

Payment Protection Products: FSA/OFT Joint Guidance Consultation

Introduction

The Financial Services Authority (FSA) and the Office of Fair Trading (OFT) launched a [joint guidance consultation \(CP\) in relation to payment protection products](#) (PPP)¹, in November 2011. PPP are described as products, or product features, designed to offer consumers short-term protection in cases of income loss, by providing alternative means to meet financial commitments under regulated mortgage contracts (RMCs) or credit agreements. These can be stand alone protection products, such as income protection, or they can be features of a credit agreement, such as debt or payment waiver or debt freeze.

The proposals in the CP come as the protection market shifts away from Payment Protection Insurance (PPI) following the Competition Commission's market investigation into PPI and the resulting remedies package, including a ban on selling PPI at the point at which credit is sold. It follows concerns amongst regulators that PPP are filling a vacuum left by PPI and that the mistakes made in relation to PPI sales must not be repeated. The FSA flagged their concerns some time ago when they included PPP as an emerging risk in their [Retail Conduct Risk Outlook published in February 2011](#)².

As part of the consultation process the OFT and the FSA jointly hosted a series of roadshows designed to give stakeholders an opportunity to voice their concerns publicly and to ask questions face to face with the regulators. During one such roadshow the FSA highlighted that its three main risk areas were :

- firms not properly identifying their target market/people in their target market;
- the product design (scope/price) not fitting correctly in their target market; and
- barriers to comparing/exiting/switching PPP.

The FSA said that it will alleviate these risks by looking at firms' product design, distribution and marketing strategies in relation to PPP.

The OFT said that its main aim was to increase transparency in the product sales process by improving consumers' understanding of how PPP work, the risks associated with them and their costs, so that consumers are in a better position to make appropriate choices when considering whether or not to buy a PPP. The OFT stressed that the guidance was just that and that existing legislation³ would already apply to PPP.

This article looks at the proposals contained in the CP and considers how they might impact PPP providers in the context of RMCs and Consumer Credit Act (CCA) lending.

¹ The joint guidance consultation paper can be accessed here http://www.fsa.gov.uk/pubs/guidance/gc11_26.pdf

² The Retail Conduct Risk Outlook can be accessed here <http://www.fsa.gov.uk/pages/Library/Corporate/rcro/index.shtml>

³ Meaning the CCA, the OFT's Irresponsible Lending Guidance and the FSA's Insurance Conduct of Business Rules..

The FSA's consumer protection strategy and product intervention

In March 2010 the FSA launched its consumer protection strategy to do more to anticipate consumer detriment from poorly designed products or distribution strategies, and to take action to prevent detriment occurring even before a product is launched. Against this background, the FSA published its Discussion Paper (DP11/1)⁴ on Product Intervention in January 2011 and a Feedback Statement (FS11/3)⁵ followed in June 2011. The approach discussed in these papers reflects the FSA's interventionist consumer protection strategy launched the previous year.

The FSA's product risk report contained within Annexe 1 in the CP is an example of FSA intervention earlier in the product life-cycle and it is probably the first example of product intervention since DP11/1 was published and to that extent it is very significant. In a statement made when the CP was launched, Margaret Cole, FSA Managing Director, said '*...we are acting early to ensure firms understand the risks they should bear in mind when designing these products, and how they can manage these risks when developing or distributing the product. We want to put consumers 'front of mind' for the providers and distributors of these products*'.

Annexe 1 contains material which would build upon existing high-level FSA guidance contained in the FSA's Responsibilities of Providers and Distributors for Fair Treatment of Customers Guide⁶, which was published in July 2007. Once finalised this part of the proposed guidance will inform the FSA's supervision of firms that provide and distribute PPP, which will include non-insurance PPP linked to RMCs, such as debt freeze and payment waiver, as well as insurance PPP such as short term income protection (STIP) .

Annexe 1: the FSA Product Risks Report

In its Product Risks Report (Annexe 1), the FSA highlights PPP design features that can cause risks for consumers leading to poor consumer outcomes. It also considers how firms should manage those risks at the product design stage, through distribution and post launch.

Identifying your target market

Identifying a PPP's target market is seen as key by the FSA. According to Margaret Cole, '*Firms must learn the lessons of the past and make sure they have consumers' needs at the heart of new product development*'. Firms will be expected to design PPP with their target market in mind right from the word go. Many of the risks highlighted in the guidance stem from a failure to do this.

A failure to properly align the protection offered by a PPP with the characteristics of the product's target customers can result in products being mis-sold. The paper says that PPP providers should be wary of selling payment protection products that may not give consumers the benefits they will need in the event of a successful claim. The FSA would expect firms to '*...use relevant data (including consumer research, as well as other sources) when defining the level of benefits offered, to ensure that the product design appropriately reflects consumers' likely needs and so supports positive consumer outcomes*'.

⁴ DP11/1 can be accessed here http://www.fsa.gov.uk/pages/Library/Policy/DP/2011/11_01.shtml

⁵ FS11/3 can be accessed here http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf

⁶ The Guide can be accessed here <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/087.shtml>

Applying this to PPI, if product providers had properly aligned their product protection characteristics with the characteristics of their customer targets there may have been fewer incidences of unemployment cover being sold to the self employed. Applying it to PPP, the CP points out that '*...a short term income protection product is inherently unlikely to meet the needs of consumers who do not have an income to protect or those who have sufficient alternative sources of income if they were unable to work (for example, through existing insurance cover, or savings or pensions)*'. Some providers are concerned that this suggests that income protection will never be suitable for customers who have savings or pension provision.

Firms will be expected to make sure that the benefits which flow from a claim meet their target customer needs too. So, for example, it may be inappropriate to sell protection which caps the benefits payable to an amount which falls short of the customer's regular loan payment, to the sub-prime market where consumers are unlikely to have savings or other resources to fall back on. Similarly, where a PPP linked to periods of unemployment, such as debt waiver, is designed with limited duration, firms will need to consider carefully whether the duration does realistically allow target customers sufficient time to return to work.

Whilst it is difficult to argue against this focus on the 'target market' there are concerns that too much focus on a narrowly defined target market could result in some consumers who could benefit from protection being excluded or overlooked in the sales process.

Barriers to comparing/exiting/switching

The FSA says that payment protection products should be sold without "product features or pricing structures" that create "undue barriers to comparing, exiting or switching cover". Product features that create barriers to exit or switching include those where cancellation is not permitted or permitted upon payment of a disproportionate fee. In the context of RMCs, presently borrowers may have to pay the mortgage early repayment fee if they wish to cancel during a fixed rate term. Firms will be expected to design PPP in such a way that enables consumers to switch providers if they choose to and to cancel cover where the cover offered ceases to be suitable. PPP which are linked to RMCs will need to be designed so that they can be cancelled without having to cancel the underlying mortgage.

Products with waiting periods and initial exclusion periods could be considered to create a barrier to switching. This will concern providers as these are important features of protection that help to manage risk levels and product pricing. Provided the features are sufficiently transparent they can work in a consumer's favour as they enable consumers to take advantage of notice periods at work and in so doing buy PPP that are more keenly priced.

Whilst it is reasonable to expect 'exclusion periods' or 'waiting periods' to be transparent, too much prescription here could result in some lenders withdrawing their PPP products if they consider their risks are too great or on the other hand it could lead to a hike in PPP prices. Further clarification on what the FSA might consider to be an acceptable exclusion or waiting period would be useful.

Extensive exclusions for pre-existing medical conditions can pose barriers to switching too.

Pricing Structures

As far as pricing structures are concerned, the paper makes it clear that work is ongoing in relation to pricing on the back of the Product Intervention DP, so we are likely to see more from the FSA on this.

For now, firms should note that exit fees are an obvious barrier to switching and will be vulnerable to regulatory challenge if they are seen as a profit line. To minimise the risk of challenge firms should consider adjusting their fees so that they reflect actual costs and they should not be used to tie customers in to products which are no longer suitable to their needs.

As with single premium PPI policies, firms should be careful when adding single premium fees to their RMCs. The FSA says that '*..... poor consumer outcomes may arise if the pricing structure for new non-insurance payment protection products for RMCs mirrors that of single premium PPI – which is prohibited by the CC. An example might be a debt waiver term within an RMC, where the consumer pays for the protection as a lump sum which is added to the mortgage at the point of sale.*' The Competition Commission found that this practice could result in high barriers to switching where the refund offered on cancellation was insufficient to enable the consumer to purchase cover elsewhere. The FSA suggests this principle could be applied to debt freeze or payment waiver '*...where the refund in the event of cancellation is significantly less than pro rata.*' This proposal is unlikely to find favour amongst lenders however as it takes no account of the risk profile associated with a debt waiver which is greater at the outset (reflecting the higher loan balance) than it would be towards the end of a loan. There have been suggestions that, to be fair, refunds should be pro-rata to the diminishing balance protected and that lenders should be allowed to recover their administrative costs on cancellation.

Distribution and post launch

Firms will be expected to select their distribution partners with their target market in mind. So, for example it would be inappropriate to engage a distributor whose customer base includes sub-prime customers where the protection product assumes a certain minimum level of saving.

Where third party distributors are used firms should be careful not to use sales incentives that might encourage sales outside the product target market. The FSA would expect firms to ensure that third party distributors are not motivated by inappropriate incentives, for example, because the target audience is too small to achieve the necessary volumes or penetration rates. Remuneration strategies are an area of regulatory focus for the FSA at the moment and work is underway in relation to strategies for incentivising in-house sales staff.

Effective governance will be key. Firms will be expected to have in place relevant policies, practices, risk controls and oversight arrangements in order to monitor risks their protection products may pose to consumers at all stages in a product's life cycle.

Payment Protection products within the OFT's jurisdiction

The OFT guidance in Annexe 2 will apply to non-insurance PPP linked to CCA regulated credit facilities, including secured and unsecured CCA loans, credit and store cards. The guidance is aimed in particular at debt freeze and debt waiver products offered with or as part of a credit agreement, in return for a fee or consideration, where the exercise of the option to buy the PPP has the effect of varying the repayment terms upon the occurrence of one or more specified events.

Debt freeze is defined as the temporary suspension of payments (capital and or interest) on the occurrence of an event (like sickness), 'typically' in return for a fee or higher interest charges. Debt

waiver is defined as the permanent suspension of interest or charges (part of the debt may also be cancelled), again, 'typically' in return for consideration of some sort.

The use of the word 'typically' means the OFT will be looking at PPP provided for no fee or consideration as well as those for which a fee is charged or consideration applied, although the guidance is principally aimed at capturing distinct products or product features which are purchased.

The application of the CCA to PPP

The OFT guidance begins by discussing the application of the CCA to PPP and differences that may arise in the treatment of unsecured and secured lending by reason of the dual regime that exists since the implementation of the Consumer Credit Directive (CCD) earlier this year.

Calculating the APR

The OFT highlights the distinction that exists between secured and unsecured credit for the purposes of calculating the APR and refers to the Court of Appeal decision in *Humberclyde Finance Ltd v Thompson* [1997] CCLR 23 in relation to secured credit. This was a decision made under the Consumer Credit (Total Charge for Credit) Regulations 1980 (the TCC Regulations 1980) and so will still be relevant to credit agreements secured on land to which the TCC Regulations 1980 still apply. The credit agreement included a payment waiver which was triggered by the death of the borrower. The fee was found to be 'payable under the transaction' even though it was optional.

In the OFT's view this decision makes the inclusion of fees for PPP a requirement in the APR calculation for secured loans even though the product is not compulsory. This in itself is not contentious but the OFT goes further and says this is the case even if the consumer does not exercise the option. This seems to overstate the position. In the *Humberclyde* case the borrower elected to take the payment waiver protection offered. It is unlikely the court would have reached the same conclusion had the borrower expressly declined to take the product. Perhaps the OFT is referring to agreements where the PPP is inbuilt in the agreement but the actual sale of the product is dealt with separately, this could be after the credit agreement is signed? In the past some lenders have attempted to side step the TCC Regulations 1980 by doing this. The guidance is unclear on this.

A more significant issue not addressed by the OFT is the need for a modifying agreement if the PPP option is 'switched on' after the credit agreement has been signed. In this scenario it is likely the exercise of the option would amount to a variation of the credit agreement terms. Creditors would need to consider carefully whether this variation triggers the modifying agreement provisions under the CCA.

For unsecured credit, following the Consumer Credit (Total Charge for Credit) Regulations 2010, the OFT would not expect optional PPP fees to be included. This said, the guidance points out that, as with optional PPI, the PPP would be treated as compulsory in relation to a credit agreement where a discounted interest rate applies by reason of the fact that the PPP option has been exercised.

Advertising

In the context of credit not secured on land, the OFT takes the view that there are two separate agreements where debt freeze/debt waiver is offered. One with the debt freeze/debt waiver terms and one without and this will need to be factored in to the calculation of the representative APR. If the proportion of agreements where the PPP option is expected to be taken exceeds 51% the representative APR will need to include the PPP fee. This will also need to be reflected in the other information required to be included in the representative example, such as, the nature and amount of the charge, the repayments and the total amount payable.

Pre-contract information

In relation to unsecured credit, consistent with the OFT's view that there are two separate agreements, where debt freeze/debt waiver is offered, the OFT expects creditors to provide two PCI documents, unless the consumer 'indicates clearly' that he does (or does not) intend to opt for the product. This would need to be addressed clearly by creditors in their telephone scripts/ application forms to avoid challenges of unenforceability.

Adequate explanations

The guidance makes it clear that where debt freeze/debt waiver is offered creditors should include this feature of the product in their pre-contractual explanation under section 55A of the CCA and if the debt freeze/debt waiver might work in a way that the borrower might not reasonably expect, and to his disadvantage, this should be made clear. The guidance specifies restrictive provisions regarding the scope of coverage or the triggering events, or regarding the extent of evidence required in support of a claim, as examples of features that might fall to be treated in this way.

Conclusions

The financial services industry cannot claim to be surprised to see the FSA flexing its product intervention muscles, we all knew it was coming after the publication of the Product Intervention DP and the trumpeting of this new 'tool' by government. Those who track the FSA, OFT, FOS Co-ordination Committee meetings will have known that PPP were very definitely on the regulators' watch lists. Nevertheless, the publication of this consultation does demonstrate the end-to-end approach the FSA is now taking to product risk and although the guidance is specific to PPP, firms should consider the potential for read across to other regulated products.

In terms of what the CP says, the FSA proposals around focusing on a target market could cause some consumers to be excluded from protection they might otherwise benefit from. The FSA should allow some degree of flexibility. The challenges around exclusions and waiting/exclusion periods will directly affect the risk associated with PPP products and coupled with the proposals around cancellation and pro rata refunds could result in some forms of protection becoming too risky from the providers' perspective and/or too expensive for consumers as providers adjust their prices to reflect an increased level of risk. There needs to be more balance. In its current form the proposed guidance risks causing the PPP market to contract, driving out providers and driving up prices. This will be bad for consumers as well as for PPP providers, as consumers most in need of protection may struggle to find protection they are eligible for and/or which they can afford.

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Quite apart from this, the FSA have hinted they may be considering revisiting the question of whether or not payment/debt waiver and debt freeze are in fact insurance products. This follows complaints by insurers that providers of non-insurance PPP such as these have an unfair advantage commercially as they are not restricted by the ICOB Rules. This will create more uncertainty for PPP providers.

With regard to the proposed OFT guidance, whilst it is useful to understand how the OFT interprets the Consumer Credit Act, it is significant that the OFT have once again included bold statements of their interpretation of the Consumer Credit Act post CCD. We saw this in the OFT's recently published revised debt collection guidance where they included very specific views around the application of s55A in the context of continuous payment authority clauses. Of course only the courts can finally decide upon questions of interpretation and the guidance is only that, guidance, which is not binding.

However, few lenders will find comfort in that. The bold statements do not always withstand close scrutiny though and it is to be hoped that the final guidance will provide much needed clarification.

Next steps

The regulators indicate that they will continue to monitor developments in the market and that they will seek to identify further areas where joint working may be beneficial. As a result further guidance and, the paper indicates, in the case of FSA regulated products, detailed rules may follow.

Firms and businesses engaged in the design and sale of PPP should review current strategies, practices and procedures against what is proposed in the guidance consultation. PPP providers should also review their commercial arrangements with third party distributors and remuneration/incentive policies with agents and sales staff.

The consultation closed for responses on 13 January and final guidance is expected in the first half of 2012. A summary of responses will be published at that time.

Contact

David Heffron

Partner

☎ 0113 209 2390

✉ david.heffron@addleshawgoddard.com

Adam Bennett

Partner

☎ 0113 209 2028

✉ adam.bennett@addleshawgoddard.com

Katie Osborn

Managing Associate

☎ 0207 160 3444

✉ katie.osborn@addleshawgoddard.com

Karen Brown

Professional Support Lawyer

☎ 0207 160 3346

✉ karen.brown@addleshawgoddard.com

Amanda Hulme

Partner

☎ 0207 880 5853

✉ amanda.hulme@addleshawgoddard.com

Rosanna Bryant

Legal Director

☎ 0113 209 2048

✉ rosanna.bryant@addleshawgoddard.com

Jayne Bennett

Managing Associate

☎ 0113 209 2228

✉ jayne.bennett@addleshawgoddard.com

Rebecca Rogers

Professional Support Lawyer

☎ 0113 209 2158

✉ rebecca.rogers@addleshawgoddard.com

ADDLESHAW GODDARD

Paul Harris

Associate

☎ 0207 160 3445

✉ paul.harris@addleshawgoddard.com

Faye Livingstone

Associate

☎ 0113 209 7576

✉ faye.livingstone@addleshawgoddard.com

Sonia Marrow

Associate

☎ 0113 209 7738

✉ sonia.marrow@addleshawgoddard.com

Katie Ward

Associate

☎ 0113 209 2110

✉ katie.ward@addleshawgoddard.com

Funmi Olufunwa

Associate

☎ 0207 880 5756

✉ funmi.olufunwa@addleshawgoddard.com

Harriet Loukes

Associate

☎ 0113 209 4936

✉ harriet.loukes@addleshawgoddard.com

Sarah Madden

Associate

☎ 0207 160 3388

✉ sarah.madden@addleshawgoddard.com

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Addleshaw Goddard LLP
Milton Gate
60 Chiswell Street
London EC1Y 4AG
DX 47 London
Tel: +44 (0)20 7606 8855
Fax: +44 (0)20 7606 4390

Sovereign House
Sovereign Street
Leeds LS1 1HQ
DX 12004 Leeds
Tel: +44 (0)113 209 2000
Fax: +44 (0)113 209 2060

100 Barbirolli Square
Manchester M2 3AB
DX 14301 Manchester
Tel: +44 (0)161 934 6000
Fax: +44 (0)161 934 6060