FINANCIAL REGULATOR
Rialtóir Airgeadais

PO BOX NO 9138
College Green
Dublin 2
T +353 1 224 4000
F +353 1 671 6561

2 February 2010

Re: Suitability of Investment Products Sold to Older Consumers

Dear «Greeting»,

The Financial Regulator conducted an examination of selected credit institutions ('firms') and life insurance firms ('firms') which commenced in December 2008 and was conducted throughout 2009, specifically reviewing the suitability of investment products sold to older consumers. During 2009 it was decided to extend this examination to include investment and stockbroking firms in order to get a comprehensive overview across the industry. The outcome of this exercise is the subject of a separate communication to investment and stockbroking firms. As part of this four part examination, a mystery shopping exercise was also conducted to assess how credit institutions[1] are interacting with older customers regarding the sales process for investment products. The purpose of this letter is to provide both industries with feedback in relation to the findings from this exercise. A number of compliance issues were identified during the inspections and are being addressed specifically with the firms concerned. The Financial Regulator requests that you consider the issues raised below in the context of your firm and incorporate them into your firm's procedures as appropriate.

1. Definition of older consumer

[1] Fourteen mystery shopping visits were carried out in a number of credit institutions in August 2009. These were undertaken by mystery shoppers aged over 71, seeking advice on a lump sum to invest, having no previous investment experience. The mystery shopping was carried out by a third party appointed by the Financial Regulator. The Financial Regulator has not carried out any testing of the research carried out by the appointed third party.

On 13 October 2006 the Financial Regulator wrote to credit institutions and life insurance firms further to its Sales Process Review and advised firms that they needed to have a practical definition for older customers and that 60 years of age was a useful benchmark. More recently the Consumer Director issued an industry letter on 18 June 2008 in relation to the mis-selling of investment products. This letter again highlighted the need for firms to have a practical definition for older customers. The Financial Regulator again suggested 60 as a useful benchmark. Despite this it was noted during the inspections that a number of firms still do not have a definition of an older customer. The procedures used by firms when dealing with older customers should be updated where appropriate as the Financial Regulator expects firms to have robust and fair procedures for dealing with older customers.

2. Knowing the Customer

During the inspections, the Financial Regulator noted instances where basic client information such as income and assets/liabilities were not recorded on the fact finding documentation. The Code requires that before providing a product or service to a consumer, a regulated entity must gather and record sufficient information from the consumer to enable it to provide a recommendation or a product or service appropriate to that consumer. While the recording of supplementary information is not mandatory, recording as much information as possible aids the sales process and in general provides better evidence of compliance. The level of information gathered should be appropriate to the nature and complexity of the product or service being sought by the consumer, but must be to a level that allows the regulated entity to provide a professional service.

The gathering and recording of information was tested as part of the mystery shopping exercise carried out, with the results detailed as follows:

- in six of the fourteen mystery shops, products were discussed before conducting a review of the mystery shopper's personal circumstances;
- from the mystery shoppers' experience, it would appear that all of the firms explained the purpose of the factfind. However, it appeared that only three mystery shops made a reference to completing a factfind during the interview process;
- notwithstanding the previous finding, from the mystery shoppers' experience, it would appear that regardless of the low number of mystery shoppers that were aware of a formal factfind taking place, nine of the mystery shops did indicate that the firms recorded key personal and financial information during the interview process undertaken; and
- eleven of the mystery shoppers were asked for their date of birth.

The Financial Regulator reminds firms of the requirements of the Code with regard to knowing your customer and gathering information to be cognisant of the findings of the mystery shopping exercise, particularly with regard to the recording of information and the discussion of products before reviewing a customer's personal circumstances.

3. Statements of Suitability

Some statements of suitability reviewed during the inspections were generic in nature. The Financial Regulator requires that firms prepare and issue consumer-specific statements of suitability. The Consumer Protection Code requires that the written statement of suitability provided to a consumer sets out the reason why a product or service offered to a consumer is considered to be suitable to ***that*** consumer. Therefore statements of suitability should relate specifically to the needs of that consumer and reflect the advice provided to the consumer at face-to-face meetings. The Financial Regulator recommends that statements of suitability should, in addition to setting out the reasons as to why the product is suitable, also include details of restrictions on withdrawals/encashments, any potential impact on the customer's estate in the event of death, early exit charges that may apply and details on the risk profile of the consumer and how the product recommended matches this profile.

4. Classification of Investment Risk

The Financial Regulator expects firms to reconsider how they classify investment risk. Firms must ensure that the customer's attitude to risk corresponds with their individual profile and that customers are recommended a product in a suitable risk category. Firms should be careful that terms for investment risk are well understood and are not subject to misinterpretation by consumers. In particular, firms should be careful about the designation "low risk" as some customers may interpret this to mean "no risk".

Risk and attitude to risk were a key focus of the mystery shopping visits carried out and the findings indicate that some improvement is necessary in this area. The following are the findings from this aspect of the mystery shopping exercise:

- nine of the fourteen mystery shoppers were asked which risk category they felt they belonged. However, out of these, only six considered the concept of attitude to risk was explained clearly;
- three mystery shoppers were asked if they understood the different risk categories;
- six of the fourteen mystery shoppers considered that risk versus return was explained in relation to each of the different risk categories; and
- in less than half of the mystery shops (six) were the risk categories of the investment products that were discussed in the interview process outlined.

However, it should be noted that information gathered through post visit interviews with the mystery shoppers indicated that risk and attitudes to risk may not have been discussed in detail because the firms made an automatic assumption of the risk profile that best fit based upon the mystery shopper's age. The Financial Regulator would consider that firms should be cognisant of this in their dealings with older customers.

5. Term of Investment Products

Many of the guaranteed products sold are only guaranteed on a set date. In a falling investment market any encashments before this date have the potential to reduce the value of the guarantee. In addition, such products are often subjected to early encashment penalties which further erode the encashment value.

The Financial Regulator recommends that sellers of such products ensure that the customer can afford to leave his/her funds invested for the period of time required under the guarantee. Firms should ensure that the customer has sufficient emergency funds in place so that they would not have to draw on the product before the maturity of the product. As the customer gets older this issue needs greater consideration on the part of the adviser.

The mystery shopping exercise indicated that discussions took place in at least four instances concerning products which could not be accessed for periods ranging up to 6 years.

6. Maturity of Investment Products and Capital Guarantees

The Financial Regulator recommends that firms ensure that, where the investment product has a fixed term or a specific guarantee term, that they contact the customer, giving the customer at least one month's notice before the guarantee term runs out, with information on the options that are available to them. Customers should never be placed in a position that they will lose their capital secure guarantee on their investment by the failings of firms to remind the customer of the limited guarantee period.

Where a product has capital guarantees on a specific date, firms should seek and obtain a positive confirmation from customers for their investment to be invested in a non-guaranteed investment option after the guarantee date.

7. Level of Emergency Funds

The Financial Regulator recommends that firms refer to the need for an emergency fund in their fact find and statements of suitability, to ensure that customers have sufficient disposable funds in the event of an emergency. Customers who fall under the definition of older customers may have a specific need for access to an emergency fund that would cover any expenses that may occur such as medical and long term care.

Firms should provide guidance to customers on the level of emergency funds that may be required, taking into consideration their age, other investments, assets and potential income streams as part of the factfind process. It is important that the customer does not invest all their liquid assets in a product where they are unable to access their money for a fixed term or without incurring a financial penalty.

The need for access to emergency funds and what level this should be were focussed on as part of the mystery shopping exercise undertaken. The results of the mystery shopping exercise in relation to this aspect of the sales process were positive and indicated that:

- the need to have access to emergency funds was discussed in all fourteen mystery shops;
- in eleven of the mystery shops discussions were held on how much should be allocated as emergency funds;
- thirteen of the mystery shoppers were asked questions regarding how long they would be willing to go without access to their funds; and
- twelve of the fourteen mystery shoppers were asked to indicate how much they wished to invest over the medium and long term.

8. Third party presence at meeting

The Financial Regulator recognises that some customers who fall within the definition of an older client are experienced investors and may not want or require a third party at the sales meeting. However, the Financial Regulator recommends that firms should always offer older customers the option of having a third party present at the sales meeting. This option would be particularly useful in cases where the customer has no prior investment experience.

From the mystery shopping exercise carried out, just over half (eight of fourteen) of the mystery shoppers were asked if they wished to have a third party present.

9. Post-sale compliance monitoring

It was noted during the inspections that some firms carry out post-sale monitoring on the sale of their products. The post-sale monitoring and verification methods vary across the industry. Some firms have comprehensive and detailed practices which relate specifically to the sale of investment products to older customers while other firms carry out monitoring on a random and generic basis.

The Financial Regulator would encourage all firms to implement product specific post-sale monitoring for all sales of investment products especially in cases where the customer falls under the definition for older customers. This type of monitoring is a useful tool to ascertain whether the older customer understood the features of the product and associated risks. In particular, that the customer had sufficient emergency funds, that their funds might be inaccessible for the term of the product or that the value of their investment may not be guaranteed if they encashed their policy before a specified date.

10. Internal controls and training

The Financial Regulator noted that some firms inspected have internal controls surrounding the sales of investment products. The Financial Regulator expects all firms to have robust controls around the sales process, particularly in relation to sales to older customers. The following were noted as being good examples of internal controls and positive practices:

- the compliance function conducts an audit on files where investment products are sold to consumers. In order to pass the audit the files have to achieve a certain standard score. If during the course of the 'knowing the consumer' process the advisor fails, for example to gather sufficient information on the consumer's attitude to risk, the file would fail the audit;
- as much of the sales process is conducted verbally and therefore may not be recorded, the Financial Regulator noted that mystery shopping is used as a method of ensuring that the firm's sales staff comply with the various Code requirements. This method of verifying compliance can also ensure that the consumer is receiving full and comprehensive information on the product recommended in order for them to make an informed decision and that items such as emergency funds are comprehensively discussed with the consumer;
- certain firms review all findings of the Financial Services Ombudsman in relation to sales to older customers and consider what enhancements may be required to their sales process based on this information; and
- one firm only offers older customers capital secure products unless they specifically request otherwise.

From the inspections carried out, the Financial Regulator considered that training provided to advisors focussed more on what needs to be done to meet regulatory requirements as opposed to understanding why these requirements are there in the first place. The Financial Regulator requests that firms consider this issue as part of their staff training programme.

11. Mystery Shopping - additional issues

Set out below are a number of additional findings specifically arising from the mystery shopping exercise that should be considered by firms:

- the Code requires that a regulated entity must provide each consumer with a copy of its Terms of Business prior to providing the first service to that consumer. In only three of the fourteen mystery shops were Terms of Business provided;
- all of the mystery shops considered that they had been provided with a product recommendation. This should be considered in the context of the findings from the factfind process, where only nine of the fourteen mystery shops recording key personal and financial information during the interview process;
- in seven of the mystery shops, it was explained to the mystery shoppers that the value of investments may go up as well as down; Twelve of the mystery shops made some reference to the mystery shoppers regarding the capital guarantee of products; and
- of the products recommended, two products could only be accessed on-line. Firms must consider the appropriateness of such products as access to computer based technology would be required.

Should you have any queries in relation to the contents of this letter, please contact;

- Joe Morley at joe.morley@financialregulator.ie, for insurance firms;
- Patricia Fogarty at patricia.fogarty@financialregulator.ie, for credit institutions; and
- Mary McEvoy at mary.mcevoy@financialregulator.ie, where the query relates to mystery shopping.

Yours sincerely,

Fiona McMahon

Fiona McMahon
Deputy Head of Consumer Protection Codes