OLIVER WYMAN

Financial Services

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Mis-selling in the UK

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Contents

Section 1

Mis-selling in the UK

Overview

Overview

- Mis-selling is the sale of unsuitable products resulting in customers being left in a disadvantageous position, e.g. due to
  - Unclear, incomplete or misleading product literature
  - Sales representatives pushing a product
  - Bundled sales of products not requested or wanted
  - Incomplete discovery of customer needs and demands, leading to sub-optimal product recommendations
  - Marketing aimed at the under-aged or pensioners
- Mis-selling has become one of the most hotly debated and costly problems for UK insurers, brokers and banks in recent years, adding to the low levels of confidence in the UK financial system
- Notable cases include personal pensions, mortgage endowment policies, split capital investment trusts and, most recently, payment protection insurance (PPI)
- So far, the UK financial industry has made compensation payments of ~£15 BN to millions of UK consumers, with a majority of PPI compensation payments yet to be made
- Mis-selling (as defined above) happens in all countries – there are several, interconnected reasons why the UK industry has been made to pay so heavily for it
  - Early scandals leaving hundreds of thousands worse off…
  - …leading to a strong consumer association, political and regulatory focus on conduct regulation…
  - …combined with strong competition and product innovation

Section 2

Mis-selling in the UK

Incidents from the 1980s to 2011 (excluding PPI)

Pensions mis-selling

Various life insurers and their brokers

- **£4.5 BN** of losses were racked up in the insurance industry. The problem of mis-sold pension products built up during the late 1980s and was fully recognised in 1993-94 when watchdogs and lawyers sought compensation for millions of customers

- The 1980s saw the introduction of many new insurance products. Deregulation of financial markets and an influx of foreign capital/companies fuelled this growth
- In the summer of 1991, an estimated 172,000 people were selling insurance – one for every 200 working people in England
- Most salespeople were hired from college or unemployment and incentivised to sell to family and friends. Working mainly on commission, most would leave once their networks were exhausted, and 80% left within two years of joining a company
- In 1993-4 it emerged that millions of consumers had changed from work-place pension schemes to private policies over the past decade, leaving them worse off
- A total of two million individual cases were reviewed in a drawn-out process which has yet to be fully concluded
- Customers are being compensated for “any financial loss suffered”. This has meant attempting to reinstate customers in their original pension schemes, pay a lump sum equivalent to the value of the future missed benefits from that scheme, or to reshape the mis-sold scheme to track the features of the original schemes

Endowment mortgages

Various life insurers and their brokers

- **£2.7 BN** of losses were incurred due to fines and compensation payments to customers who had been mis-sold endowment mortgages during the mid 1990s. A general trait of the mis-selling cases was the lack of proper risk warnings to customers

- According to the FSA, some six million households held around 11 million endowments by 2000
- Endowment mortgages boomed in the mid 1990s and allowed customers to purchase property on an interest-only basis, with additional sums being invested into an equity-based endowment policy intended to cover the principal upon maturity
- In December 2002, Lloyds was fined by the FSA and ordered to compensate around 44,000 customers for mis-sold endowment mortgages, costing the bank a total of £165 MM
- Numerous other institutions were fined and ordered to compensate customers. The losses from fines and compensation payments to 430,000 home buyers totaled £2.7 BN. The companies most affected included Royal London Group, Royal Scottish Assurance (RBS), Scottish Amicable (Prudential) and Royal & Sun Alliance
- Firms were ordered to restore customers to the financial position they would have been in if they had had a traditional repayment mortgage rather than an endowment mortgage

Precipice bonds

Various life insurers and their brokers

- **£459 MM** was lost as sales continued long after the risks of loss and mis-selling of the products emerged in the late 1990s

- Precipice bonds are high-yield financial products and have been sold under various names, e.g. high income bonds, stock market income bonds, premier bonds and extra income and growth plans
- The risks with precipice bonds emerged in 1999 when customer complaints started mounting
- A common issue was that the bonds were not regulated products as per the Financial Services and Markets Act of 2000, nor were they covered by general UK listing rules. The bonds typically guaranteed two-figure returns, but the principal was not guaranteed and was rapidly wiped out in market downturns
- In the stock market downturn of 2003, many precipice bonds matured with substantial losses, and it became evident that many customers had not realised the downside risk to the products
- A total of 150 firms had to compensate customers and restore them to their original financial situation, with Lloyds TSB/Scottish Widows bearing the lion's share of complaints and setting aside £300 MM
- The FSA pushed hard for a reduction in the number of precipice bond products offered to consumers, and by 2004 most such products had been withdrawn

Other mis-selling examples
Standard Life, Royal Liver

- Standard Life lost **£84 MM** in fines and compensation on transactions in 2006-2009, mainly due to misleading advertising and incorrect descriptions of one of its pension funds
- Royal Liver lost **£6.5 MM** on transactions in 2006-2009 as it had failed to provide proper and individually adapted products to its clients

- In January 2010, Standard Life was fined by the FSA for misleading thousands of customers about the safety of its Pension Sterling Fund. The fund had invested in mortgage debt and the risks had not been accurately described in marketing materials
- In February 2010, Royal Liver announced it would compensate thousands of customers who had been sold unsuitable pension or investment products over the past four years. The products had been sold by the company's independent advisor Park Row Associates

Section 3

Mis-selling in the UK

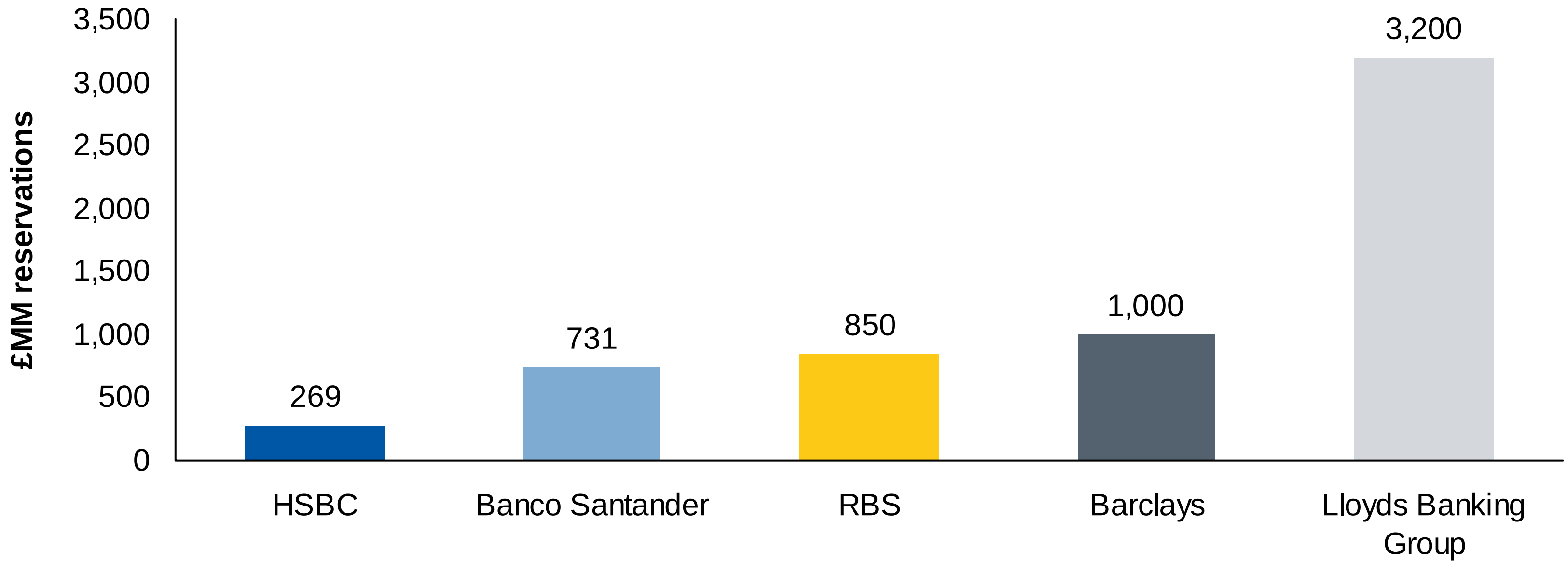
Payment protection insurance

Background

- (Mis-)selling of PPI accelerated in the early 2000s, fuelled by
  – Bundling with other products (e.g. credit cards, loans and mortgages)
  – Incentive structures
- The FSA has taken action on PPI mis-selling against more than 20 firms since 2006
- The FSA estimates that issuers and advisers overcharged customers by more than £1.4 BN a year

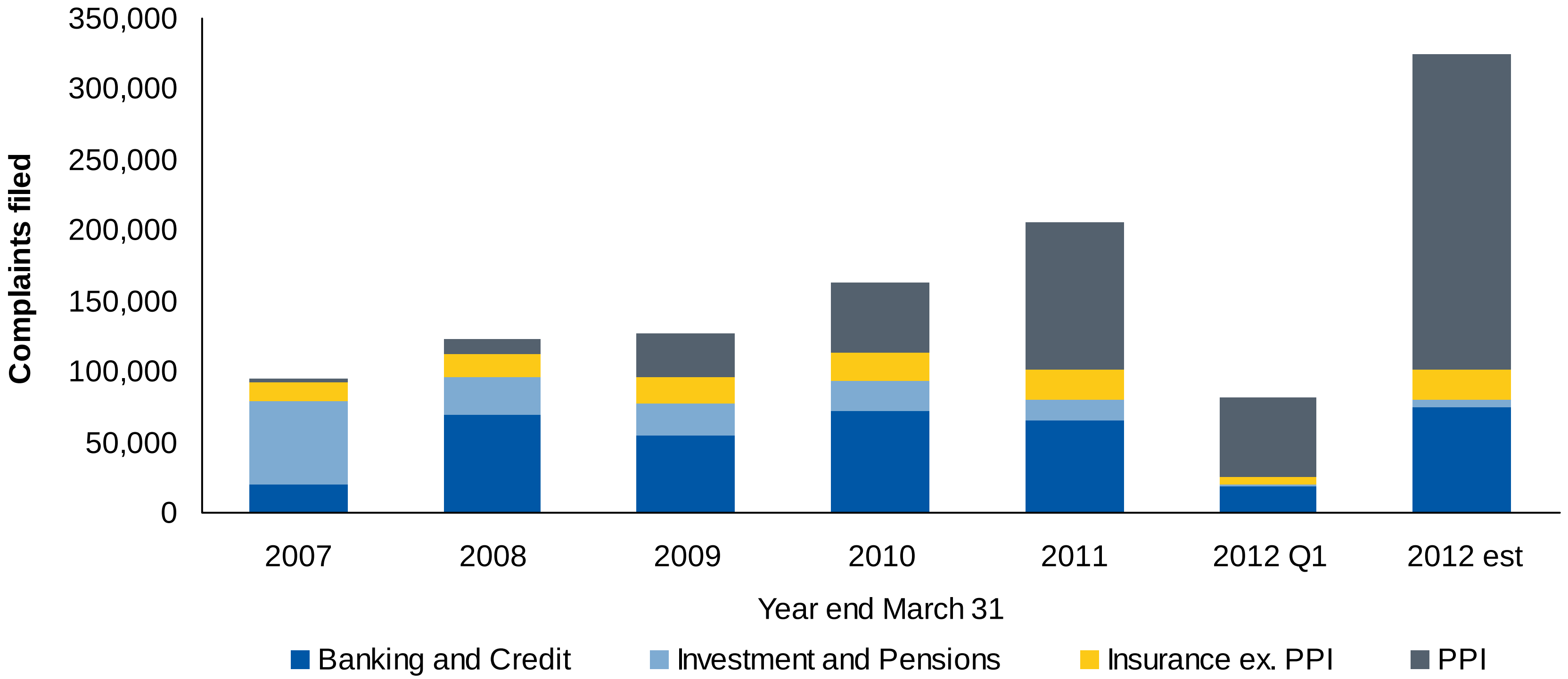
Major British banks set aside £7.4 BN to cover PPI liabilities after the April 2011 High Court ruling on the sale of PPI

Major UK retail banks' PPI loss provisions (pre-tax)



- Following the High Court ruling on 6 April 2011, major banks have set aside substantial provisions to cover fines and compensation to PPI customers. The Court dismissed the British Bankers' Association's (BBA) challenge to having new PPI standards apply retrospectively
- Early estimates said that Lloyds and four other leading UK retail banks would have to pay £5.1 BN in a worst-case scenario – the latest estimates are £7.4 BN. Average payout per customer is expected to be ~£2,500

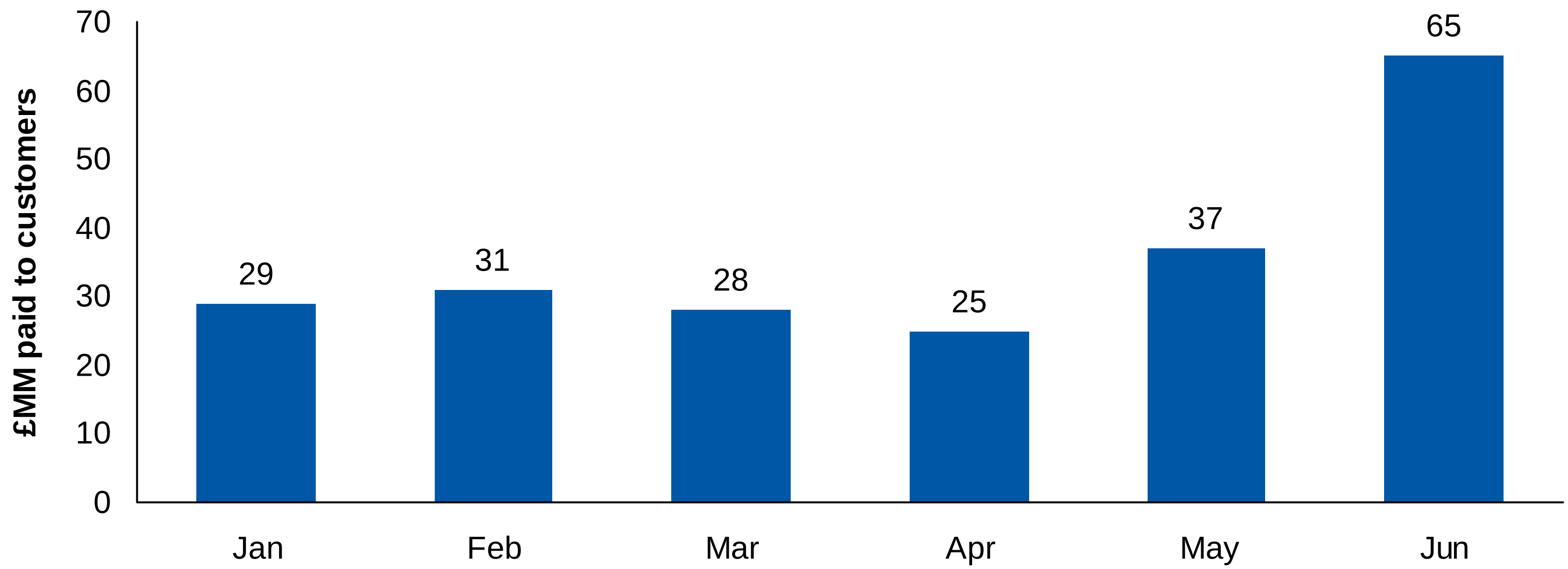
PPI complaints have increased substantially following the ruling…



- Complaints to the Financial Ombudsman Service (FOS) surged by 50% in H1 2011, with PPI complaints accounting for over 60% of total complaints in the period

… as have compensation payments

PPI compensation payments 2011



Data from 16 firms which shared 92% of PPI complaints in H1 2011

- PPI complaints handling was put on hold awaiting the Court's ruling
- However, by October, all delayed compensation payments had been made, and the firms involved have begun to address current claims

Section 4

Mis-selling in the UK

Lessons learned: How to avoid the risk of mis-selling

Previous mis-selling scandals share certain traits

- **Breaches of control routines**: many examples of breaches of company policies and disregard for and/or inactivity of Compliance and other control functions
- **"Over-selling" of products**: extensive (cross-)selling driven by incentive structures and internal company targets, enabled by complexity of product offerings and insufficiently and even improperly informed customers
- **Improper (often complex) products sold**: failures to properly explain the features of products to customers and/or to match the products to the situation and risk appetite of customers
- **Documentation failings**: incorrect, unclear or incomplete product literature
- **Systematic misrepresentations or omissions by salespeople**: salespeople have repeatedly been found to omit key information to secure sales
- **Product bundling**: unwanted products were often bundled with other products without the customer asking for it or even realising
- **Under-informed customers**: customers relied on salespeople's superior knowledge to advise them on what was best for them
- **Difficulty of comparing with similar products on the market**: product complexity, exotic naming and bundling make it more difficult for customers to make comparisons with other products on the market

Solutions to prevent mis-selling as implemented in the UK

Regulatory solutions

- Financial advisors are prohibited from receiving commission, instead having to charge the customer directly
- Requiring financial advisers to be better qualified – minimum equivalent to the first year of a university degree
- The FSA is increasing its use of mystery shopping

Industry solutions

- **Customer orientation**: reinforcing a consumer focus throughout the organisation, including product design, documentation, marketing and sales, e.g. through top-down communications, risk appetite, policies and sanctions
- **Incentives structures**: change incentive structures to put less focus on short-term sales, including claw-backs
- **Professionalisation/training**: provides an entry barrier to short-term, unserious staff, and improves standards of advice as well as pride
- **Transparency is key**: the shift towards wrapper accounts allows consumers to shop around and compare
- **Enhanced monitoring of sales force**: mystery shopping, taping of calls and separate follow-up on customers help to detect improper sales practices
- **Disposing of direct sales forces**: major players like Prudential got rid of their direct sales forces after earlier mis-selling scandals, and Barclays have recently announced that they will no longer provide financial advice in their branches and will shift towards online distribution
- **Enhanced checks of product literature**: facing large fines, advisers and issuers alike are taking greater care to review the documentation of financial products to assure that it is clear and compliant with regulations
- **Strengthening control functions**: Compliance, Op Risk and Legal have been given stronger powers of review and veto in new product approval and literature review processes