

The following Compliance articles are for the week ending 17 April 2009.

## COMMENTARY

FSA responds to criticism of their supervisory approach in relation to Dunfermline Building Society.

On 17 April, Lord Turner, Chairman of the FSA, wrote at length to the Chancellor, Alistair Darling giving a detailed commentary on the events leading up to the issues with the Dunfermline Building Society, with particular reference to the quality and level of supervision exercised by the FSA. He copied his response to Dr Vince Cable, Liberal Democrat Shadow Chancellor, summarising his points as follows:

- To reduce the risks arising from rapid credit growth and from diversification by building societies into 'non-traditional' lending activities would be likely to involve changes in legislation (what building societies were allowed to do) or in the capital adequacy required, rather than a changed approach to "firm by firm" supervisory approach.
- Notwithstanding this, a reformed supervisory approach clearly had a role to play. The Supervisory Enhancement Programme launched in April 2008 had made major changes. This entailed a greater willingness for FSA to make judgement about the sustainability of business models and to intervene directly, rather than relying on monitoring systems and controls and assuming that firms' senior management were best placed to judge appropriate overall strategy within legal constraints.
- However FSA did clearly and repeatedly warn the Building Society sector about the risks inherent in lending outside their core residential mortgage lending activities and in October 2007 stopped building societies from purchasing non prime residential mortgage assets.
- On the specific quality of personnel in Retail Firms Division, during the second half of 2006 and 2007 there was a significant upgrading of the quality of staff which led to a number of individuals departing.
- As to whether there were other building society issues of which the FSA is unaware, it was not FSA practice to comment on individual institutions. However, Lord Turner pointed out that FSA had subjected building societies to severe stress tests as a condition of eligibility to the Government's Credit Guarantee Scheme. These stress tests evaluated whether the societies have adequate capital to absorb the significant losses which might arise, in different categories of lending, in a severe economic downturn. All of the rated building societies other than the Dunfermline passed the stress tests.
- Regarding Dr Cable's comments on a 'climate of fear' within FSA, Lord Turner stated that FSA prided itself on its ability to learn and listen to all reasoned views.

The timing of Lord Turner's appointment was fortunate for him, as the run-up to the major issues clearly did not happen "on his watch" and he is seen as leader of the solution not the problem. It is interesting to read the reference to "fear" in the final comment and one wonders how that sits alongside Mr Sants' speech on 12 March when he said "There is a view that people are not frightened of the FSA. I can assure you that this is a view I am determined to correct. People should be very frightened of the FSA." Whereas Mr Sants presumably was referring to the relationship between Regulator and the regulated community, and not relationships with staff internally, any culture of fear seems contra-indicatory to a mature and evolving regulatory culture. Lord Turner's view by comparison seems balanced and proportionate.

**Source: FSA Website**

### **FSA CONTINUE THEIR CRACK-DOWN ON MORTGAGE FRAUD**

As part of their continuing campaign to eradicate mortgage fraud, FSA on 16 April announced a six figure fine against a small mortgage broker which had been found to submit false mortgage applications which significantly overstated income.

Margaret Cole, director of enforcement FSA, said: "This posed an immediate risk to lenders. As part of our crackdown on mortgage fraud, we have banned more than 30 brokers in the last two years and have levied a number of large fines. Perpetrators of fraud will increasingly find themselves facing bans and significant fines as we continue our work in this area."

**Source: FSA Website**

### **CONSUMER RESEARCH ON ICOBS**

On 15 April, FSA published a Consumer Research paper written by the British Market Research Bureau which reviewed the Oral Disclosure rule in sales of Critical Illness Cover (CIC). The research explored whether improved oral disclosure, arising from the implementation of ICOBS standards, allowed better consumer understanding of critical illness cover (CIC). This report follows on from mystery shopping research in 2006 and suggests that many of the disclosure problems found in 2006 persisted into 2008 and with them the need for better quality oral disclosure.

Evidence from consumer research clearly showed that purchasers of protection products rely more heavily on oral rather than written disclosures. This suggests that the complexity of these products requires additional and focused oral information, enabling consumers to make informed purchasing decisions. ICOBS introduced a requirement for sales people, where they are giving oral information to the consumer, to make sure it is appropriate and covers all the main characteristics of the policy (ICOBS 6.4.2). The oral disclosure rules are designed to benefit consumers buying protection products by ensuring that they receive sufficient information, in a comprehensible form and in good time before making a purchasing decision.

The 2008 research found that consumers by-and-large considered that they had received sufficient information about the product at the point of sale. There was also a high level of satisfaction among consumers with the CIC product they had recently purchased. However, there were serious areas of misunderstanding among consumers about their policy. Consumers place a great deal of reliance and trust in what they are told by sales people and advisors and they often do not have sufficient prior knowledge of the product nor the confidence to ask questions for clarification. The research findings also indicate that reliance cannot be placed on consumers gaining a fuller understanding of the product from the policy documentation, as only 26% read the documentation fully.

The problems highlighted by the research do not appear to stem from too little information or disclosure, but from disclosures not meeting a sufficient level of quality. With a significant number of consumers unable to provide a moderating influence on the quality of oral disclosure through probing and questioning, it is the responsibility of firms to ensure that the quality of oral disclosure is sufficient. The new ICOBS oral disclosure requirements target this quality issue by requiring firms to take reasonable steps to ensure that the oral information is sufficient to enable the consumer to make an informed decision on the basis of that information, without overloading the consumer or obscuring other parts of the information.

**Source: FSA Website**

### CP ON STRENGTHENING LIQUIDITY STANDARDS

In the second paper of this series addressing Liquidity Standards, FSA have published CP 09/13 which looks at Liquidity Reporting. The CP, published on 15 April, asks for comments by 15 July 2009.

FSA commented on the paper as follows: "Given the dynamic and multi-faceted nature of liquidity risk, our new regime will require in-scope firms to develop in-depth understanding of their liquidity risks and to manage them closely. This drives our proposals for both the granularity and frequency of firms' reporting to us.

While we recognise that our quantitative reporting requirements may be costly to implement for many of the firms that fall within the scope of our Individual Liquidity Adequacy Standards (ILAS) regime, we believe the data requested under the new proposals would normally be required by most firms in undertaking prudent liquidity risk management for their own purposes. Recent experience has demonstrated the need for firms to track and manage their liquidity positions across such dimensions in that kind of detail."

**Source: FSA Website**

### INDUSTRY GUIDANCE ON EFFICIENT TRANSFER OF INVESTMENT FUND UNITS

FSA has confirmed Investment Management Association Industry Guidance which will facilitate paper-free electronic transfer of ownership of units held in an authorized investment fund (an authorized unit trust or an open-ended investment company). Published on 9 April, the guidance will permit Investors who sell or transfer units by electronic means such as e-mail or through the internet site of the fund manager. This is designed to permit more automated and efficient processing of unit transfers for investors, while providing adequate protection to the fund and to individual investors against fraud. The Government estimates that these provisions could bring annual administrative savings for UK fund managers of between £70 million and £290 million.

Dan Waters, FSA director of retail policy & conduct risk, said: "We are happy to confirm the IMA's Industry Guidance which will help fund managers to make the move from the current cumbersome paper-based transfer system to electronic dealing and settlement without weakening protection for unit holders. Industry Guidance gives firms help and advice on ways of complying with FSA principles and high-level rules, in a way that allows flexibility and innovation. The FSA will, where this is appropriate, use confirmation of Industry Guidance as an alternative to making additional Handbook rules."

**Source: FSA Website**

### POST IMPLEMENTATION REVIEW OF DEALING COMMISSION REGIME

On 7 April FSA published the results of the post implementation review of their work on the use of dealing commission. The origins of this work on use of dealing commission lie in the 2001 report by Paul Myners which identified problems in asset managers' use of bundled brokerage and soft commission arrangements. Subsequent investigation suggested that these created a market failure through their lack of transparency, accountability and the conflicts of interest they created. As a result market controls were weak, meaning that asset managers' customers did not receive value for money. The FSA therefore introduced rules on the use of dealing commission on 1 January 2006 promising a review. FSA conclude that the new regime is having the intended effect and moving the market towards the outcomes they sought. However, it has yet to deliver all the outcomes desired, in particular those deriving from the use of disclosure. Nonetheless, FSA maintain that disclosure can deliver benefits.

As more information on commission becomes available to fund managers and trustees, the use of disclosure should improve; some of the data in this report may help by facilitating the construction of benchmarks.

In summary, the evidence indicates that as a result of the new regime, the market appears to be delivering the outcomes sought, although not all have been achieved yet. Areas of concern have been identified, in particular the disclosure regime, this can be resolved through usual supervisory actions.

**Source: FSA Website**

### **ABI – FOCUS ON FRAUDULENT CLAIMS**

On 16 April, the ABI announced that its members were detecting record levels of fraudulent claims amounting to 2,000 every week worth £14 million. Research shows that one in five people are tempted to cheat on their insurance despite the likelihood of being caught and the possibility of a criminal record.

Examples of fraudulent claims include:

- A policyholder who claimed that his car had been stolen following a mugging. Investigations revealed that he had actually sold the car to a friend.
- A car was reported stolen and recovered burnt out. However it transpired that the vehicle had been set alight before the policyholder reported it stolen. The policyholder received a criminal conviction.
- A woman claimed for a lost engagement ring, and was told that her policy did not cover her outside of the home. So she extended the cover, and the next day claimed for the loss of the same ring.

**Source: ABI Website**

### **ABI – LAUNCHES PENSION INSURANCE GUIDE**

Bulk Insured Pension companies (commonly known as 'buy-out firms') reported a 50% increase in funds under management, of £22 billion to the end of 2008, according to new figures released by the ABI on 15 April. The pensions of over half a million people are now covered by these funds. Responding to the increased interest, the ABI has produced a guide for trustees and companies explaining how Bulk Insured Pensions work. A Bulk Insured Pension is the term for the purchase of a long-term insurance policy by the trustees of a Defined Benefit (DB) pension scheme to cover and protect scheme members' pension rights.

There are two main changes for members of a scheme which becomes fully covered by an insurance policy. Firstly, their pension guarantee moves from a sponsor's promise to a contract with an insurer. As well using a company with experience in managing pension risks, there is also the reassurance that insurers are regulated by the FSA and are required to hold large amounts of capital to meet their liabilities. Secondly, members are covered by the Financial Services Compensation Scheme (FSCS), giving consumers a higher level of protection.

**Source: ABI Website**

### **ABI – IDENTIFIES NEED TO HELP SAVERS**

The need to kick-start the attractiveness of saving is reinforced by research published on 9 April by the ABI. The ABI's Savings and Protection survey for the first quarter of 2009 shows that:

- Nearly two thirds of people expect the economy to deteriorate further during 2009. This is a slight improvement on the number who felt the same in the last quarter of 2008.

- The lack of retirement provision continues to be a serious problem. 42% of the UK workforce face financial problems in retirement. 13% of people are currently saving at levels unlikely to provide an adequate income, while an alarming 30% are saving nothing for their retirement.
- Property is regarded as the best long-term investment, with 45% of people choosing this as their preferred investment. Low interest rates and uncertain investment conditions continue to make savings accounts and equities unpopular.

Dr Rebecca Driver, the ABI's Director of Research and Chief Economist, said: "Although consumers remain pessimistic overall, there has been an improvement in sentiment over the last quarter, with fewer people predicting the economy will worsen a lot. At the same time, the number of people who see property as the best long-term investment has risen by 5%. It is good news that the economy seems set to rebound, and helpful that the current crisis has also led to a shift in consumer attitudes to finance. Falls in mortgage rates, and worries over job security, mean that 25% of people now say that they are either paying off their mortgages at a faster rate than before, or starting to do so, up from 16% last quarter. Similarly the proportion of those paying off non-mortgage debt more rapidly has increased to 28%.

The economy needs to rebalance if it is to return to sustainable growth in future, so this shift in attitudes to debt is helpful. However, achieving this will also involve encouraging households to make a conscious decision to increase long-term savings and the forthcoming Budget is one opportunity to do so. That is why the ABI is calling for an increase in the equity ISA limit to £10,800, and allowing employers to automatically enrol employees into workplace pensions before 2012. Over the next few months, the ABI will be unveiling further proposals to boost the popularity of saving."

**Source: ABI Website**

#### **CML – PUBLISHES RESEARCH ON HOUSING EQUITY**

On 16 April, the Council of Mortgage Lenders (CML) stated that, at the depth of the last housing market recession in 1993, 1.5 million households or more were estimated to have negative equity. Most sat tight, saved, continued to pay their mortgages and eventually recovered their equity position. This is what most of today's borrowers with reduced or negative equity are also doing.

A new research article by James Tatch, senior statistician at the CML, suggests that about 900,000 home-owners currently have some degree of negative equity, although the majority of these - around two thirds - face only modest shortfalls of less than 10% (equating to around £6,000 for those first-time buyers with negative equity, and £8,000 for other home-buyers).

While reduced and negative equity are likely to constrain the ability of affected households to move house, the overall scale and impact of this for the market as a whole needs to be kept in perspective - even in today's weaker market, the CML estimates that home-owners still have around £2.1 trillion of un-mortgaged housing equity.

**Source: CML Website**

### **CML – LENDING STATISTICS FOR FEBRUARY 2009**

The number of house purchase loans ticked up in February, according to new data published on 14 April. There were 24,300 house purchase loans worth £3.1 billion, compared with 23,400 loans worth £3.1 billion in January - a 4% increase. But historically activity remains very weak, running at around one-third of the average February total of 76,000 loans for house purchase between 2002 and 2007.

Re-mortgaging declined steeply with 35,000 re-mortgage loans, down from 44,000 in January- a 20% decline. We expect demand for re-mortgaging to remain muted as lenders' standard variable rates are attractive compared to new mortgage pricing, and house price falls continue to erode equity levels which will exclude some borrowers from the best re-mortgaging deals available to those with large deposits. Michael Coogan, CML director general, said: "These figures represent February mortgage completions. Recent mortgage approvals figures published by the Bank of England show some signs of improvement at the beginning of the borrowing process, although activity is at a very low level historically. We are not convinced that underlying trends have shifted sufficiently to change our forecasts for mortgage market activity in 2009, but there are some positive signs for later in the year.

Some large banks are making more funding available through enhanced lending commitments, which is helpful but will not satisfy consumer borrowing demand on its own. We need further market measures to be introduced by the government around the Budget to encourage a mortgage market where all types of lenders – banks, building societies and specialist lenders, and large and small businesses – are encouraged, and enabled, to commit more funds to the mortgage market if we are to enhance lending activity significantly."

**Source: CML Website**

### **FOS - OMBUDSMAN NEWS EDITION 76**

In the latest edition of his newsletter, Walter Merricks covers the following topics:

- The effect of cut-backs in customer service (main article).
- Case studies involving the transfer of money abroad and associated currency exchange.
- A selection of travel insurance complaints.
- Frequently asked questions about using the Ombudsman service.
- A Q & A page.

**Source: FOS Website**

### **BERR - CONSULTS ON EUROPEAN CONSUMER CREDIT DIRECTIVE**

The Government on 14 April launched a consultation on the European Consumer Credit Directive. The Directive aims to protect consumers, offer them new rights and set out common standards across the EU in relation to a range of unsecured credit products. The consultation will close on 10 June 2009.

The provisions to be consulted on include:

1. A 14-day right for consumers to cancel any credit agreement without penalty.
2. A standardized information form setting out important information for consumers before they sign a credit agreement.
3. Lenders will have to explain their products to help consumers make the right choices.

4. Lenders will have a responsibility to check consumer's creditworthiness.
5. A consumer right to make partial early repayment (this is in addition to the existing right to repay early in full) Consumer Minister, Gareth Thomas, said: "We want to further promote responsible lending and responsible borrowing. These measures will help with that objective. It's important we hear the views of consumer groups and the credit industry to ensure that we improve consumer protection whilst taking into account the practical concerns of business."

**Source: BERR Website**

#### **Dates and Deadlines**

22 April – Budget Day

**George Bylett**

**Corporate Governance Assurance Services Ltd**

**[www.cgas.co.uk](http://www.cgas.co.uk)**

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