# FSA Raises the Bar on Suitability

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Theoretically that large finance firms-banks, financial product manufacturers and financial advisory firms-move to countries with lax regulation. This is happening real time right now. In the next two years, I expect large boat-loads of suits to wash up on the Indian coast. They'll all be escaping from rules that make cheating retail investors very difficult. The British regulator, the Financial Services Authority (FSA), has just raised the bar for investment advice and is continuing its practice of large-ticket fines to show that its teeth actually bite. A January 2011 FSA paper titled "Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection" (*http://bit.ly/fOb8by*) lays out the results of an audit of advisory firms between March 2008 and September 2010. The report looks at the practical issues of implementing the suitability criterion in product sales and financial advice.

What is suitability? The basic premise of adviser regulation is that the advice given and the products sold be "suitable" to the customer. Which means that an artist with irregular income flows not be sold a product that needs a regular infusion of funds. Or that a retired person is not sold a life insurance cover. FSA has taken this to another level by not just defining suitability but conducting audits to see if these rules are being actually followed, resulting in good customer outcomes. The FSA audit found evidence that more than half of those judged "unsuitable" were due to the fact that the products sold were unable to meet the risk a customer was willing and able to make. Willingness is a function of what somebody thinks she can do. Ability is what she can actually do. A diabetic patient may be willing to eat sweet stuff, but may not be able to. Translate that into finance and it means that a 70-year-old person with limited funds may want to take risk but his financial situation may not allow him to do that.

The findings resulted in a fresh set of fines on adviser firms that failed the suitability test. On 14 January, FSA fined Barclays Plc £7.7 million (Rs56 crore). The final notice can be read here: *http://bit.ly/gm8JCV*. Barclays' crime? Around 12,000 customers, many of them close to retirement, were mis-sold two income-focused funds that lost money during the financial crisis. The problem that FSA or other regulators have with market-linked products is not that they lose money, but that they are sold as products suitable for people who cannot afford to lose money. The FSA said Barclays had failed to ensure that two funds, Aviva Global Balanced Income Fund and Aviva Global Cautious Income Fund, were suitable for its customers.

The failings, as documented by FSA, found the training material given to Barclays' staff "inadequate". It did not identify the types of customers the funds were suitable for. The sales briefs sent to advisers spoke about just potential benefits and not the risks. Product brochures had inadequate information and had statements that could mislead customers. It failed to put in place adequate procedures for monitoring of the sale of funds.

Barclays did two things-it apologised to the customers in both funds and said it would pay compensation. As step two, it closed down its financial planning business. On 26 January, Barclays announced that it would cut 1,000 jobs by closing its branch-based advisory service Barclays Financial Planning (*http://bit.ly/hpArtx*). Reason: a decline in commercial viability. The press note of the bank said: "Barclays has been conducting a detailed review of its financial planning advice over recent months. This review has concluded that, given the changes to the retail investment marketplace, it is unlikely that this business would be able to deliver a return that would justify the investment required."

The timing of the FSA audit, the slapping of the fine on Barclays and the bank's decision to shut shop seem to be linked. What I hear Barclays (and other retail-focused financial firms) saying is this: unless we are allowed to sell products that maximize our profits and not the financial well-being of the customers, we will not stay in that business. Or, we will move it to locations with no, low or lax regulation. India is still at the no-regulations stage. Even the basic definition of who should be sold what is not in place in India. We have no regulation that makes advisers responsible for what they sell, making us a zero regulatory cost market for the suits. The woollen suits are buying linen to make the cultural shift.

# 9 billion pounds: UK banks' compensation for mis-selling insurance

British Lloyds Banking Group blinked in its fight with the regulator, the Financial Services Authority (FSA), and agreeing to a £3.2 billion (Rs. 23,427 crore) provision to meet insurance mis-selling claims. While global investors (including pension funds from the US, the UK, Norway and Denmark) in Satyam were to be compensated by the auditor found guilty of not following basic rules of an audit, Indian investors will get not a paisa (*http://bit.ly/j9Zbg2*). The Indian story was about a lack of clear regulatory jurisdiction, archaic laws and the inability to take tough decisions against large corporations. The British story was about consumer agencies active enough to push the regulator into action, the legal system providing the platform to do this and the institutional will to actually go ahead with a decision to punish that will make markets fall.

In 2007, the UK's FSA, pushed by consumer groups, charged banks with mis-selling an insurance product called Payment Protection Insurance (PPI). FSA had used a mystery shopping exercise (something that any regulator in India can use, should it choose to do so) to discover that the PPI was indeed mis-sold. FSA found that though the PPI's main aim was to cover loan repayments if the borrower's income stopped due to ill health or unemployment over the period of the loan, it was being sold to the retired, those already unemployed and those with existing medical conditions without disclosing that the cover was useless to them. The FSA found that by bundling the insurance into the loan, banks were effectively charging for a product that the customer did not know she was buying or was buying not fully understanding the product. Estimates put the total PPI cover sold at close to £6 billion. In 2010, FSA fined 22 firms £8.9 million to compensate PPI victims who had complained. But the regulator did not stop there. It drew up guidelines to get the banks to contact all past PPI customers (banks have the database, right?) and invite them to complain if they thought they had been mis-sold the product so that they could be compensated! Sounds unbelievable that in India that a regulator would ever do that. Of course, the banks challenged it and went to court. In April 2011 a high court ruling rejected the challenge and it was expected that the banks would take the case higher. But in a surprising retreat, instead of contesting the verdict, the banks, led by Lloyds, accepted the FSA directive last week. Lloyds was the first to do so and has set aside £3.2 billion to meet the PPI claims. Barclays Bank will reserve £1 billion and its chief Bob Diamond apologized to customers saying: "We don't always get things right for our customers; when we get them wrong, we apologize and put them right." Royal Bank of Scotland will not appeal the case but has not said what provision it will make for mis-sold PPI, while HSBC has made a provision of $440 million. A total of three million customers will benefit from this high court ruling and get paid around £2,000 each as compensation.

Not only were bank stocks down due to this hit on the bottomline, but the news dragged down global indices where the banking stocks were listed. The logic is clear—if you make an error, the penalty should be a deterrent to repeating the action that caused harm. Cut to India. There has been no large-ticket refund of investor money, other than one case fought by Midas Touch Investors' Association that got Rs. 975 crore back for investors in a guaranteed fund from Canbank Mutual Fund that did not keep the guarantee. The reasons are many—tangled regulatory turfs, fuzzy laws that make pinning down responsibility almost impossible, a regulatory framework that is happier targeting front-level junior employees rather than the firm, its directors and management and an overall reluctance to use financial penalties of any consequence to punish wrongdoing. In the rare case of enough evidence being found, the penalty is something that firms smirk at in private. How a fine of Rs. 5-15 lakh (the penalty imposed by the Indian banking regulator on banks found guilty of selling complicated derivative products to companies) will hurt a bank with a net profit figure that reads like a telephone number is a question not worth answering. Regulatory action when the firm under investigation has been found guilty has to be twin-pronged. One, make good the loss to consumers who were mis-sold financial products. Two, impose a cost on the perpetrators of the crime such that there is internal pressure not to be caught with their paws in the customer's wallet again. But first, of course, the battle in India is to even admit that there is a problem of mis-selling by banks.

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