



Financial Services User Group's (FSUG)

A SIMPLE FINANCIAL PRODUCTS REGIME

FSUG DISCUSSION PAPER

Contents

Executive summary	2
1. Introduction and background	5
2. Regulation: theory and practice	9
3. Analysis of the potential of simple products	13
4. Recommendations	17
Annexes (case studies)	25

EXECUTIVE SUMMARY

- As FSUG set out in its position paper, *Making financial services work for financial users: New model financial regulation*¹, the usual approach to financial regulation has failed to protect consumers and make financial markets work for EU financial users². We proposed a new model for financial regulation based on identifying root causes of market failure and, critically, identifying effective interventions to correct market failure including product intervention. Product intervention is a direct form of intervention and can take many forms including national authorities developing simple financial products with mandated features.
- This paper focuses on the potential role of a simple financial products regime. We assess the contribution a simple financial products regime could make to: improving access to suitable products; promoting real competition, innovation and efficient markets; promote fairness and market integrity; and improving the effectiveness of financial regulation. We identified specific policy goals and product areas for which product intervention is most appropriate and assessed the potential for EU level interventions.
- Simple financial products – if accompanied by the appropriate regulatory and advice regime – in our view could reduce the unit costs of distribution. In theory, a reduction in unit costs should enable financial firms to extend their reach to greater numbers of consumers who were considered to be economically unviable. This in turn could improve access to appropriate financial products and services and promote financial inclusion. Moreover, the advantages would be even greater if simple financial products were distributed using alternative financial institutions and/or financial guidance. Additional savings could be made on acquisition costs, remuneration costs and profit margins.
- Simple products would also promote genuine financial innovation. Competition and market forces has failed to produce sufficient innovation to ensure consumers’ needs are met efficiently and fairly. We reject the argument that product regulation stifles genuine financial innovation.
- We use six tests to judge whether a financial innovation is socially useful (or competition is working well to produce markets that work in the interests of financial users). The tests are – does competition and innovation: reduce costs/ enhance value for consumers; make markets safer/ reduce risk/ help manage risk better; improve access for consumers; result in consumers making better choices and decisions; meet a hitherto unmet need for consumers; result in more efficient allocation of resources within the financial system?
- Much of the ‘innovation’ in financial markets over the past decades would not pass those tests. While there has certainly been plenty of market ‘innovation’ and new product development, many of the new products are just variations of the same basic products. This

¹ http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/new_model_fin_regulation-2012_09_en.pdf

² The reasons are complex but the primary intellectual failure was the over-reliance on conventional models of regulation which assumed that the role of regulators is to create the conditions for markets in the expectation that competition and market forces would then ensure that markets met consumers’ needs and preferences. The approach adopted by financial regulators was an ‘article of faith’ rather than based on objective, rational analysis of market failure from the consumer perspective.

has resulted in an oversupply of similar products with little to differentiate them aside from spurious features and branding.

- A simple products regime would also mitigate (but not completely remove) the risks of consumers being sold unsuitable or inappropriate products and would put real pressure on financial institutions to treat customers fairly and behave with integrity.
- We also conclude that ex ante regulatory interventions such as a simple products regime would be a more effective, efficient form of regulation than intensive, ex post supervision of firms behaviour.
- Considering the available research on consumer needs and detriment in financial services, FSUG proposes that consumers would benefit from a simple products regime. We have not yet agreed which product areas are a priority. But, we think that the following product areas should be considered:
 - simple payment product³
 - short term savings product
 - medium term investment product/ personal pension product
 - core income protection insurance product
 - basic life insurance product
 - fair unsecured loan product
 - mortgage product
 - complementary health insurance product
 - simple intra EU travel insurance

A simple products regime should cover the following aspects of the relevant products:

- costs and fees including penalty charges
- access terms
- transparency and disclosure of key benefits and risks
- quality and value – in terms of service standards

There are a number of potential barriers which could hinder the success of simple financial products primarily the lack of a commercial imperative for financial firms to manufacture and distribute simple financial products. Therefore, more work needs to be done to develop an alternative regime which allows simple financial products to be distributed efficiently and safely.

For simple products to work effectively FSUG's view is that one of three options are needed to ensure they are distributed safely and cost effectively to consumers:

- **Alternative financial advice/ guidance:** FSUG is currently exploring ideas to improve access to alternative models of financial advice and guidance. New EU laws such as MIFID2⁴ - if enforced effectively - are expected to improve the quality of specific advice related to a financial transaction for financial instruments and structured deposits. However, this will not apply to comprehensive financial guidance that assesses the *overall financial and asset situation* of consumers and provides them with generic advice (tailored advice), including financial plans, to achieve their goals. Moreover, MIFID2 will not help financial users who are

³ The decision to provide EU citizens with a legal right of access to a basic bank account provides an ideal opportunity to create a simple payment product

⁴ http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:JOL_2014_173_R_0009&from=FR

not economically viable for commercial providers. Alternative financial guidance models could be adapted to ensure simple financial products are distributed safely and efficiently.

- **Non-profit partnership/ affinity distribution:** there are a number of ways of reducing distribution costs including creating economies or distributing through non-profit channels. For example, there may be a case for promoting simple products through approved distribution organisations such as charities, trade unions, or even national Post Offices.
- **Regulatory interventions:** unless there is a commercial imperative for the industry to distribute simple financial products they are likely to continue to recommend existing products to their client base. However, targeted regulatory interventions⁵ can be used to ensure industry recommends a simple product (or at least a product of equivalent value).

FSUG is very concerned about the situation facing financially excluded citizens whose core financial needs are not met because they are:

- not economically viable for market based provision-for example, they cannot afford to use commercial financial services priced at market rates or they are sold financial services priced at market rates which cause them significant financial harm⁶; or
- excluded or financially disadvantaged due to other socioeconomic factors.

However, the financial needs of these important disadvantaged groups are outside the immediate scope of this paper. The simple financial products regime proposed in this paper is primarily intended to make markets work better for citizens who are excluded because of market failure and market inefficiency. In other words, those citizens who could be served by financial services providers if the market was more efficient at creating the type of appropriate, fair, value for money products citizens need.

Of course, simple products could be very suitable for meeting the needs of disadvantaged groups. But, the point is, even with a simple products regime, the market - left to its own devices – is unlikely to be able to provide for these citizens. Therefore, if these simple products are to be made available to disadvantaged citizens, alternative solutions would be needed. These are discussed in more detail in Section 4. However, it is important to note that much additional separate work would be needed to take these ideas forward.

In terms of EU wide interventions we propose the following:

- EU policymakers and regulators (ESAs) should monitor and disclose the level of financial exclusion and underprovision across the EU including consumer impact studies;
- EU policymakers and regulators should develop a common simple products framework including accreditation framework based on the proposals for charges, access, terms and conditions, quality standards and transparency outlined in this paper; and
- Based on the common framework, policymakers and regulators in Member States should develop detailed standards to account for specific requirements of consumers. Consideration should be given to a consumer friendly '29th regime'.

⁵ such as the RU64 rule used in the UK to ensure stakeholder pensions were effective

⁶ An example of this is payday lending. The payday lending market is willing to supply hitherto excluded citizens with credit – but at a price and on terms which cause serious financial harm to those citizens.

1. INTRODUCTION AND BACKGROUND

As FSUG set out in its position paper, *Making financial services work for financial users: New model financial regulation*⁷, the dominant approach to financial regulation failed to provide effective consumer protection and, more generally, make financial markets work for EU citizens⁸. We proposed a new model for financial regulation based on identifying root causes of market failure and, critically, identifying effective interventions to correct market failure. One particular form of intervention is ‘product intervention’

In the paper, we described how product intervention could be used to shape markets for the benefit of citizens. Product intervention is a direct form of policy and regulatory intervention and it can take many forms (see FSUG paper). However, this project will focus on product governance and product design aimed at creating simple financial products.

Simple financial products are products that:

- are fair, clear and transparent
- offer good value
- do not have hidden or unfair charges, terms and conditions
- do not have spurious, unnecessary features.

The overall aims of the project are to:

- examine the potential effectiveness of product governance and design as a policy intervention for making financial markets work for EU citizens including identifying existing examples of product intervention in financial markets;
- make recommendations to policymakers on how product intervention could be used as part of financial regulation to make markets work;
- identify specific policy goals and specific product areas for which product intervention is most appropriate; and
- assess the potential for EU level interventions.

Specifically, we address the following questions:

Access: can simple products improve access to financial products and services that meet consumers’ needs and improve financial inclusion? Can reducing product complexity encourage new types of financial advice?

Choice and decision making: can simple products help consumers make better financial decisions, use financial products more effectively, and promote positive financial behaviours?

⁷ http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/new_model_fin_regulation-2012_09_en.pdf

⁸ The reasons are complex but the primary intellectual failure was the over-reliance on conventional models of regulation which assumed that the role of regulators is to create the conditions for markets in the expectation that competition and market forces would then ensure that markets met consumers’ needs and preferences. The approach adopted by financial regulators was an ‘article of faith’ rather than based on objective, rational analysis of market failure from the consumer perspective. This approach is very different to the one FSUG advocates in which policymakers and regulators actively intervene to ‘make markets work’.

Efficiency, competition and innovation: can simple products make markets more efficient, reduce distribution and search costs in the supply chain, force competition into the market, force providers to manufacture and distribute socially useful products, and reduce advice costs? What is the impact on innovation – does product intervention promote or inhibit socially useful innovation?

Fairness and integrity: can product governance and design improve the way products are marketed and sold, address the embedded conflicts of interest in the supply chain, so that consumers are treated fairly and firms behave with integrity?

Regulatory effectiveness: what are the benefits of product intervention as a regulatory intervention in terms of cost-effectiveness?

This paper provides our preliminary assessment of the role of a simple financial products regime and an outline of how such a regime might work including initial proposals for product features.

As we explain, simple financial products offer significant potential for policymakers, regulators, and of course citizens. However, it is important to note that additional development work needs to be undertaken before a simple products regime could be established. One of the key issues is how simple products could be distributed/ made available to citizens who are not economically viable for commercial financial services firms.

The role of simple financial products in social policy

Before assessing the benefits of simple financial products from a regulatory and market perspective, it is helpful to discuss the potential role this initiative might play in tackling social policy issues such as financial exclusion or financial discrimination.

Citizens have a range of core financial needs. If these needs are to be met, a number of conditions must be met:

- the right products⁹/ services must be available; and
- citizens must be able to get access to and use those products/ services (in other words, we might have an ideal product but it is not much use if citizens cannot get access to it and use it).

Meeting these conditions can be a difficult challenge for policymakers and regulators. In particular, there are a range of demand side, supply side/ market, and socio-economic factors that mean the financial needs of many citizens are not being met.

Possible solutions include: making markets more efficient so more citizens can be reached, mandating provision, mutual provision, alternative provision of products and advice, financial education, and so on. The table below summarises the causal factors and potential solutions.

⁹ 'Products' here does not just refer to products sold by financial services providers – it refers to any means of meeting citizens core financial needs. For example, pensions and income protection 'insurance' is often provided by the state or employer. State or other forms of collective provision is often more efficient than market based provision.

Table 1: causes of financial exclusion/ discrimination

Causal factors	Description	Potential solution
Demand side factors	Low levels of financial capability, lack of awareness, confidence and trust etc	Financial capability initiatives, information disclosure, public information
Supply side factors	Market inefficiencies, weak or distorted competition, product design, sales practices and behaviours, training and competence of agents/ staff, poor risk assessment etc	Structural/ market interventions, regulatory interventions, product interventions, campaigns to improve confidence and trust (addresses demand side problem above) etc
Socio-economic factors	Economic viability, low incomes, discrimination on grounds of disability, ethnicity, gender, age etc	Mandated provision, alternative provision, social justice interventions (eg USOs), cross subsidies, mutual provision

FSUG is very concerned about the situation facing financially excluded citizens whose core financial needs are not met because they are:

- not economically viable for market based provision—for example, they cannot afford to use commercial financial services priced at market rates or they are sold financial services priced at market rates which cause them significant financial harm¹⁰; or
- excluded or financially disadvantaged due to other socioeconomic factors.

However, the financial needs of these important disadvantaged groups are outside the immediate scope of this paper. The simple financial products regime proposed in this paper is primarily intended to make markets work better for citizens who are excluded because of market failure and market inefficiency. In other words, those citizens who could be served by financial services providers if the market was more efficient at creating the type of appropriate, fair, value for money products citizens need.

Of course, simple products could be very suitable for meeting the needs of disadvantaged groups. But, the point is, even with a simple products regime, the market - left to its own devices – is unlikely to be able to provide for these citizens. Therefore, if these simple products are to be made available to disadvantaged citizens, alternative solutions would be needed such as:

- mutual provision – that is, financial services providers could choose to offer products on a mutual basis (which is often the case with insurance in member states such as France and Belgium);
- mandated provision of simple products (for example, the recent decision on basic bank accounts);

¹⁰ An example of this is payday lending. The payday lending market is willing to supply hitherto excluded citizens with credit – but at a price and on terms which cause serious financial harm to those citizens.

- explicit cross subsidies – for example, through a ‘solidarity tax’
- the provision of alternative financial products and use of alternative financial institutions – see FSUG work on Alternative Provision¹¹; and
- the creation of alternative forms of financial guidance and advice – see our work on Financial Guidance.

These are discussed in more detail in Section 4. However, it is important to note that much additional separate work would be needed to take these ideas forward.

¹¹ http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/2012-priorities-report_en.pdf

2. REGULATION: THEORY AND PRACTICE

This section summarises the various theories and practices of financial regulation and explains where product intervention/ governance fits into the regulatory landscape.

Ex post and ex ante regulation

Different regulators have different regulatory philosophies and approaches to protecting consumers and making markets work. One of the key distinctions relates to the stage at which regulators should intervene when markets fail. The primary distinction is between *ex-post* and *ex-ante* regulation.

Ex-post regulation is defined as regulators intervening in a market after an event (or market failure) has occurred to clean up a problem or ensure that consumers get redress. This is usually once there is compelling evidence of consumer detriment and/ or public pressure to intervene.

In contrast, an ex-ante approach to regulation is based on the theory that regulators should intervene before consumer detriment or market failure occurs to prevent or pre-empt that detriment/ failure from occurring.

There is a range of ex-ante interventions regulators can use to prevent market failure one of which is product interventions (including simple products).

Permissive regulation and the precautionary approach

On a similar theme, regulators can choose to adopt a permissive approach or precautionary approach to regulation.

A permissive approach is one where the regulator assumes the market knows best, that there is an alignment of interests between producer, distributor, and consumer, The default position here is that the market should be allowed to operate without major intervention¹² unless and until there is compelling evidence of market failure which cannot be ignored. The permissive approach also assumes that financial innovation is generally a 'good thing' and that regulators should not seek to inhibit the process of innovation and market activity. This is related to ex-post regulation.

In contrast, the precautionary approach is much more sceptical. It does not assume an automatic alignment of interests between firms, distributors and consumers and that market behaviours will result in the right outcomes for consumers. The precautionary approach involves policymakers and regulators doing much more to shape the market to producing the right outcomes for consumers. For example, this may involve regulators requiring firms to stress test new products with different groups of target consumers before they are launched onto the market.

Product intervention is a form of precautionary regulation. It works on the basis of policymakers and regulators directly influencing and shaping the type of products that meet consumers' needs rather than leave it to the market to determine.

¹² To be precise, policymakers and regulators ensure there is a foundation of legal protection and regulation in place

Information asymmetry theory

The basis of information asymmetry theory is that one party to a transaction has relevant or more information compared to the other party (or may be in a position to utilise that information better than the other). This leads to the weaker party being exploited during a transaction or ending up with a poor deal. Generally, the individual consumer is the weaker party in the transaction with the firm or distributor/ adviser the stronger party.

This is especially the case in complex markets such as financial services. If information asymmetry leads to large numbers of consumers being exploited, this results in widespread market failure.

Regulators can try to address information asymmetry by ensuring that consumers are provided with appropriate information at the right stage of the transaction. Indeed, much of the regulatory reform in financial services over the years has been focused on dealing with information asymmetry through greater information disclosure. The theory is that better informed consumers will have greater market power and force firms and intermediaries to behave fairly and compete for the custom of consumers leading to a well-functioning market.

It is important that financial users have access to the necessary information to help them make effective choices and decisions. However, there is not much evidence that information disclosure on its own is a very effective tool for changing consumer behaviour and, therefore, market behaviour in complex markets such as financial services. The complexity of financial products, sheer number of products on the market and prevalence of 'confusion marketing' inhibits the effectiveness of information disclosure. Therefore, in the view of FSUG, information is necessary but not sufficient.

Direct supervision and enforcement

Once policies, regulations and rules have been developed to make markets work, these have to be supervised and breaches enforced. But, direct supervision and enforcement of large complex markets such as financial services requires significant financial and human resources.

However, product interventions such as simple products can, if used properly, circumvent the need for intensive supervision of firms' behaviours to make markets work.

PRODUCT INTERVENTION

Product intervention can take a number of forms including: product governance, product banning/ selling restrictions, product choice restrictions, price controls/ interventions, minimum standards/ product design (including simple products).

Product governance

This refers to the regulator requiring firms to have the necessary systems and controls in relation to product design, product management, stress testing of products with target audiences and distribution strategies¹³. The objectives of product governance are to: i. ensure firms develop products that are right for their consumers by making sure they place the consumer's best interests at the centre of every stage of product design and marketing, and ii. allow the regulator to directly intervene where it sees potentially harmful products.

¹³ For example this approach is now used by the UK Financial Conduct Authority (FCA)

Product banning/ product approval/ selling restrictions

Ultimately, regulators may decide that certain products are too risky to be sold to consumers or can only be sold to certain groups of consumers. Restrictions may be permanent or introduced temporarily. For example, the UK Financial Conduct Authority (FCA) announced temporary restrictions (lasting from 1st October 2014 to 1st October 2015) on the distribution of contingent convertible instruments (CoCos) to ordinary retail investors¹⁴. Alternatively, regulators may subject products and financial instruments to pre-approval before being allowed to sold on market (see case study on Commodities and Futures Trading Commission).

Product choice restrictions:

One of the major concerns FSUG has relates to the prevalence of confusion marketing in financial services and the lack of genuine financial innovation (there are vast numbers of similar products on the market with little to differentiate them). Individual financial institutions can have numerous similar products. In Belgium, regulation around savings accounts has been strengthened to “standardize” many characteristics of savings accounts including a maximum of 6 different saving account “formulas” per bank.

Price controls/ interventions

This relates to policymakers and regulators explicitly mandating the costs that can be applied to products. This includes, for example, capping charges on payday loans or limiting penalty charges (see Annex for details of the US Card Act).

Minimum standards/ product design (including simple products)

Another form of product intervention occurs when policymakers identify a market failure and mandate minimum product standards. A good example of this was the stakeholder pension product introduced into the UK in the late 1990s¹⁵. The stakeholder pension legislation mandated level of charges, access terms and requirement for a default option. Stakeholder pensions were very effective at bringing down high pension charges in the UK where information disclosure failed to have much impact. However, as described below, additional regulatory interventions were needed to ensure stakeholder pensions had the desired effect.

This is a very important aspect to product regulation. A dual approach – mandating the design of the product and the sales/ advice process - may be needed to ensure financial users can get access to the products.

A similar but voluntary initiative in the UK known as CAT¹⁶ standards was not as successful at changing market behaviour. This initiative was replaced by the stakeholder products initiative¹⁷. Again, it is not clear how much impact this initiative has had on market behaviour.

¹⁴ <http://www.fca.org.uk/static/documents/temporary-product-interventions/restrictions-in-relation-to-the-retail-distribution-of-cocos.pdf>

¹⁵ <http://www.legislation.gov.uk/ukpga/1999/30/contents>

¹⁶ For charges, access and terms

¹⁷ <http://www.legislation.gov.uk/uksi/2004/2738/made>

The UK is now considering the Simple Financial Products initiative which is intended to create a suite of simple products. Further work is being done on developing an accreditation scheme for these products including a product 'badge' and ideas for raising awareness amongst consumers¹⁸.

¹⁸ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293854/BBA01-_428251-v1-Joint_Trade_Body_Letter_to_HMT_-_Simple_Products_doc_pd....pdf

3. ANALYSIS OF THE POTENTIAL OF A SIMPLE PRODUCTS REGIME

In this part of the report, we address the main questions set out in the Introduction.

Access: can simple products improve financial inclusion and ensure consumers' needs are met by making products more affordable and accessible? Can reducing product complexity encourage new types of financial advice?

Before answering this question, it is helpful to deconstruct the costs involved in distributing financial products to consumers. The total price that a consumer pays for a financial product in a market based system consists of a number of component costs. This is not an exhaustive list but the main components are:

- Operational and administration costs;
- Legislation and regulation costs (the cost of complying with conduct of business and prudential regulation-fines etc);
- Product design and development costs
- Risk premia (for products such as loans and insurance);
- Marketing, distribution and acquisition costs;
- Information and advice costs (when consumers buy products directly they incur 'search costs', when consumers are 'advised' on a course of action or specific products recommended the costs include remuneration for employees, sales agents or financial intermediaries/ advisers and time taken to collect information, assess the needs of consumers, and make recommendations);
- Post sale/ ongoing relationship costs; and
- Profit margin (including where relevant shareholder returns etc).

The 'unit cost' of distributing products is in turn a function of the volume and monetary value of products sold. In theory, selling larger numbers or higher value of products reduces unit costs which in turn should reduce the price paid by consumers (assuming providers don't exploit market failure to increase profit margins to unreasonable levels). This should make financial products more affordable and attractive for excluded or underserved consumers.

Of course, in a market based system excluded or underserved consumers are at a disadvantage as they generally cannot afford to pay as much for financial products and may be considered as a higher risk (rightly or wrongly). This makes them less economically attractive for commercial financial organisations who will tend to target more profitable segments.

Looking at those cost components, we can see how simple financial products could reduce the overall cost of distributing products to excluded or underserved groups.

For example, simple products should have lower product design and development costs. Information and search costs should be lower as simple products can act as a 'beacon' to help consumers spot good value products in a crowded market. Furthermore, advice costs could also be reduced as simple products are designed for a specific need which may enable a more focused information gathering and assessment process.

Therefore, simple financial products – if accompanied by the appropriate regulatory and advice regime – in our view could reduce the unit costs of distribution. In theory, a reduction in unit costs should enable financial firms to extend their reach to greater numbers of consumers who were considered to be economically unviable. This in turn could improve access to appropriate financial products and services and promote financial inclusion.

Moreover, the advantages would be even greater if simple financial products were distributed using alternative financial institutions and/or financial guidance. Additional savings could be made on acquisition costs, remuneration costs and profit margins.

Choice and decision making: can simple products help consumers make better financial decisions, use financial products more effectively, and promote positive financial behaviours?

One of the main root causes of consumer detriment and market failure in financial services is product complexity – this makes it more difficult for consumers to make effective choices and decisions and undermines financial capability (a full list of the root causes can be found in our paper on better regulation¹⁹).

Simple products, in theory, are easier to understand, make it easier for consumers to spot products which are better value and/ or more suitable for their needs, improve the quality of the advice process, and promote more effective competition. Therefore, simple products by addressing some of the root causes and promoting more positive behaviours on the part of consumers and distributors should reduce the likelihood of consumer detriment or market failure occurring in the first place.

Efficiency, competition and innovation: can simple products make markets more efficient, reduce distribution and search costs in the supply chain, force competition into the market, force providers to manufacture and distribute socially useful products, and reduce advice costs? What is the impact on innovation – does product intervention promote or inhibit socially useful innovation?

Stakeholder pensions (see above) were very effective at bringing down high pension charges in the UK where information disclosure failed to have much impact. However, it should be noted that the implementation of the RU64 rule (which requires advisers who recommend a non-stakeholder pension to explain in writing why it is at least as suitable as a stakeholder pension) has been widely credited for the success of stakeholder pensions. Relying on the existence of stakeholder pensions (which clearly offered much better value than other personal pensions) to make markets work may not have resulted in significant changes in market behaviour given failures of competition and conflicts of interest in the supply chain. A clear regulatory intervention was also needed to ensure that intermediaries recommended clearly better value products.

This is a very important aspect to product regulation. A dual approach – mandating the design of the product and the sales/ advice process - may be needed to ensure financial users can get access to the products.

¹⁹ New model financial regulation http://ec.europa.eu/internal_market/finservices-retail/docs/fsug/papers/new_model_fin_regulation-2012_09_en.pdf

With regards to financial innovation, we do not see any justification for the view that a simple products regime if implemented properly would inhibit the capacity of competitive markets to develop **socially useful** financial innovation.

To understand this point, it is important to understand the difference between real competition and innovation (competition and innovation that works in the interests of financial users) and the illusion of competition and innovation activity.

We use six tests to judge whether a financial innovation is socially useful (or competition is working well to produce markets that work in the interests of financial users). The tests are – does competition and innovation:

- reduce costs/ enhance value for consumers
- make markets safer/ reduce risk/ help manage risk better
- improve access for consumers
- result in consumers making better choices and decisions
- meet a hitherto unmet need for consumers
- result in more efficient allocation of resources within the financial system?

Much of the ‘innovation’ and product development we have seen in financial markets over the past decades would not pass those tests.

There has certainly been plenty of market ‘innovation’ and new product development but many of the new products are just variations of the same basic products. This has resulted in an oversupply of similar products with little to differentiate them aside from spurious features and branding.

There has certainly been plenty of competition *between* financial providers to acquire market share but that is very different to competing to meet the needs of end users. It is important for policymakers and regulators to understand that competitive forces and oversupply, far from resulting in falling prices and enhanced value as might happen in other markets, has often resulted in higher charges and value extraction/ destruction for consumers in financial services.

The amount of product proliferation in financial services increases the level of search costs, distribution and advice costs for the end-user. This pushes up the cost of financial products overall and in turn reduces access as products are more expensive than they need to be.

Product proliferation increases the risk of confusion marketing which undermines the ability of consumers to understand product risks. It also undermines consumers’ ability to make effective financial choices and decisions.

Conversely, a simple products regime if properly designed and implemented has the potential to:

- reduce end-user costs and enhance value
- help users understand the true risks associated with products
- help users make better choices and decisions in turn helping them better manage their own personal financial risks
- extend access to financial users whose needs have not been so far met by the financial services industry

- ultimately, result in more efficient allocation of resources within the financial system as less value is extracted in the form of unnecessary product design, advertising and promotion, distribution and advice costs by financial firms and intermediaries/ advisers.

We conclude on this point that simple products could indeed be very effective at promoting real competition and innovation.

Fairness and integrity: can product governance and design improve the way products are marketed and sold, address the embedded conflicts of interest in the supply chain, so that consumers are treated fairly and firms behave with integrity?

It is FSUG view that simple financial products could lead to consumers getting a fairer deal by putting more pressure on firms and intermediaries to behave with integrity. However, as we explain elsewhere, this needs an appropriate advice and regulatory regime to address conflicts of interest and ensure intermediaries recommend appropriate products in the right circumstances.

Regulatory effectiveness: what are the benefits of product intervention as a regulatory intervention in terms of cost-effectiveness?

As we explain in this paper (and in more detail in our paper entitled New Model Financial Regulation), the conventional approach to economics and financial regulation has too often failed to protect financial users from adverse market behaviours or make markets work in the interests of financial users (in terms of producing real competition, innovation and efficiency).

The conventional approach is based on the assumption that if policymakers and regulators create the right conditions for financial institutions then the 'invisible hand' of competition and market forces will produce the products and services users need and want. It is difficult to defend this view given all that we have seen in financial markets over the past few decades.

Policymakers and regulators need to accept that markets as inefficient and dysfunctional as financial services must be made to work in the interests of financial users.

To be fair, some regulators have recognised the need to intensify the supervision of financial markets. But intensive supervision is in turn resource intensive.

A simple products regime, if well designed and accompanied by an appropriate advice and regulatory regime, could be a more cost effective way of protecting consumers than resource-intensive direct supervision.

Overall, we conclude that a simple products regime offers significant potential benefits for policymakers, regulators and, most importantly, financial users.

4. RECOMMENDATIONS

This section makes a series of recommendations and propose next steps for taking forward simple products regime.

Which types of market failure are most suitable for product intervention, which financial sectors/ products are priorities for this type of intervention?

Considering the available research on consumer needs and detriment in financial services, FSUG proposes that consumers would benefit most from the development of a simple products regime in the following areas:

- Simple payment product
- A short term savings product
- A medium term investment product/ personal pension product
- A core income protection insurance product
- As basic life insurance product
- A fair unsecured loan product
- Mortgage product
- Complementary health insurance product
- Simple intra EU travel insurance

A simple products regime should cover the following aspects of the relevant products:

- Costs and fees including penalty charges
- Access terms
- Quality
- Transparency and disclosure of key benefits and risks

Costs, fees and penalty charges

Opinions differ on whether an effective simple products regime should include a specific cap on the level of product costs and charges.

There are arguments that explicit price caps would inhibit the ability and willingness of financial institutions to offer simple products specifically to financially excluded or underserved consumers. Opponents also argue that capping would inhibit financial innovation.

Therefore, based on this argument, price caps would defeat one of the aims of simple products – to improve access and better meet the needs of these households who are not well served by mainstream financial services.

On the other hand, supporters of price capping argue that the industry is being disingenuous about the impact of price caps on underserved or excluded households. The absence of a price cap would not encourage financial institutions to serve these underserved or excluded households as they are simply not interested in these households anyway. In this case, the industry's real objection to price capping is the precedent this sets and the limits this intervention would place on the ability of firms to extract revenue from higher income households.

There are other arguments to support capping prices and charges. Firstly, there are serious concerns that competition and market forces are not working very effectively in key parts of the financial system to bring down charges or improve value. Therefore, there needs to be some form of external intervention to act as a proxy for competition and force charges down. This type of intervention has already proven to be effective in markets such as personal pensions. For example, in the UK the stakeholder pensions initiative led to significant reductions in personal pensions costs²⁰.

More fundamentally, the cost and quality of financial products are in many cases often inversely related - unlike other more traditional consumer products. For example, given that it is not possible to predict *ex ante* which fund managers will perform well, *ceteris paribus* higher charges reduce the net return available to the investor. Therefore, capping the charge would improve the return received by the investor.

As mentioned, there are arguments for and against capping charges. In principle, we think there is a strong case for capping. But we cannot reach a definitive conclusion without further detailed analysis of the impact on capping on firms' and adviser behaviour.

Moreover, as mentioned above, if we wanted to ensure that firms and advisers recommend simple products to consumers, this may require some form of regulatory direction along the lines of the RU64 rule used in the UK (see above).

These are big questions to be addressed. But we emphasise that there is little reason to believe that competition and market forces *per se* will change firms' and intermediaries' behaviours, create better value for consumers or promote socially useful innovation. If EU policymakers want to make markets work for consumers, major interventions such as those outlined above may be necessary.

However, even if the actual level of charges are not capped at this stage, the structure of charges would need to be mandated. Note that all of these principles do not apply to each of the products we propose.

The most important principles are that:

- charges should not be 'front-end' loaded or structured to penalise consumers who hold financial products for a short time
- there should be limits on the level of any penalty fees or charges and based on the true cost of administering, for example, late payments;
- financial institutions should not be able to treat penalty charges and fees as a means of generating revenue;

²⁰ Stakeholder pension charges are capped at 1.5% for the first ten years of the plan and at 1% thereafter. The mechanism that actually led to reduction in pension charges was the RU64 rule introduced by the Financial Services Authority (FSA). This required financial advisers to justify to the client why they were recommending a personal pension that had a higher charge than a stakeholder pension. This forced insurance companies to significantly cut their charges down to the level of stakeholder pensions. FSUG has observed that the detrimental charging structures that damaged the interests of consumers of insurance based personal pensions and investment products in the UK are still evident in many EU member states. Therefore, there may be a strong case for adopting the stakeholder product approach along with a RU64 style rule. The absence of an RU64 style rule would mean that firms and advisers would not choose to recommend simple, stakeholder products.

- any penalty fees should not disproportionately affect financially vulnerable consumers (for example, a flat rate penalty charge has a disproportionate impact on lower income consumers who borrow small amounts). Therefore, penalty fees should be expressed as a percentage of payment, instalment, premium, or contribution;
- if there are any ancillary or extra charges levied (for example, when providing duplicates of product documentation/ statements etc), these should be clear, transparent and fair;
- there should be a standardised format for disclosing charges to allow consumers to easily compare comparative value of products.
- moreover, if we want simple products to be fair, it is important that consumers are not ‘trapped’ in unsuitable products – products which may have been suitable at one stage of their lives but may no longer be due to unforeseen changes in financial circumstances. Therefore, pricing structures should be designed in such a way that do not prevent cancellation or switching to more suitable products.

Access terms

Fair and easy access is a critical principle of a simple products regime. As we explain above, a key goal of product intervention is to minimise the product design risks consumers may be exposed to – for example, in the form of hidden charges, and unfair terms and conditions. Moreover, if simple products are to help promote access and inclusion they should also not have restrictive or unfair access terms.

Below, we suggest a set of access features which could apply to a simple products regime. These are high level and a more work would need to be done to flesh out the details that would apply to each of the simple products suggested above.

Feature Description

Minimum deposit/ contribution/ premium/ payment	Should be set at a low value to ensure low income households are not discouraged
Maximum balance/ sum assured	None (with the exception of the loan product which should be designed for borrowing small amounts)
Method of deposit/ contributions/ payments	No restriction, all methods allowed
Frequency of deposit/ contributions/ payments	Flexible, no restriction for savings and investment product
Charges	Capping charges – we are as of yet undecided on this. There are pros and cons to this No discriminatory charging structures (eg front end loaded charges)-see above for details Administration and penalty fees (where allowed) capped, should not be profit centre No additional charges for basic usage of account Charges for exceptional items must be set and prominently displayed
Access/ withdrawal/ usage restrictions	Withdrawals, with no penalty, allowed Restrictions on usage limited, clearly displayed For loan product, overpayments should be allowed
Limit on number of accounts per distribution channel	Only one product, per brand allowed

Pricing of products through different distribution channels	No – pricing should be consistent but small additional fee may be allowed for advice
Unfair practices	Mixing, bundling, tying not allowed

Quality and value

It is important that if simple products are fairly priced, this is not done at the expense of good quality. Simple products should not be seen as second class products.

Financial products are not physical goods so defining ‘quality’ can be difficult. However, it is possible to expect a certain level of quality with regards to service levels.

For example, we would suggest that with regards to an insurance product there should be minimum standards on claims handling. Similarly, with regards to loan products, there should be minimum standards relating to loan application processing etc.

We are still considering whether there should be guaranteed minimum returns for investment-based products or minimum interest rates on deposit accounts. There are pros and cons to this approach. It has the advantage of helping financial users understand the nature of the deal they are getting. On the other hand, care needs to be taken to avoid hidden cross subsidies paid for by other groups of financial users.

Communications, transparency and disclosure of key benefits and risks

Above, we make some proposals on charges and access terms which include requirements on transparency.

In addition to those, it is critical that the key risks associated with the product are clearly displayed and communicated to consumers at pre-sale, point of sale, and post sale (including ongoing relationships).

Moreover, we argue that it is important that any simple products regime includes a form of accreditation scheme and/ or kitemark to ensure that consumers are able to identify products. This accreditation scheme should be developed by policymakers and regulators in conjunction with consumer representatives.

Furthermore, policymakers and regulators would need to provide sufficient resources to raise awareness of and promote the availability of simple products including information on availability and benefits and limitations.

OBSTACLES TO THE CREATION OF SIMPLE FINANCIAL PRODUCTS:

It is clear that much further work would need to be undertaken to make a simple financial products regime work for consumers. To inform any potential further development work, it is helpful to identify obstacles to the creation of this regime. We have identified the following potential obstacles and made some recommendation on how these should be addressed.

Competitiveness vis-à-vis other financial products in the same category

Simple financial products, precisely because of their “simplicity”, could be uncompetitive or offer a lower value for money as compared to other comparable financial products. This issue is especially salient for insurance contracts for instance, where the inherent complexity of individual risk pricing can offer some consumers a better value than a “standard” universal coverage. This is explained in more detail above.

Complexity based on future assumptions

The inherent value of many financial products is linked to future prospects and assumptions about the financial market and the economy, especially investment type products. It is hard to simplify or regulate such products since there is no way to accurately predict the future.

Life cycle of financial products

Some financial products’ lifecycle can be quite short which is why new products are being devised all the time, either as innovations with new features or as a combination or mix of existing products. Simple financial products designed by public authorities could not be able to “evolve” as fast as similar products in their category and could end up being outdated and therefore unsuitable for consumers.

Existing regulation as a barrier to simple financial product design

Some financial products are already be subject to regulation which can be very complex. This might come in direct contradiction to the design of simple financial products.

Distribution barriers

One of the key factors which will determine the success or failure of this latest initiative is the advice regime which will accompany the distribution of these products. The industry is arguing that these products will be uneconomic to distribute to the target market if they have to comply with the full regulated advice provisions. On the other hand, consumer representatives are concerned that although simple products will be more transparent than existing products (which should reduce the risk of misbuying), there is still a considerable risk of consumers being missold products. Furthermore, consumer representatives are concerned that industry will use the simple products regime as a ‘Trojan Horse’ to reduce the level of consumer protection available to consumers. The risk is that rather than use a simplified advice regime to distribute simplified products, the industry will just sell more expensive products.

So, it is important to recognise that although simple products may be good for consumers, the benefits may be lost unless consumers can access those products. Distribution is critical.0

RECOMMENDATIONS

Ensure that simple financial products are competitive

In order to prevent simple financial products to present poor value compared to other financial products in the same category, public authorities should identify the key reasons and address them. For example, in some areas like insurance, complexity and individual risk pricing can benefit a certain category of consumers (the ones presenting the lower risk aka the young, healthy, rich, well-educated). “Simple” insurance product could therefore shy away consumers with a low individual risk and attract consumers with a high risk profile only that are “priced out” of the market, thereby rendering such a product unsustainable. One proposal would be to create a “solidarity tax” that would be added to all other insurance products sold by banks and create a fund that would not only ensure that a “simple” universal insurance product was financially viable for banks but also to increase its value and competitiveness vis-à-vis other insurance products. The logic would be the same as in universal healthcare where all citizens pay a fixed amount for a relatively high level of healthcare coverage as opposed to a system where the unhealthy are priced out of healthcare and the healthy pay very low premiums.

Another possibility is to tap into unmet demand from consumers. A study carried out by the Adam Faruk from the Ashridge Centre for Business and Society showed that about 27% of UK adults were interested in purchasing an “ethical financial product” in the future²¹. This could be bridged with the development of “simple financial products” to add a further incentive for consumers to turn to such products.

There are other potential solutions such as mandating provision or developing alternative provision.

Use existing financial incentives of the market for supervisory authorities

Simple financial products are not restricted to products designed solely by public authorities. They can also be developed by financial institutions based on a number of standards or regulations in place. Any regulation or standard that pushes for more transparency and clearer information to the consumer or restricts the terms and conditions of contracts can arguably foster the design of simple(r) financial products. However, implementation has to follow suit. Financial institutions will always be tempted to circumvent ex ante regulation by a variety of strategies including regulatory arbitrage or simply non-compliance given the weakness of governmental implementation bodies. Such bodies or often understaffed and/or lack the proper institutional powers to be able to intervene effectively. One suggestion would be to provide the same financial incentive for such bodies as those that exist on the financial market, namely, create a remuneration system that highly encourages the identification and resolution of non-compliance to existing regulation via bonuses and fines that directly benefit the governmental body itself (obviously coupled with the according levels of authority and power).

²¹ Faruk, Adam., “Beyond the niche: bringing ethical financial products to your high street”, Ashridge Centre for Business and Society, Dec 2007.

Identify clearly where simple financial products are appropriate and where they are not

Arguably, some financial products are hard to simplify given their nature. Whereas the complexity of individual risk pricing for insurance products can be replaced by universal coverage based on solidarity, the complexity of many investment products cannot be as easily simplified as they rely on assumptions about the future. In such cases, public authorities should put in place other measures such as ensuring that consumers are given several case scenarios and not only the most rosy assumptions about the future or protecting consumers with a vulnerable financial profile from such products. In some cases, public authorities can encourage consumers to turn to “simpler” financial products such as loans with a fixed interest rate, independent from foreign currencies.

Assess whether simple financial products fit with or require other policy measures

Simple financial products don't operate in a void but are rather surrounded with other policy measures, be it “soft” law such as codes of conduct “hard” law such as interest rates caps. All of these measures can complement, strengthen or on the contrary prevent the emergence of simple financial products. Public authorities need to consider how their policy objectives (namely financial inclusion, responsible lending and borrowing) can be best fulfilled by choosing the right “policy mix”. This can be for instance a combination of product intervention measures with permissive regulation. Also, simple financial products require more than just their availability to have an impact. Regulation regarding their distribution (availability in banks) and marketing need to be addressed. Should banks not advertise them at all, consumers are very unlikely to even know they exist! One example of such regulation linked to simple financial products is the UK RU64 rule that obliges firms that recommend pensions to consumers to demonstrate why a complex product is better than a simple one.

Addressing distribution barriers and costs

For simple products to work effectively FSUG's view is that one of three options are needed to ensure they are distributed safely and cost effectively to consumers:

- **Alternative financial advice/ guidance:** FSUG is currently exploring ideas to improve access to alternative models of financial advice and guidance. New EU laws such as MIFID2²² - if enforced effectively - are expected to improve the quality of specific advice related to a financial transaction for financial instruments and structured deposits. However, this will not apply to comprehensive financial guidance that assesses the *overall financial and asset situation* of consumers and provides them with generic advice (tailored advice), including financial plans, to achieve their goals. Moreover, MIFID2 will not help financial users who are not economically viable for commercial providers. There is a need for alternative advice provision to complement fully regulated advice. This alternative financial guidance model may also be adapted to ensure that simple financial products are distributed safely and efficiently.
- **Non-profit partnership/ affinity distribution:** there are a number of ways of reducing distribution costs including creating economies or distributing through non-profit channels. For example, there may be a case for promoting simple products through approved distribution organisations such as charities, trade unions, or even national Post Offices.

²² http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:JOL_2014_173_R_0009&from=FR

- **Regulatory interventions:** unless there is a commercial imperative for the industry to distribute simple financial products they are likely to continue to recommend existing products to their client base. However, as mentioned above, targeted regulatory interventions such as the RU64 rule used in the UK have been effective in ensuring the industry recommends a simple product (or at least a product of equivalent value).

These proposals should help ensure that more consumers are economically viable for simple products. However, we must stress that there would still be large numbers of consumers who would still be unviable. Other ‘social policy’ interventions would be needed to support these consumers. These potential measures are discussed elsewhere in the report.

Potential for EU wide interventions

In terms of EU wide interventions we propose the following:

- EU policymakers and regulators (ESAs) should monitor and disclose the level of financial exclusion and underprovision across the EU including consumer impact studies;
- EU policymakers and regulators should develop a common simple products framework including accreditation framework based on the proposals for charges, access, terms and conditions, quality standards and transparency outlined in this paper; and
- Based on the common framework, policymakers and regulators in Member States should develop detailed standards to account for specific requirements of consumers
- 28/29th regime

ANNEXES

This Annex contains relevant research along with summaries of case studies of previous initiatives involving simple products or product interventions generally.

Belgium and the law on saving accounts:

Regulation around savings accounts has been strengthened to “standardize” many characteristics of a savings account without imposing a “single” standard model. Some features of this law include:

- A quarterly annual payout for the fidelity premium interest rate.
- A 3 month guarantee for interest rates (should a bank raise the interest rates for a savings account, it has to wait at least 3 months before lowering it)
- A maximum of 6 different saving account “formulas” per bank.
- A standardized information sheet for consumers to be able to easily compare the features of different saving accounts.
- An online “simulator” for consumers to be able to calculate the interest they will be paid under different conditions.

These features clearly show that there is a willingness to increase the transparency and comparability of the different offers and a push for more standardization/simplification of saving account features. Since the law is in effect since August 2013, we do not have as of yet an impact assessment. Articles from various newspapers online propose a preliminary mitigated opinion about the law. While it may definitely help consumers in terms of simplification, transparency and comparability, it is unclear whether consumers will also reap financial benefits from the new rules²³.

UK and the “Simple Financial Products” initiative:

In November 2011, Carol Sergeant was asked by the former Financial Secretary to the Treasury to chair an Independent Steering Group that would make proposals for simple, transparent and easy to understand financial products. The group initially agreed for the first set of Simple Financial Products to be: an easy access savings account, a 30 day notice savings account, a regular savings account and a fixed term life insurance. Two other products were flagged as important for future consideration: a whole of life insurance product and an income replacement product. In parallel to these “new” products, the group also proposed to create a Simple Financial Product “badge” that could be awarded via a robust accreditation process to products that meet a set of minimum standards agreed by the group²⁴.

It is too early at this stage to assess whether this set of simple financial products will be a success.

The CARD Act in the United States:

The CARD (Credit Card Accountability and Disclosure) Act of 2009 aimed at prohibiting various unfair, misleading and deceptive practices in the US credit card market. It consisted in “regulatory limits on the ability of banks to charge certain types of credit card fees, [...] and attempts to affect

²³http://monargent.lecho.be/epargner_et_investir/epargner/La_reforme_du_compte_d_epargne_ne_profite_a_personne.9404917-2221.art?ckc=1

²⁴https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/191721/sergeant_review_simple_products_final_report.pdf

consumers' repayment behavior by installing requirements that credit card bills provide clear information on the costs of only making the minimum repayment.”

The study finds that “the regulations to limit fees were highly effective. Over-limit fees dropped from an annualized 1% of average daily balances to zero in February 2010. Late fees dropped by 0.5% points in February 2010 and another 0.5% points in August 2010, for a combined decline of 1% point on a base of 2%. Combined across various implementation phases, the CARD Act seems to have reduced overall fee costs by an annualized 2.8% of borrowing volume. [...] This translates into annual cost savings for US credit card users of \$20.8 billion per year²⁵.

The Commodity Futures Trading Commission in the United States:

This example illustrates an “ex ante” approach to financial regulation.

In an effort to prevent speculation in commodities and commodity futures in the US, the US introduced regulation in 1922, with several revisions including the creation of the Commodity Futures Trading Commission (CFTC) through the Commodity Exchange Act (CEA) in 1974. Between 1974 and 2000, when the CFTC was virtually stripped from most of its powers under intense lobbying by the financial sector, commodity futures were subject to mandatory product approval regulation. “Under that regime, futures exchanges had an affirmative obligation to demonstrate, to the CFTC’s satisfaction, that every contract they intended to list was reasonably expected to facilitate efficient pricing and hedging against commercial risks in the underlying commodity markets. Under the CFTC’s approach, only contracts that satisfied this economic purpose requirement could also be expected to meet the statutory “public interest” test for contract designation.”²⁶

²⁵ Agarwal, S., Chomsisengphet, S., Mahoney, N., Stroebel, J., “Regulating Consumer Financial Products: Evidence from Credit Cards”, April 2014, p. 3, <http://ssrn.com/abstract=2330942>

²⁶ Omarova, Saule, T., “License to Deal: Mandatory Approval of Complex Financial Products”, Washington University Law Review, vol. 90, n°1, 2012, p. 106.