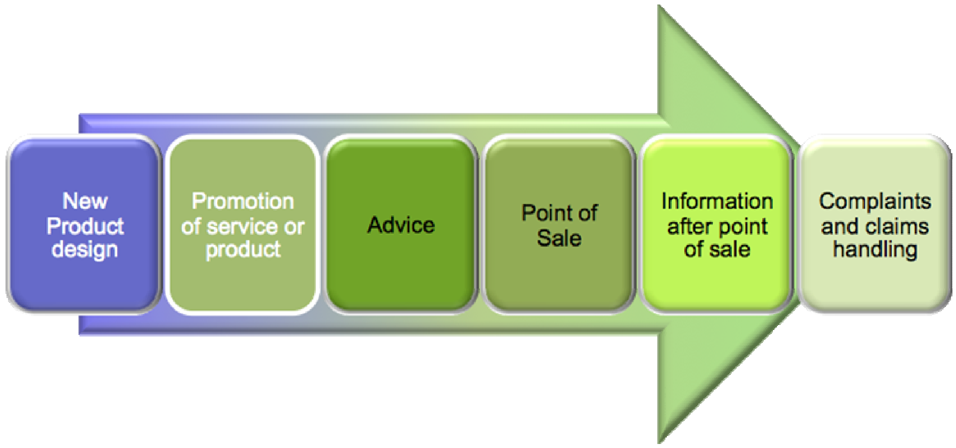
4.2.2 Product life cycle

The product life cycle approach implies that at each phase of the service, the firm needs to consider what it means to treat customers fairly.

The different phases of the life cycle of a financial service are expressed graphically in Figure 1.

[34] FSA discussion paper *Global crisis*, p 184
[35] FSA 2006, p 3

Figure 1 Phases in the product life cycle



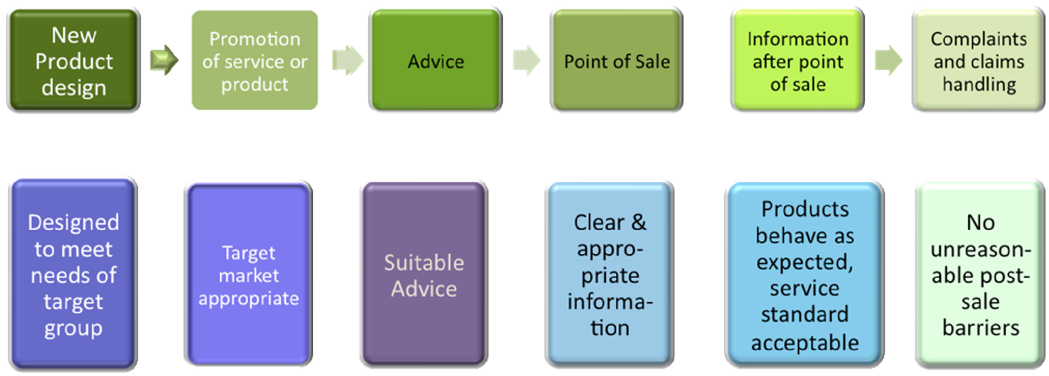
In 2004[36] the FSA set out its argument that for the TCF approach to be embedded throughout the product life cycle of a financial service, the firm may have to enhance systems, controls and management reporting across all its activities. Among the points to consider are:

- Developing and marketing products for specific target markets, based on a clear understanding of the likely needs and financial capability of each group of customers.
- Providing clear, fair and not misleading communications during promotions, advice, sales and after-sales activity.
- Making charges transparent.
- Balancing the commercial objective of increasing sales with the objective of TCF.
- Being clear to customers about what the firm, its products and services offer.
- Honouring representations, assurances and promises that lead to legitimate customer expectations.
- Identifying common underlying causes of complaints and taking action to eliminate the root cause.
- Monitoring and responding appropriately to changes in the wider environment that may affect products and impact on particular classes of new or existing customers.
- Considering what management information is needed to measure the firm's TCF performance.

[36] FSA, 2004.

The outcomes of the TCF approach should thus be apparent in every phase of the product life cycle, as is illustrated below:

Figure 2 TCF outcomes of phase of the product life cycle



In terms of TCF, the FSA envisages something more than just trying to ensure that mis-selling does not take place. The culture of TCF starts at a much earlier stage than point-of-sale and involves product design and – even prior to that – getting the right culture in place in firms. Moreover, firms are encouraged to continue providing information after the sale, and customers must also be in a position to present their complaints to the firms involved.

The FSA[37] emphasizes that TCF is not the same as being nice to customers or creating satisfied customers. While these are likely outcomes of TCF, they are not the same thing. For instance, the complexity of many products, combined with the low level of consumer understanding, means there could be occasions when customers are satisfied because they do not realise that they have not been fairly treated. Likewise, customers with unrealistic expectations might feel dissatisfied even though the firm has treated them fairly.

A firm's strategy must include fair treatment in terms of ensuring that it delivers the level of service promised, and that customers are protected from unpleasant surprises from the products they buy.

Moreover, TCF should not imply that innovation is inhibited nor should it inhibit the development or promotion of generic material to financial services markets. However, firms must identify the riskiness of new products, and build in appropriate controls to ensure that customers are treated fairly and not exposed to unsuitable or unidentified risks. And it means that that a firm must consider its

37 ibid, p 13

target market and have effective systems and controls to ensure it acts in a way that is likely to be fair for the customer groups it is targeting.

While TCF focuses on existing shortcomings in the industry, it does not absolve customers from their role in making appropriate decisions or in taking responsibility for them. Consumers still have to take responsibility for their decisions where they have the understanding and information to do so. This implies an on-going education campaign on the part of the authorities.

4.2.3 Cultural framework

In recent years the FSA has emphasised that the concept of Treating Customers Fairly represents a cultural issue for the firm concerned[38]. By this is meant that senior management needs to set the tone and guide practices in the organisation so that all employees of the firm can contribute to fair outcomes for consumers.

The FSA has defined the cultural framework as incorporating a number of elements, including:

- Leadership
- Strategy
- Decision making
- Controls
- Performance management
- Reward

These will be discussed in turn.

1. Leadership

The Board, senior and middle management need to provide direction and monitor the delivery of TCF behaviour and outcomes. The importance of TCF must not only be understood - it must also be implemented in all business areas.

Good practice in this area included the following examples: demonstrating commitment to treating customers fairly through clear messages from the Board, CEO and senior staff; strong TCF leadership in terms of publication of the company objectives in this regard; maintaining high standards of TCF (and disciplining breaches); listening to and acting on staff feedback (sometimes given anonymously) when customers were not being treated fairly.

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[38] This section is largely based on FSA, 2007 (b).

Poor practice included failing to identify what TCF means, and no discussion or feedback between firm employees of different levels; inappropriate delegation of TCF, without direction and monitoring; inappropriate method of delivering the message (through junior employees, for example); failing to ensure that management intentions were delivered by staff when they served customers; failing to identify TCF risks and failing to take action to resolve concerns where they were identified.

2. Strategy

The TCF aims should not merely be part of a firm's vision and values. They also need to be carried through to implementation. Moreover, the TCF approach should be built into any plans (or changes in plans) developed by senior management.

Good practice in this area included the following examples: using consumer bodies and consumer feedback sessions to understand consumers' needs in the development of retail products and services; valuing and responding to consumer feedback; appointing agents with consistent TCF values; translation of the six TCF outcomes into plain and simple language.

Poor practice included failing to identify the impact of (say) a new growth strategy on resources and TCF issues; re-assignment of TCF resources to other business areas when work pressure demanded it, creating the impression in the firm that TCF was not important; lack of senior management oversight of TCF implementation; delegation of TCF responsibilities to third parties, without any monitoring of outcomes; inappropriate and exclusive reliance on a strategy, without attempting to identify the behaviour and processes required to achieve strategic outcomes.

3. Decision making

All decisions that impact on consumers should be subject to the challenge implicit in the TCF strategy of the company. Ability to evaluate and challenge decisions from the TCF perspective may require that processes are set in place or that a conducive environment is created. The FSA identified fears that speaking up may affect an individual's remuneration or employment package.

Good practice in this area included the following examples: demonstration of commitment to TCF by making difficult decisions – like withdrawing a product because of its risk; contacting consumers to remind them of the risks associated with a particular product as stock market volatility heightened; integration of TCF into product design.

Poor practice included failing to respond to consumer concerns and complaints by simply assuming they were the exceptions; failure to set out why such complaints were not material; failure to identify that poor staff ratings - on the suitability of advice given - held inherent risk for customers and the firm; poor decision-making in complaints handling with an apparent lack of equity in the decisions, and no controls to monitor such decisions.

4. Controls

The monitoring of the success of a firm's TCF strategy requires that management information (MI) be identified, collected and evaluated. Perhaps the most difficult task is to identify which information needs to be monitored.

Good practice in this area included the following examples: checking staff understanding and implementation of TCF through randomly applied 30 minute interviews to check knowledge and application of key TCF issues; monitoring delivery through listening to, and giving immediate feedback to, staff in call–centres; monitoring of front-line staff through a mystery shopping exercise and using it to explain appropriate and inappropriate TCF behaviour.

Poor practice included failing to consider the ability of consumers to understand information provided; failure to capture qualitative features (the quality of advice must be monitored, not just the number of sales or commission received); implementation of ineffective controls - for example, feedback on customer satisfaction, not fairness. MI provided to the CEO or board may be inadequate to enable them to evaluate whether or not TCF objectives are being met; and information on TCF implementation may not have been collected. Important areas, such as the monitoring of the quality of work performed, may have been omitted.

5. Performance management

Performance management has to do with the recruitment of appropriate staff and agents. Moreover, all staff must be trained to deliver appropriate TCF outcomes. Evaluation of competence in this area involves linking TCF to individual roles as well as expected behaviour and action. Evaluation of performance will hence be linked to meeting TCF expectations.

Good practice in this area included the following examples: learning from experience - where an analysis was made of customer complaints on a regular basis and this was translated into appropriate required behaviour for staff; recruitment and training processes were modified to accommodate TCF strategy.

Poor practice included failing to provide adequate guidance as to what was meant by TCF expectations beyond a general exhortation to treat customers fairly; failure to correct poor performance; failure to measure or monitor TCF behaviour and failure to monitor performance – particularly of new recruits.

6. Reward

A reward strategy may have a number of aspects – such as salary, bonus, commission and profit-sharing as well as staff incentive and recognition schemes. While firms will establish targets related to the growth of firms and the growth of profits, incentive schemes need to take cognisance of fair consumer outcomes. Hence reward structures may need to be reviewed in terms of quality issues and need to consider ways of rewarding good outcomes in terms of TCF.

Good practice in this area included the following examples: rewarding TCF through incentives for all to act in the long-term interests of the firm (where the latter involves building a sustainable client base through fair treatment); clawing-back commission where it came to light that customers had been treated unfairly; rewards tapered to include quality, not just volume of sales; recognition schemes which rewarded fair treatment of customers with awards and spot bonuses.

Poor practice included rewarding inappropriate behaviour, so that where unfair treatment was evident, performance bonuses for meeting sales targets were still paid; weak or ineffective reference to TCF in appraisal processes, so that a general comment on adherence to regulations was seen as adequate to cover a host of administrative and behavioural requirements.

The importance of the cultural framework in every firm continues to be emphasised by the FSA. For example, it is an on-going theme in speeches by the FSA:

> *We explained what we meant by 'culture' in the context of Treating Customers Fairly in 2007 when we published a 'culture tool', looking at some key factors which drive the firm's behaviour. These were: leadership; strategy; decision-making; controls (including the use and existence of appropriate MI); recruitment, training and competence; and reward.*
> *And the significance of culture was very evident to us when we came to assess firms against the March 2008 deadline. Those firms that showed good practice against that deadline (ie they were able to measure whether they were treating their customers fairly) had treated TCF as something which needed to be built into the firm's culture. In particular, they tended to have built fair treatment into the commercial strategy – not necessarily in name; the senior management were involved – they knew what measures they wanted to see and could use to drive change; there tended to have been a focus on reward and incentives; and customer feedback was taken seriously.*
> *There is of course a very strong overlap between the factors that we suggest create a culture and the responsibilities of a Board. It goes*

> *without saying that leadership (the first factor suggested in the FSA framework) is central: where there is strong leadership with a clear vision of what treating customers fairly means for the firm, it is more likely to have a culture which is geared towards delivering fair consumer outcomes.* [39]

And:

> *In short, those firms that showed good practice against the March 2008 deadline had treated TCF as something which needed to be built into the firm's culture:*
> - *Firms' own commercial strategies were consistent with fair treatment of customers;*
> - *Firms demonstrated active senior management involvement - not only in terms of engagement, but also in terms of driving change throughout the business;*
> - *Good firms also ensured that the fair treatment of customers was written into personal objectives and reward at all levels within the company; and*
> - *Good firms listened to, and acted on, feedback from customers.*[40]

The key point here is that TCF should be consistent with the long-term sustainability of the firm and the industry, and requires a shift in outlook from short-term profits to longer-term success. Much the same as a firm or industry that expels pollutants into a river needs to change its practices so that it can achieve a sustainable future, financial firms need to examine their practices and attitudes so that treating customers fairly becomes a mechanism for long-term success.

4.2.4 Assessing progress and enforcement

The FSA has attempted to facilitate the adoption of the TCF through the publication of guide notes and self-assessment tools. In order to evaluate the progress of firms, it has undertaken assessments of a broad spectrum of firms both large and small and has attempted to evaluate the success of the firm in developing and inculcating a culture of TCF. It has typically published reports on the outcomes of these assessments.

In once such publication[41] the conclusion was rather bleak, and that there was much room for improvement. As indicated earlier, the FSA seeks to measure its performance in terms of six outcomes. The scorecard for each of the six outcomes was as follows[42]:

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[39] Sarah Wilson, Director, Treating Customers Fairly, FSA, ABI seminar for Non-Executive Directors of insurance companies, 5 February 2009
40 Speech by Nausicaa Delfas, Head of Department, Retail Policy and Conduct Risk, FSA. Freshfields Client Seminar, 26 March 2009.
[41] FSA, 2007 *Treating customers fairly: measuring outcomes.* November
[42] FSA 2007: p 5

Box 4 2007 outcomes of the TCF programme

Outcome 1: For firms of all sizes and sectors, while many are committed to TCF, there is little evidence so far of firms making the cultural changes which are necessary if they are consistently to treat their customers fairly.

Outcome 2: We have seen some improvements, but more work is required by firms to ensure they are consistently providing products and services which meet consumer needs.

Outcome 3: There has been an improvement in standards of financial promotions and some improvements in mortgage and general insurance disclosure. However, we have not seen improvements elsewhere and overall there is a lot more to do before information from firms to consumers could generally be considered to be fair and clear.

Outcome 4: We have seen specific products where there is evidence of unsuitable advice and broader work has shown common weaknesses in firms' advice process. This increases the risk of mis-selling.

Outcome 5: In very broad terms, financial products and services generally function as expected. However, we have found several areas where false customer expectations may be created. Together with our disappointing findings elsewhere, in particular on information and the risk of poor quality advice (Outcomes 3 and 4), this suggests consumers may often not experience the specific product and services features or standards they expect.

Outcome 6: We are unable to draw general conclusions on the extent to which unreasonable barriers are preventing consumers from switching product or provider. Last year we noted some improvements in claims handling, while complaints handling shows a mixed picture.

This assessment, and others like it, has resulted in the FSA emphasizing the concepts of enabling and enforcing. From the perspective of enabling better outcomes, the FSA has produced and published product-level outcome testing tools (such as the FSA's pension-switching advice suitability assessment template). Based on the report on their findings on the *Quality of advice on pension switching*[43], this template is designed to help the firms consider the quality of advice they provide to consumers. The FSA's stated intention is for firms to use such outcome-testing tools on themselves.

In terms of enforcement, the FSA uses a risk-based approach in which those considered most likely to breach the TCF programme are under the most scrutiny.

In the past, the FSA was accused of exploiting its light touch regulatory approach to attract international capital[44]. Everything points in another direction now, however, as a recent speech by the outgoing FSA head, Hector Sants suggests:

> *In the past, the FSA was primarily reactive, only making interventions on readily observable facts and adhering to the view that it should leave management to make its own decisions.*

[43] FSA, 2008. *Quality of advice on pension switching*. December
[44] see Davidson 2006: 11.

Intensive supervision, in contrast, focuses on the risks inherent in a firm's business model and enables us to be proactive and not reactive to the management of these risks.

Our outcomes-focused philosophy requires supervisors to judge firms on the likely consequences of their decisions.

This means the proportion of our time spent looking at systems and controls will diminish relative to our focus on assessing the outcomes of a firm's actions. This will necessarily be controversial at times, as our view and the firm's view will not always coincide.

This divergence of judgement can normally be resolved, but the FSA recognises that this new approach may create tensions and will certainly no longer be seen as light touch!

To enable us to deliver on this approach we have equipped ourselves both to forecast and test outcomes. This capacity is needed to enable us to effectively make judgements on the judgements firms are making. [45]

The recent emphasis from the FSA is on the intensive supervisory model – which in the words of the FSA is more *intrusive and direct:*

... our intensive approach will mean a greater emphasis on outcomes testing relative to assessments of adequate systems & controls. In the past the principal focus was on ensuring that there was adequate management information and controls in a firm and then relying on management to address the issues. This is a slight caricature but broadly correct. In the future we will switch resources to outcomes testing. For example, on conduct issues I believe a better use of resources is 'mystery shopping' and 'branch visits' rather than detailed reviews of high-level management information. This switch to outcomes testing is also central to the delivery of 'credible deterrence'.[46]

The FSA is empowered (by the FSMA) to publish details of a firm's non-compliance and to impose a fine, typically only after a period of redress is allowed for. Naming and shaming can only be done within the confines of their regulatory regime which gives firms the protections of due process, right to appeal, etc. For this reason, the FSA typically only names a firm when it has been through the entire enforcement route - i.e. at the end of the process – after the firm has been warned, allowed a period to remedy the situation and then been re-evaluated. A case in point is Heaney Finance, whose license was revoked in November 2009.[47]

Competition also has a role to play in compliance, and industry bodies can help create the environment for gradual adjustment of attitudes. Moreover, membership bodies can also help the setting of benchmarks to which firms can aspire and once achieved, can be seen as holding a competitive advantage. The

[45] Speech by Hector Sants, Chief Executive, FSA *Bloomberg* 9 November 2009
[46] Speech by Hector Sants, Chief Executive, FSA *The Reuters Newsmakers event,*12 March 2009
[47] FSA, Final Notice 27 November 2009.

FSA will give comment on such industry standards, but will not actually endorse them.

An example is AIRMIC, the *Association of Insurance and Risk Management*. In January 2009 it brought out a 12-page document on *Delivering excellence in insurance claims handling*. The guide "sets out parameters by which an insurance buyer can objectively evaluate how a given insurer is performing and compare the services offered by competing insurers."

4.2.5 The FSA and consumers

The TCF approach of the FSA is presented from the vantage point of firms. It hopes to change the behaviour of firms so that the fair treatment of consumers will, over time, be built into the corporate culture. Consumers cannot, however, appeal to the FSA directly if they feel that they have been treated unfairly. For this, they need to rely on the services of the Financial Ombudsman Service. In the words of the FSA:

> *We are the UK's financial regulator set up by the government to regulate financial services. We protect consumers by setting standards that FSA-regulated firms must meet and taking action if they don't.*
>
> *Although we cannot deal with your complaint on your behalf, we still take seriously individual complaints against the firms we regulate. For example, we require firms to categorise all the complaints they receive and to report this to the FSA regularly. We use this, along with information from other sources, including any information that the Ombudsman may share with the FSA, to build up a picture of where firms may be failing to meet our standards. As a result we then take appropriate action.*
>
> *At the same time that the FSA received its formal powers, the Ombudsman was set up as a separate and independent body to investigate individual complaints on behalf of consumers. The Ombudsman decides cases on the basis of what it considers to be fair and reasonable, taking into account the law, FSA's rules and good industry practice. Its decisions are binding on firms but not on you. More information about the Ombudsman can be found on its website.* [48]

4.3 Australia

In Australia *The Corporations Act of 2001* encompasses the regulation of those who deal with financial products. The items that fall under this act are: securities, derivatives, short term insurance (excluding health insurance and funeral benefits), life insurance policies (excluding funeral benefits), deposit-taking

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[48] http://www.fsa.gov.uk/pages/About/Complaints/roles.shtml

facilities (bank accounts), foreign exchange contracts, super-annuation interest and retirement savings accounts.

Firms and individuals that deal with such products are regulated by the Australian Securities and Investments Commission (ASIC) and such dealers have to obtain a licence from the ASIC. The Act specifies that financial services licensees must operate fairly. Hence in terms of the licence, the licensees have to:

> *Do all those things which are necessary to ensure that the financial services covered by the licence are provided efficiently, honestly and fairly (Davidson 2006: 14, quoting from the Corporations Act)*.

A distinction needs to be made between ASIC and APRA. APRA is the Australian Prudential Regulatory Authority. The chairman of APRA recently pointed out that:

> *APRA's primary purpose to ensure that the financial institutions it regulates remain financially sound and able to meet their commitments to their beneficiaries. In the context of banking, APRA's role is to protect the depositors of authorised deposit-taking institutions (ADIs) from the risk that they might lose their deposits due to the failure of an ADI. … Under Australia's 'twin peak' regulatory model, matters relating to conduct of business and disclosure (particularly for borrowers) fall within ASIC's jurisdiction. APRA has no mandate for business conduct or consumer matters and does not get involved in dealings with individual customers or groups of customers* [49]

ASIC liaises regularly with the APRA with a view to identifying and minimising duplication between ASIC and APRA[50].

In terms of the Corporations Act, firms have to have sufficient (and trained) staff to ensure that customers are treated fairly. Mechanisms for dealing with internal and external disputes also have to be in place. Firms are obliged to provide disclosure statements and the legislation also prohibits "misleading and deceptive conduct and unconscionability"[51].

An Australian evaluation of the TCF approach was undertaken by Davidson in 2006. Davidson's research was funded by the Consumer Advisory Panel of ASIC. The ASIC does not have jurisdiction over credit products and mortgages and these are thus excluded from the Australian analysis.

Davidson points out that the way the act is worded means that fairness is something that has to do with all applicable laws (such as, for example, common law). In common law the fairness issue arises through concepts such as

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[49] Letter from John Laker, Chairman of APRA, to a Parliamentary Joint Committee on Corporations and Financial Services.
[50] ASIC 2006: p 11.
[51] Davidson 2006: iii.

misrepresentation, undue influence and unconscionability. He cites a case study in which an Australian court held an action to be unfair even though it did not involve criminal conduct[52].

Persons applying for a licence from the ASIC have to go through a vetting process. The applicant's ability and capacity to deliver the financial services are investigated to establish whether or not the applicant has the systems in place to deliver the financial services in a fair and efficient manner. The vetting process is important because once the licence is granted the ASIC may be able to consider compliance only through "risk focused surveillance"[53]. Applicants also have to agree to put in place systems for internal and external dispute resolutions.

Three schemes that assist in external dispute resolution are the Banking and Financial Services Ombudsman, the Credit Union Dispute Resolution Centre and the Financial Industry Complaints Service. All three of these schemes have received ASIC approval.

Licensees also have disclosure obligations. For example, licensees that provide a financial service to an individual need to provide a financial services guide that contains information about the licensee and the services it provides. Such information includes information about commissions and other remuneration.

If the licensee also gives personal advice, the action must be accompanied by a statement of advice. In terms of the statement of advice, the licensee acknowledges that the client's objectives, financial situation and needs have been investigated and various options available to the client considered.

Licensees are also required to provide a product disclosure statement whenever they make a recommendation on a financial product. Such a statement contains information about the product such as the risk involved, the cost, fees, taxation implications, dispute resolution issues and cooling off requirements. If a time dimension is involved, ongoing information about the product must be provided.

The Corporation Act 2001 specifies that the financial services guide, statement of advice and product disclosure statement documents must be worded clearly, concisely and effectively.

The ASIC is considering risk-based surveillances to ensure compliance. In terms of the Corporations Act 2001, licensees have to notify the ASIC if they are unable to fulfil the requirements of the licence.

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[52] Davidson 2006: p15
[53] Davidson 2006: p16

If the obligations of the license have been breached (including the obligation to treat customers fairly), the ASIC may cancel or suspend the licence. For this to occur, a significant breach must have taken place. Conditions can also be placed on the licence.

Various codes of practice exist in the Australian financial landscape. Thus the Australian Bankers Association (ABA) have a voluntary code of conduct. On the other hand, the Insurance Council of Australia (ICA) has a mandatory code of practice. The ICA represents 90% of the general insurance market. The Financial Planners Association (FPA) also has a mandatory code of practice. The FPA has more than 12000 members. Davidson points out that there is some overlap between the industry codes and the laws specifying licensees obligations and argues that such discrepancies can actually promote compliance since it raises awareness.

Davidson (2006: Section 4) suggests that there is no evidence that a principles-based approach would bring about a situation in Australia where consumers are treated more fairly. While issues related to the unfair treatment of customers surface regularly in Australia, Davidson points out that issues are concerned with compliance and that there is no evidence to suggest that a differently worded framework would be successful.

As might be expected, however, there are Australians who believe that aspects of the TCF approach have some merit. Paul Resnick, an Australian with 40 years of experience in the financial services industry had the following to say in a deposition to an Inquiry into Financial Products and Services in Australia:

> *In the UK a less prescriptive regime called treating customers fairly has proven to be reasonably successful in making planners personally more conscious of their obligations.*[54]

Resnick suggests that a preoccupation with the letter of the law (as one might encounter where a rules based approach is applied) could lead to diminution of personal responsibility and a lack of understanding of the intent of the law. Referring to the Storm debacle in which a financial services provider went bust, Resnick writes:

> *Australian financial advisers work within a highly prescriptive regulatory environment. This can lead to an abrogation of personal responsibility in many cases. It becomes all too easy to work within the letter of the law without paying any significant attention to the intent of the law.*
>
> *In the Storm case it looks as if the business model was largely consistent with the laws as most participants in it, internal and*

[54] Resnick, July 31, 2009

external compliance managers, accountants and auditors, the FPAS and ASIC for example applied it. Yet the business was hardly an exemplar of integrity and client focus.

The challenge for regulators is to infuse some level of personal integrity into the exercise. There are two issues that should be reviewed.

The first can be seen in operation in the UK where the notion of treating customers fairly has created a sense of personal responsibility for the integrity of advice that this author has rarely seen in Australia.

TCF ... is about setting personal professional standards, not just ticking compliance boxes. Prescriptive regulation is never sufficient by itself. For a successful outcome there has to be a higher moral and professional obligation in play.

4.4 Conclusion

While at first glance, the UK and Australian examples provide an apparent juxtaposition regarding the structure of the regulatory regime (i.e. principles-based or rule-based), in reality both systems employ both structures, and both rely on effective enforcement for their success.

The Madoff saga in the US illustrates that the existence of regulators does not necessarily prevent fraud. The regulator needs to be efficient. A good regulatory system should be: Efficient, Fair and Certain. In the US, the matter is complicated by the fact that financial firms have an ability to shift between regulators.

Larry Summers, President Obama's economic adviser has recently remarked on the need to establish a consumer financial protection agency and the need to eliminate the possibility that firms can choose their regulator.

Mr Summers said it was essential to create a dedicated consumer financial protection agency because only such a regulator would have a clear focus on protecting the consumer.

He set out five core principles that he said must be embodied in financial regulatory reform legislation.

These were additional capital requirements for systemically important financial institutions, special resolution authority to allow regulators to organise the controlled failure of a complex financial firm, the elimination of firms' ability to choose their regulator, a shift towards regulating system-wide risks in addition to firm-specific risk, and the creation of the consumer protection agency.[55]

55 *Financial Times*, 18 September 2009

5. "Conduct unbecoming" examples in South Africa

The discussion above has highlighted the notion that evidence of TCF outcomes should be apparent at each stage of the product life-cycle. Of course, absence of a TCF approach will also be apparent in market outcomes. In this section, examples of unfair treatment of consumers are highlighted.

Table 4 Conduct unbecoming in product life-cycle phases

Phase	Design of product	Promotion of service	Advice	Point of sale	After sales service	Complaints & claims handling
Conduct unbecoming outcomes	Inadequate evaluation of consumer needs	Marketing material unclear or misleading	Failure to adequately assess needs of client	Poor or misleading information about risks or exclusions	Discontinuous after sales service	Complicated or inaccessible processes

Table 4 above sets out common and generic types of outcomes associated with firm attitudes, behaviour and practices that belie fair treatment of consumers.

In the discussion below, known examples of unfair treatment are assigned to a particular phase of the product life-cycle. While it is clear that conduct unbecoming in one phase of the product life cycle is likely to have an impact on all the subsequent phases, the assignment is made to a particular phase because it is deemed to originate there.

Some of the examples of unfair outcomes highlighted below are historical and some current. These are merely examples, and there may be a range of other concerns. So while some of these have already been brought to the attention of the ombudsmen and the regulator and may even been the subject of recent regulation, a new approach that involves principles of fairness embedded in the cultural behaviour of firms is called for, rather than an *ad hoc* regulatory fix. It is not unreasonable to suggest that innovation may lead to similar types of situations presenting themselves in the future, and these examples are illustrative of the type of conduct that a commitment to treating customers fairly should eliminate.

As becomes apparent from the examples, the need to treat customers fairly cuts across all industries in the financial sector, and indicates the need for a commitment to adjusting firm culture and behaviour that goes beyond re-writing regulation.

The examples in the textboxes have been provided in workshops with the statutory and voluntary ombudsmen and with industry stakeholders and experts. They are accordingly South African examples. It should be noted, however, that the examples here are not exhaustive; rather they are provided for illustrative purposes.

5.1 Product design phase

5.1.1 Design defeats the purpose of the product

A number of examples have come to light where the design of the financial contract is such that there appears to be little or no value for the consumer, for example where:

- High and layered fee structures are imposed on investment policies, making the likelihood of a positive return improbable. Even if these fees are disclosed, the consumer may not understand the implication of such fees.

- Funeral policies are designed so that the cover terminates when the insured reaches a certain age, such as 65 years. For those who live to this age, the cover terminates when they are most likely to need it. The Ombudsman for long term insurance has, for example, stated that:

  > *We are … concerned about the effect such a [Upper Age Limit] clause would have on the lives assured who have attained the age of 65 because it would be difficult, if not impossible, for them to obtain alternative cover in the market at that stage. We intend to engage the regulator and the industry in this regard. Consideration should be give to find ways in which this problem can be minimised.*[56]

5.1.2 Contractual wording restrictive

- The wording on risk policies may be so restrictive that the risk is shifted back to the insured. For example, in the case of health policies, the conditions covered may be highly obscure, while more common diseases and conditions are excluded. This type of product has the effect of creating a very small claims ratio, as most claims are rejected.

5.1.3 Policy loans

- While the funds underpinning an investment policy or pension can be considered one of the most liquid forms of security, high interest rates (significantly higher than prime) on loans secured by such policies or pension

[56] *Ombuzz*, 2009, June.

funds are still charged. The consumer is not always aware of the extent to which high interest rates will erode the value of their accumulated funds in the case of default. In cases such as these, the bank will typically claim its surety (outstanding capital and interest) from the insurer or pension fund if a consumer goes into arrears, leaving a hole in the consumer's savings.

Box 5 High rates of interest, the in *duplum* rule and treating customers fairly

The Ombudsman for Long term insurance[57] has raised concerns regarding the nature of loans taken against the security of a policy with an investment component. In one case, a policy holder took a loan of R415 in 1988, against a policy initiated in 1985. Interest was payable. The loan was not repaid and no demand was made, however, premium contributions continued. In 2000, the policy lapsed as the loan value plus interest exceeded the surrender value. At that time the loan debt was R5891.79 and the fund value R5347.99. The consumer contributed R7288 over nearly 15 years, but received the value of only R415.

The *in duplum* rule is a common law rule that the interest on a debt cannot exceed the outstanding capital component of debt. A provision in the 1943 Insurance Act exempted policy loans from the operation of this law. When the Long term Insurance Act became effective on 1 January 1999, policy loans were no longer exempted from the *in duplum* rule. Had this been the case in the example above, the interest owed by the consumer could not exceed the value of the principle debt, R415.

While insurers have argued that loans granted prior to 1 January are still exempted from the *in duplum* rule, the view put forward here is that where fair treatment of customers is embedded in an insurance firm, the firm would not take advantage of this exemption. Rather, such loans could be treated as a part surrender of the policy rather than a loan.

5.2 Promotion phase

5.2.1 Failure to take into account the circumstances of the target market

- Examples here included situations where a decision is made to expand the target market beyond a middle-class market, say, to one where there is less likely to be adequate understanding of the nature of product or service and its concomitant responsibilities. In essence, suitability of the middle-class product for an emerging market may not be taken into consideration. The failure to adapt the product and its marketing material to a less sophisticated market may mean that the consumer chooses an inappropriate product.

- A specific example is the appropriateness of marketing contractual savings products - such as endowment policies - to low-income consumers. Here, the nature of the product (including early termination penalties and the tax treatment of the savings) is unlikely to meet the needs and circumstances of consumers with low and volatile income, relative to other savings products.

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[57] *Ombuzz*, 2008, July.

- Failure to explain the use of terms that may have particular cultural meanings in marketing material, so that the potential client persists in a mistaken expectation or interpretation. For example, a potential client's interpretation of family member may include a broader range of people than the product designers had in mind.

5.2.2 Misleading promotions

- Marketing material may make misleading promises. For example, a promise is made to pay the claim within 48 hours, even although there are no structures to ensure such a turnaround time.

- There is misrepresentation where adequate detail of the contractual arrangements - such as consequences of a missed premium payment, or the extent of exclusions or limitations – is not provided.

5.2.3 Reliance on inadequately trained or monitored social structures to market financial products

- While marketing of financial products and services may make use of church, work or community groups - given that they are a useful and broad-based distribution channel, such channels need to be adequately trained and monitored, to ensure that they are providing accurate and appropriate marketing information.

- In some cases, social networks may coerce participation by members. But of even greater concern is that while the agents used in this case are paid commission, they may be unable to explain adequately the nature of the product, or its exclusions. (See Box 6).

- In other cases, cover is bundled with membership - such as union membership or club membership. The individual has little ability to assess value of policy or to opt out of contributions.

Box 6 Inadequate marketing information provided by shop stewards

The Ombudsman for Long term Insurance has recently highlighted a case where a life assured had been a member of a group funeral scheme arranged through a labour union. The policy provided that the member could apply for a paid –up policy (i.e. a policy on which no further premiums are payable) when taking retirement. The life assured died a few years after retirement, but the death claim was declined because he had failed to apply for a paid-up benefit when he went on retirement.

The son of the life assured contested the decision, based on the fact that the life assured had never been provided with the terms and conditions of the policy, nor could he be expected to know them, given that he was illiterate – and could only know of the terms had he been adequately explained them. Although the insurer contended it had informed members through road shows, and encouraged shop stewards to advise members about terms and conditions, there was no certainty whether the correct information had been relayed to the life assured, during the marketing phase or any other interaction.

The Ombudsman for Long term Insurance advised the insurer to pay the claim on an *ex gratia* basis and advised that the matter of paid-up benefits be taken up with the industry body ASISA, given that it is not always clear that the terms are understood by retiring members[58].

5.3 Advice phase

5.3.1 Failure to balance commercial interests with client needs

- In too many instances it appears that intermediaries may provide investment advice driven by profit-sharing or other vested interests, rather than on the identified needs and circumstances of the client (See Box 7). Such conflict of interest can lead the intermediary to unquestioningly relay the product provider’s high “projected” or “illustrative” returns, without disclosing the nature of the investment or status of the firm – such as whether or not it is licensed, on the verge of bankruptcy, and so on.

- The upfront commission structure in long-term insurance can lead to over-eagerness to sell policies – even when they are inappropriate – such as where a non-insurance investment product would be more suitable or where the client clearly cannot sustain the premium contributions.

- Commission structures also contribute to the churning of policies, and the churning of books of policies, where all policies held by a broker are moved to a new insurer. While the broker receives new commission, the client may be disadvantaged, as he or she is older and the new policy may have more restrictive clauses of which the client is not made aware.

- A further risk is that a financial firm – such as a bank - may direct all business to an associated insurance company, with the client unaware of whether the

[58] *Ombuzz*, 2009 (b)

associated company offers value for money or of his or her ability to choose an alternate supplier.

5.3.2 Failure to disclose all cost and benefits of switching products

The intermediary may fail to disclose all information pertinent to the transaction when advising the client to switch products:

- Here, the intermediary may focus on the benefits of switching products, such as product innovation or lower fees, but fail to disclose the full costs of such a switch. In particular, switching from a contractual savings product of an insurer to a non-underwritten investment product may involve substantial early termination charges that should be incorporated properly into the advice given to the consumer. Again, the risk exists that such advice may also be driven by intermediary remuneration issues

Box 7 Advice on projected values and treating customers fairly

A client seeking a monthly return of R3000 p.m. was advised to invest R250 000 in an investment company for a year. The client was unaware that the company was unlicensed. When the return failed to eventuate, the client sought answers and attempted to withdraw his funds. The company had by then been placed into liquidation.[59]

The advisor did not provide information regarding the nature of the investment and the status of the firm to the client. The client's expectation of a high return and the promise to achieve these returns appears to have beguiled the client into undertaking the investment with the minimal amount of information.

An advisor that is committed to fair treatment of consumers should refuse to expose his customers to risks, even where a firm is licensed, through unrealistic projected returns.

[59] See the FAIS Ombuds Annual Report, p 16 for further details.

5.4 Point-of-sale phase

5.4.1 Providing misleading or incomplete information

- Disclosure at point-of-sale is sometimes selective. For example, the consumer may be encouraged to buy short-term insurance based on the cheapest price, rather than on the apparent value of the product. In this way, the consumer is misled into thinking that he or she has a good deal, with a similar insured value for a comparatively lower monthly premium. However, the 'fine print', such as the extent of exclusions, excess or the no claims bonus, which shifts the risk back to the consumer, is often not properly disclosed at the point-of-sale. Furthermore, differences in the format and content of disclosure also make comparisons between options extremely difficult.

- Bundling may occur such that the different components of the product and its associated premium or fee are not discussed, nor brought to the attention of the consumer. This means that the consumer may not be aware of the extent or nature of the insurance, or its value, or the ability to opt out or to claim. (See Box 8).

Box 8 Credit life insurance and treating customers fairly

Consumer credit insurance is the insurance a consumer takes out to cover a debt he or she has incurred. It is typically taken out at the insistence of the credit provider as a form of collateral security, should the consumer die or become disabled - or in some cases - become retrenched, before the debt is repaid.

The credit life insurance *does not* provide security should the asset against which the debt is incurred, be lost, destroyed or damaged prior to repayment, however, the consumer may often believe this to be the case.

The Panel Enquiry into Consumer Credit Insurance[60] pointed out a number of practices that were inappropriate, misleading and detrimental to consumers at the time the contract is concluded, such as not offering the consumer a choice of credit insurance, not making the customer aware of the insurance component, and so on.

The Panel also pointed out, however, that the pre-sale disclosure requirements for consumer credit insurance are detailed and comprehensive. However, a number of cases demonstrated "the wide divergence that sometimes occurs between market conduct regulation, on the one hand, and actual compliance, on the other"[61]. Hence what the head office intended through disclosure in the small print of the contract may have little bearing on what happens on the shop floor at the time furniture is purchased through an instalment sale.

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[60] 2008. A report by the Panel of Enquiry on consumer credit insurance in South Africa.
[61] Ibid. p 179, Section 2.2

The practical difficulties of each shop floor assistant being able to advise on the finer details of each contract was pointed out to the Panel[62].

However, the view put forward here is that while not every assistant may be able to offer comprehensive information about the contractual clauses of the contract, a firm that is committed to treating the customer fairly would ensure that every branch has at least one supervisor who could do so. Such a supervisor would be responsible for explaining the implications of consumer credit insurance to each consumer before concluding the contract.

5.4.2 Inadequate or confusing disclosure at the point-of-sale

- This involves the absence of clear and simple language to explain concepts, as well as inadequate definition of the terms used in point-of-sale material and by the sales person or broker.

- In addition, there may be no attempt to define words which have an interpretation different from the common-use meaning. For example, retrenchment has a common-use meaning, which is undermined in some contracts through multiple restrictions and limitations.

- Moreover, there may be inconsistent use of terms, and use may be made of confusing terminology - such as “regular driver” and “nominated driver” (see Box 9).

5.4.3 Charging maximum permissible fees, as a default

- In the case of collective investment scheme products, the maximum permissible fees may be charged (such as for example where they are capped at 5% of the value of the monthly contribution), even where little advice or administration is done. An example given here is where the client selects the investment vehicle, based on information obtained on the internet, completes the forms and then instructs a broker to ensure the investment is made. While the broker cannot claim they have provided advice or undertaken significant administrative work, the full permissible fee is charged, as a default.

5.4.4 Telemarketing

- The meaning of terms may be obscure and glossed over where the telephone is used as a point-of-sale channel. For example, a potential customer is asked if they have any “judgements, defaults, or adverse financial history”. On requesting this be further explained, the response is to re-phrase the question as “Do you have any judgements?” No explanation is made of the need to

[62] A point which was accepted by the Panel, p 218 Section 2.8.

mention adverse listings on credit bureaux, for example. However, when a claim is made, the claim is subsequently rejected for incorrect or non-disclosure.

- In too many instances, the emphasis is on concluding the transaction quickly and the client has no opportunity to check his or her responses.

- Additional information requested – such as the ID numbers and licence numbers of additional drivers - may not be to hand at the time of the sales conversation, but the importance of submitting this information may not emphasised or followed-up (by either the client or provider). However, the consumer runs the risk that claims involving such additional drivers will be rejected.

Box 9 "Regular driver" and "nominated driver" and treating customers fairly

Sometimes the terms "regular driver" and "nominated driver" are used interchangeably in the same documentation or by sales persons or brokers. While the term "regular driver" may appear innocuous, it is not always explained that this means that the use of the car by any additional drivers must be less than that of the regular driver. This is ambiguous as it is not specified over what period of time this regularity is measured – over a year, a month or a day?

Paradoxically, while the term "nominated driver" is more restrictive, consumers tend to understand better what is meant.

The view put forth here is that a firm committed to treating customers fairly would take care not to confuse the consumer by using similar sounding terms interchangeably where they have different definitions in law. Nor would a firm treating customers fairly employ terms that appear to rely on a commonsense understanding - since they are not adequately defined in the documentation. Firms are usually aware that a very specific interpretation of the terms involved will be employed at the time a claim is made.

5.5 After sales service

5.5.1 Collection of premiums

- Insurance premiums and investment contributions are typically collected by bank debit orders. These debit orders are usually only cancelled when the beneficiary (i.e. the insurer or broker) so instructs the bank. Delays in relaying this information to the bank, after a policy is cancelled or investment suspended, mean that premiums or contributions are sometimes still collected. In so doing, the consumer may be financially inconvenienced and may find it difficult to recoup the premiums.

- Where a consumer misses a premium payment or contribution, perhaps due to insufficient funds in the bank account on the day the debit order is processed, it is difficult for the consumer to make up the missed contribution or premium.

In some cases, the beneficiary attempts to recoup the missed contribution through a double debit the following month. If the consumer is not fully aware of this, there may once again be insufficient funds available in the bank account, which leads to further costs for the insured, including bank charges and administrative costs.

5.5.2 Failure to provide ongoing service

- The up-front nature of intermediary commission for contractual savings products of insurers may not provide sufficient incentive to the intermediary to ensure that an on-going service is provided to the consumer. In many cases the consumer may find that their reasonable expectations of after-sales service are not adequately met.

- This may be exacerbated by the fact that arrangements by insurance companies to keep brokers informed revolve around the importance of the broker in terms of volume of sales. Some necessary information may not be relayed to a broker because such a broker is considered to be inconsequential. In this way, the client-base of the broker loses out as well.

5.5.3 Imposition of unforeseen charges

Consumers are sometimes surprised by charges that come into effect when a policy is called into use. In many cases, these charges are not explained at the point-of-sale, but the client experiences the effect of these charges after the sale.

Examples are:

- Charges on withdrawals or surrenders
- High or multiple excesses
- High interest rates on policy loans.

In some cases, these charges may be incorporated into the design of the product in order, for example to encourage long-term savings. However, the quality of the advice given prior to and at the point of sale may mean that the consumer has not appreciated the nature of the contract and his or her responsibility in undertaking it. Moreover, the contractual arrangements may not be at all suited to the financial position of the client. In these cases, the client's after-sale experience of the contract is likely to be negative.

Box 10 Retirement annuity payouts and treating customers fairly

It is not uncommon for payouts on retirement annuities to be delayed by a number of months[63]. The concern here is not only that the delay might inconvenience the consumer, but that the absence of funding may deny the consumer an opportunity to exercise investment options.

The view put forward here is that delays in such processing may be unavoidable from time to time, but that a firm wishing to treat customers fairly would at least compensate the customer for the interest due.

5.6 Complaints and claims handling

5.6.1 Repudiation process

- Firms may assign considerable resources to repudiation of claims, rather than ensuring that adequate information is provided to consumers upfront. For example, after a claim is made, much effort may be put into proving there was inadequate disclosure by the policy holder, or that a condition pre-existed. At the time the contract was signed, however, little or no effort was made to extract sufficient information or explain the consequences of pre-existing conditions.

- Incentives of loss adjusters or claims handlers may be structured in such a way as to minimise claims, which sets them in opposition to the claimant in such a way that the claimant feels intimidated.

- Providers may not apply the Didcott principle to non-disclosure cases[64]. In other words, the insurer simply repudiates a claim, rather than reconstructing an appropriate policy (See Box 11).

5.6.2 Claims handling

Lack of clear processes often leaves the claimant in an uncertain position. For example, there may be no formal acceptance and tracking of a claim. Upon query of progress regarding a claim; the claimant may simply be informed that there is no claim.

- Providers may delay payment of claims unnecessarily.
- Providers may not pay interest when a claim is delayed.
- Providers may refuse to pay a claim on technical grounds, even though the claim would otherwise have been honoured. For example, a late submission of

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[63] One of the FSB TCF Task team members has personal experience of this.
[64] See Preiss, 2008 and box below.

a claim where the delay is excusable, the delay is minor, or the claim period is unusually short and where the insurer has suffered no prejudice.

5.6.3 Complaints handling

- The process may lack transparency, or be difficult and unhelpful, so that the complainant gives up before a problem is resolved.

- The complaints handling process may impose language and other hurdles for the client. An example might be one where the complaints process requires written complaints, even where a client is illiterate.

Box 11 The Didcott principle and treating customers fairly

The Didcott principle is based on a 1991 judgment in which Judge Didcott suggested that reconstruction of a policy rather than cancellation of a policy is more equitable under certain conditions of material non-disclosure.

The suggestion was that where non-disclosure by the insured materially affects the risk to the insurer, but that the insurer would have issued the policy anyway, even with loaded premiums, then it is inequitable for the policy to be cancelled and the insurer to have no liability when a claim is made and the non-disclosure become apparent[65].

An example of this might be a case where a consumer fails to disclose that he is depressive at the time his life is insured. Some years later the insured dies in a motor vehicle accident. Had the disclosure been more complete, the insurer would still have originated the policy, but at inflated premiums.

Some in the industry have argued that if the approach is generally known, then unscrupulous customers may deliberately exploit it. The point has been made by the Long Term Ombudsman that where the non-disclosure is on a balance of probabilities fraudulent or made with the intension to deceive, the Didcott principle should not apply. However, if the insured's lack of disclosure was not fraudulent, affording the insurer no liability is also inequitable.

The view is put forward here that those insurers that have spontaneously adopted the Didcott principle are treating customers fairly in this regard.

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[65] See the Long Term Ombudsman *Annual Report*, 2006, p 21.

6. TCF in South Africa – ensuring compliance

British experience in the financial services industry highlights some key elements of the debate on how regulators can best ensure that customers are treated fairly. In the UK, the movement towards an explicit TCF policy emerged early in the decade with the FSA arguing in favour of a principles-based approach to regulation. Movement towards a principle-based approach was seen as a movement away from a rules-based approach. We have argued that the debate about rules and principles appears in various guises in different disciplines. For current purposes, the issues in the legal field are of particular relevance.

In our view it is a misconception to view the debate over rules and principles as a rules *versus* principles issue, since this encourages the mistaken view that if one has more of the one, one necessarily needs less of the other. A regulatory system needs both rules and principles. If the rules are badly drafted they need to be re-drafted, and from time to time the principles involved need to be re-examined. It is, however, a mistake to think that if one gets the principles right, the rules can be dispensed with (or vice versa). From the vantage point of economic theory, rules and principles should thus be viewed as complementary inputs to the system, rather than substitutes.

However laudable the intentions of the FSA are as far as promoting a TCF culture are concerned, the implementation thereof raises issues rather similar in kind to the arguments surrounding rules and principles. The cultural framework that the FSA has in mind is linked to the TCF programme. In an ideal world firms that lived by TCF principles would by the same token reflect the appropriate cultural behaviour. As the principles and rules debate has indicated, it is not enough to have principles, the regulatory system requires rules as well. Moreover, compliance remains an essential ingredient of an efficient regulatory system and if we now apply compliance issues to the debate on the appropriate cultural framework, we are forced to ask: What sanctions should be applied if firms do not inculcate the appropriate culture? Unless there is clarity regarding what appropriate cultural behaviour is, and unless there is certainty regarding the punishment involved if firms do not obey cultural imperatives, the drive to generate an appropriate cultural environment would appear to resemble a drive to eliminate crime by exhorting individuals to behave in a non-criminal manner.

In any event, after a few years of promoting the principles-based approach, the FSA soon appeared to be changing tack towards an outcomes-focussed policy. The success of the TCF campaign was thus to be judged in the light of the outcomes generated. Soon after the emergence of the global economic crisis the FSA appeared to be changing direction once more. In the wake of the criticism that its light touch approach had aggravated (or even contributed towards) the financial crisis, the FSA has recently been adopting a more hard-line policy towards firms that are not treating customers fairly. Once again, there is a temptation to regard this as a movement away from a principles-based approach to a rules-based approach, but once again such a temptation should be avoided. It should rather be seen as an acknowledgment that compliance issues play a key role in an efficient regulatory system. The principles versus rules debate pursued by the FSA tended to obscure this. The head of the FSA recently noted the following:

> *Historically, the FSA characterised its approach as evidence-based, risk-based and principles-based. We remain, and must remain, evidence- and risk-based but the phrase 'principles-based' has, I think, been misunderstood. To suggest that we can operate on principles alone is illusory particularly because the policy-making framework does not allow it. Europe, in particular, has a particular penchant for rules and in any case in a number of key areas such as prudential they are indeed necessary.*
>
> *Furthermore, the limitations of a pure principles-based regime have to be recognised. I continue to believe the majority of market participants are decent people; however, a principles-based approach does not work with individuals who have no principles.*
>
> *What principles-based regulation does mean and should mean, is moving away from prescriptive rules to a higher level articulation of what the FSA expects firms to do. In other words, it helps emphasise that what really matters is not that any particular box has been ticked but rather that when making decisions, executives know they will be judged on the consequences - the results of those actions.*
>
> *Similarly, the FSA, when it supervises, needs to supervise to a philosophy that says 'It will judge firms on the outcomes and consequences of their actions not on the compliance with any given individual rule'. Given this philosophy, a better strapline is 'outcomes-focused regulation'*[66]*.*

Hence recent regulatory experience in the UK simply highlights that a good regulatory system (and the achievement of fair outcomes for consumers) requires both principles and rules. Moreover, compliance is a key issue in the regulatory debate. Here too, the literature on a related field, namely the economics of crime, is instructive. The theory underlining the economics of crime is that crime will tend to abound if the price of crime is low. To dissuade criminals and potential criminals from criminal activity, the cost of getting caught (the price of crime) must be high. As with price theory in general, the prices involved provide incentives and dis-incentives. For the regulatory system to function, market

[66] Speech by Hector Sants, Chief Executive, FSA *The Reuters Newsmakers event*, 12 March 2009.

participants need to know that if they transgress, the chances of getting caught are good.

Expressed in a slightly different way, the need for market participants to be aware of the consequences of transgressing, forms part of the informational requirements of an efficient regulatory system.

Our study highlights the informational aspects of a sound regulatory system. For consumers to be treated fairly, it must be generally well-known that crime does not pay. There must be channels and processes open to promote the flow of information, and the role of the ombudsman should be viewed in such a dissemination-of-information light. The TCF policy of the FSA can also be viewed as one of promoting information – in their instance the information was to be disseminated by firms.

In order to facilitate the successful implementation of a TCF programme in South Africa, the FSB intends to approach the matter holistically. The following elements need to be considered:

- Providing clarity concerning regulatory expectations
- Putting pro-active and intensive supervision in place
- Ensuring appropriate incentives are in place
- Encouraging consumer responsibility
- Facilitating ultimate fairness by working with the ombudsman

6.1 Providing clarity concerning regulatory expectations

As has been highlighted above, providing clear guidance on what is expected by regulators is essential for the TCF framework to succeed. Firms prefer a system which contains rules of which they are certain. To establish a common understanding between regulators and firms may, therefore, be challenging. Firms appear to want explicit guidance on the rules of the game. They want to know what fairness means in terms of their usual business activities.

In South Africa, for the endorsement and adoption of the programme to be fully realised, there may be a need for legislative revision in some cases, and in others there may be a need for regulatory modification. Over and above this, guidance notes and tools may be necessary to enable firms to move beyond adoption of the broad principles of TCF to ensuring it has become part of the firm's operations. Ultimately, industry codes may also be changed to reflect the inculcation of the TCF programme.

Over and above any legislative or regulatory changes, the TCF programme will involve re-iteration of engagements with the industry, so that guidance notes and tools become useful mechanism to encourage the programme. A simple example would incorporate:

1. Setting out expectations, in the form of guidance notes and case studies.
2. Involving industry bodies and other experts in helping to disseminate expectations and review the guidance notes.
3. Testing that the firms in the industry have an understanding of the concepts similar to the understanding of the FSB.
4. Revising guidance notes and case studies in the light of the testing process.

6.2 Putting pro-active and intensive supervision in place

In adopting the TCF programme, the FSB is conscious that its supervision will need to become both more pro-active and intensive.

In recent years, the FSB has been considering adopting a conduct risk approach to market conduct supervision. This approach - which by now has become relatively commonplace in the prudential areas of financial services supervision - will provide a boon to the implementation of the TCF programme.

Conduct risk supervision will allow pro-active identification of risks leading to consumer detriment by placing firm behaviour in a broader socio-economic framework as well as in an industry-wide context. Moreover, the conduct risk approach will provide the point of entry for intensive supervision of firms' business models and culture as well as product strategy, development and sales.

Just as in the case of prudential supervision where regulators use early warning indicators to identify liquidity and other risks, conduct risk supervision will rely on certain indicators to help regulators establish where the important and large risks for consumers lie.

Intensive supervision will allow the FSB to expand its supervisory approach beyond the current one of analysing returns and meeting with company officials to one where inspectors are able to view the treatment of customers first hand, by visiting retail outlets and by mystery shopping. Moreover, the analysis of the firm will become more intensive by examining not only standardised industry returns but other information which has bearing on customer treatment – from the business model of the product, to its claims ratio, to the time it takes for complaints to be handled.

6.3 Ensuring appropriate incentives are in place

The experience of the FSA in the UK suggests that the FSB will require a full range of methods to encourage compliance with the TCF programme.

For the TCF programme to work, firms must be aware that the FSB will test the implementation of the programme, will design toolkits for such a process, will propose recommendations for remedy when firms fail and will impose sanctions if the failure is not addressed.

As has been mentioned several sanctions are available to the FSB, including:

- Naming and shaming defaulting firms
- Imposing fines (such as those envisaged through the establishment of the FSB's Enforcement committee)
- Revoking licences and prosecuting defaulters.

Key to the efficacy of such sanctions (or their threat) is the credibility of the FSB in creating the impression that it is both willing and able to impose such sanctions.

Moreover, there are mechanisms to encourage firms that have performed well, including:

- honouring the firms that have met TCF expectations through award lists
- publication of names of firms that have met required standards.

6.4 Encouraging consumer responsibility

Throughout the discussion, the focus has been on protection of the consumer, from the perspective of the regulator and the supplier. Clearly, though, the consumer has a key role to play in ensuring fair outcomes, by behaving responsibly.

Both local and overseas evidence indicates that consumers are relatively unsophisticated about financial matters. Once again, the issue has to do with informational aspects.

Both the FSB and the FSA have a statutory requirement to inform and educate consumers[67]. In South Africa, educational programmes will need to be enhanced so that the consumer is also increasingly aware of his or her need to behave responsibly, and ask about and understand certain key concepts – before launching into complex contractual relationships. Creating awareness of call-centre facilities or hotlines that can deal with consumer queries will also contribute towards a more efficient regulatory system.

While FSB consumer education programme may be highly effective in informing customers and greatly improve their awareness and responsibility, this does not obviate financial firms from the TCF programme. They will still be required to evaluate their treatment of customers through all the stages of the life cycle of their product or service and they will still have to ensure that they are engaging in fair practices throughout. Just as principles and rules are complementary, so too are consumer education and the TCF programme.

6.5 Facilitating ultimate fairness by working with the ombudsmen

It is important that consumers and suppliers understand the concept that ultimate fairness also has a role to play in the TCF framework.

In this regard, it is important consider the role of both the statutory and voluntary ombudsmen and adjudicators in creating the possibility of ultimate fairness. The ombudsman receives complaints from aggrieved customers and transmits the message to the firm concerned, the regulator and (possibly) the public at large. If customers are to be treated fairly, they must have processes that they can follow if they feel that they have been aggrieved. The ombudsman provides a safety net to the consumer.

Once again, the UK experience is salutary. The huge number of initial queries handled by the Financial Ombudsman Service - an estimated 800 000 in the 2008 financial year - of which 127 500 evolved into full scale disputes, and of which 114 000 were resolved, suggests the need for dispute mechanisms that cover broad areas and are easily accessible[68]. Moreover, the role of the Financial Ombudsman Service in providing feedback to the regulators in identifying common trends in the industry is also important in addressing the fact that many consumers do not report their grievances to the ombud.

The FSB will need to work in co-operation with the ombud schemes that exist in South Africa and may need to enhance channels for communication, as well as consider ways of obtaining feedback from these schemes.

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[67] In the UK, this is set out as "promoting public understanding in the financial system".
[68] Financial Ombudsman Service, 2009

6.6 The way forward

Each of these key elements discussed above is interrelated and its success is dependent on the other elements. Failure to implement any one of these is likely to retard or scupper the success of the others.

The FSB has published this discussion document with the intention of obtaining views from industry, with a view to refining what is meant by treating customers fairly. The aim is not necessarily to rework this document, but to stimulate comment and debate. It is intended that written submissions be made on the concepts set out in the document and that a workshop be convened to discuss the comments.

The process should lead to a further document which will set out the FSB's TCF vision and programme for the next stages.

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