Analysis

Buyer Beware

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Retail customers have arguably never had more choice when looking for ways to borrow or invest. Not only is there a growing – some might say bewildering - range of products on offer, but the number of providers is also increasing.

Add mixed economic and market signals, and you have a recipe for consumer confusion. But it's not just customers that are confused. The other side of the story is that financial services providers are finding it increasingly difficult to ensure that the right products are being sold to the right customers.

Both customers and providers have a lot at stake. A poor choice of investment can be ruinous for consumers – but if they can demonstrate that their choice was the result of a bad advice or inappropriate sales pressure, they can sue for compensation – and that can prove extremely costly for their financial services providers.

The evidence suggests that consumers, or their representatives, are bringing more cases against banks and insurers, and that they're being more successful in winning large amounts of compensation. Mis-selling of long-term investments has led to a succession of major scandals in the UK – the latest casualty being Lloyds TSB. In the US, the issues have revolved more around sub-prime lending, an example being the controversy around HSBC's recent acquisition of Household.

This kind of problem can be expected to recur time and time again, says Alan Aldridge, a senior lecturer in sociology at the University of Nottingham. Aldridge says firms are finding it hard to explain increasingly complex financial products to their customers.

"The financial services industry is finding itself heavily-exposed to risks arising from mis-selling," he says. "Some products are more complex than people think – a lot of financial engineering lies behind apparently transparent products."

Although the designers of financial products usually have a good understanding of their sensitivities to changes in interest rates or stock markets, they may find it harder to communicate these to the sales-force, or to convey them in marketing literature. Product warnings tend to be buried in the small print, rather than part of the overall message.

The result can be local problems at a single firm or widespread

problems with a whole class of product. In one recent example, American Express Financial Advisors (AEFA) was fined for its sales procedures in the US. AEFA accepted a $350,000 fine arising from a regulatory investigation that concluded the firm's sales-force had failed to "explain the costs and features" of variable annuity products, and that AEFA had failed to adequately supervise those sales.

A much broader fiasco is emerging in the UK endowments market, and particularly endowment mortgages, in which a long-term investment is supposed to pay off the principal borrowing at the end of the mortgage term. Endowment mortgages became very popular in the UK during the 1980s, but the poor performance of the stock markets over the last three years has resulted in many policies undershooting expectations. Customers now claim not to have been adequately warned of the risk that the policy could be insufficient to cover their repayments.

That's what caught Lloyds TSB, via an insurance unit it acquired in 1996. The Financial Services Authority fined it a hefty GBP1 million – the largest fine ever handed down by the FSA – and the ruling generated a slew of bad press. It got worse for Lloyds: it shocked the market in an interim trading statement shortly after the fine was announced by revealing that it would set aside reserves of GBP165 million for compensation.

Many other companies are expected to be in the same boat. The FSA has talked about a "long pipeline" of endowment cases that it is working through. Many reports have put the total cost to the industry at GBP1 billion; some say it could reach as much as GBP11 billion.

The industry is not keen to acknowledge publicly that mis-selling is an ongoing concern. In the UK, both the British Bankers Association (BBA) and the Council of Mortgage Lenders (CML) point to the industry's codes of conduct for consumer sales. A BBA spokesman argues that "there are guidelines there to make sure that the consumer gets the product they want." At the CML, a spokesman makes the same point, and claims that the endowment debacle means that "everyone is quite attuned to the risks already."

But in a survey carried out earlier this year by the Centre for the Study of Financial Innovation, bankers identified the risks that most worried them. Front-office selling placed at number 17 – four places higher than in the 2001 survey – and that was before the huge potential costs related to mortgage mis-selling became apparent.

Warren Edwardes, chief executive of Delphi Risk Management – a risk consulting and product development firm – suggests that financial services firms may need more than a code of conduct. "Great care must be exercised in selling any highly structured products direct to Joe Public. There is always the danger that the buyer may claim, truthfully or otherwise, not to have understood the product and declare that it was mis-sold."

Not all cases are particularly well founded, Edwardes suggests, pointing to NatWest's attempt to charge a replacement cost for fixed-rate mortgages when borrowers repaid the loans early. In his opinion, the charges were justifiable, "but ill-informed pressure groups hounded the bank to give in." Customers can exert pressure on financial institutions by claiming not to have fully understood a product – and more complex products make it easier for regulators or courts to sympathise with those complaints.

There's now a real danger that innovation may be stifled as a result. Edwardes argues that if an institution wants to reduce its exposure to allegations of mis-selling "the most successful products are those that can be explained in a 30-second television sound-bite. While these have the inherent problem of being easy to replicate by competitors, anything much more complicated could lead to complaints years down the line over mis-selling and misrepresentation".

The industry, in the UK at least, appears to have an ally in the government, which has recognised that innovation could be threatened, says Nottingham University's Aldridge, and has recently shown a desire to adopt policies that subtly shift the responsibility away from institutions and on to the consumer.

A similar principle could be embraced by the companies themselves, says Delphi's Edwardes, who suggests that if banks and insurers act to minimise potential confusion in the sales and marketing process, customers are less likely to have grounds for complaint later. In this way, he says, institutions could still continue to develop and sell structured products.

"The internet is an ideal sales medium in that respect. The provider could offer a detailed explanation of its products at negligible cost. Customers would be expected to read the literature and understand the product themselves. Questions could be answered not by lowly-paid and hardly-trained telephone-sales staff but via e-mail which would allow a considered answer."

The only problem with this kind of approach, perhaps, is that it serves to weaken the bond between the industry and its customers. But if banks and insurers continue to develop and sell complex products, they will either have to put the onus on their customers or accept the risk of mis-selling.

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