

Discussion Paper on the Regulation of Christmas (Hamper) Saving Schemes

December 2006

About the Scottish Consumer Council

The Scottish Consumer Council (SCC) was set up by government in 1975. Our purpose is to promote the interests of consumers in Scotland, with particular regard to those people who experience disadvantage in society. While producers of goods and services are usually well-organised and articulate when protecting their own interests, individual consumers very often are not. The people whose interests we represent are consumers of all kinds: they may be patients, tenants, parents, solicitors' clients, public transport users, or simply shoppers in a supermarket.

Consumers benefit from efficient and effective services in the public and private sectors. Service-providers benefit from discriminating consumers. A balanced partnership between the two is essential and the SCC seeks to develop this partnership by:

carrying out research into consumer issues and concerns;

informing key policy and decision-makers about consumer concerns and issues;

influencing key policy and decision-making processes;

informing and raising awareness among consumers.

The SCC is part of the National Consumer Council (NCC) and is sponsored by the Department of Trade and Industry. The SCC's Chairman and Council members are appointed by the Secretary of State for Trade and Industry, in consultation with the First Minister. Martyn Evans, the SCC's Director, leads the staff team.

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The SCC assesses the consumer perspective in any situation by analysing the position of consumers against a set of consumer principles.

These are:

ACCESS

Can consumers actually get the goods or services they need or want?

CHOICE

Can consumers affect the way the goods and services are provided through their own choice?

INFORMATION

Do consumers have the information they need, presented in the way they want, to make informed choices?

REDRESS

If something goes wrong, can it be put right?

SAFETY

Are standards as high as they can reasonably be?

FAIRNESS

Are consumers subject to arbitrary discrimination for reasons unconnected with their characteristics as consumers?

REPRESENTATION

If consumers cannot affect what is provided through their own choices, are there other effective means for their views to be represented?

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Introduction

On reading the first press reports about the collapse of the Farepak Christmas savings scheme on 17 October 2006, the Scottish Consumer Council wrote that day to the Chief Executive of the Office of Fair Trading and the Chairman of the Financial Services Authority's consumer panel, expressing our concern at the apparent lack of regulation of such companies, and asking whether their respective organisations had a view about the issue.

Following the announcement on 8 November that the Minister for Consumer Affairs had asked the OFT, the FSA and the Department of Trade and Industry (DTI) to look at the regulatory framework within which Farepak operated, and report back to him, we decided to seek advice on the possible regulatory options available. We commissioned Professor Frank Stephen, Professor of Regulation in the School of Law at the University of Manchester, to write a paper considering, from the consumer perspective, the possible regulatory options – whether formal or informal - which might be appropriate to regulate such schemes.

The paper does not seek to address the issue of improved access to alternative appropriate and efficient savings schemes. There is a wide range of literature on this matter.

The remainder of this paper was written by Professor Stephen, to whom we are very grateful for carrying out this work.

Background

The recent collapse of the Christmas savings company Farepak and the attendant press coverage has focused considerable attention on the lack of regulation of such companies. They are not regulated by either the Financial Services Authority (FSA) or the Office of Fair Trading (OFT). Much of the attention to date has focussed on helping those affected by the collapse of Farepak to deal with their immediate financial problems. The Minister for Consumer Affairs has asked the OFT, the FSA and the DTI to look at the regulatory framework within which Farepak operated and to report back to him on the issues which this consideration raises.

This paper sets out some of the key issues which have to be addressed before an appropriate regulatory framework can be identified.

Responses to the Issue of Regulation

Responses to the collapse which have addressed the regulatory issues have focused on the 'savings' dimension of organisations such as Farepak suggesting that this requires that they be regulated by the Financial Services Authority (FSA). Such an approach has an initial attractiveness. Whilst a Christmas Hamper¹ is not

¹ In this paper 'Christmas Hamper' is used as shorthand to indicate Christmas hamper, saving and voucher schemes as operated by Farepak and other members of the Hamper Industry Trade Association.

a 'financial product' this business model involves a financial outlay over a period of time in return for something to be received in the future. This has many of the characteristics of an 'investment product', except that the future return is in the form of a hamper, other physical goods or a voucher redeemable for physical goods in a network of stores. The 'investment' is also, purportedly, risk free (although no interest is paid on the sum invested). On this view, it could be argued that these Christmas hamper schemes should be regulated by the FSA.

An alternative view is that Farepak's customers are in no different position to that of any unsecured (consumer) creditor of a retailing company that goes into administration. This can be seen to be a consequence of combining the unpredictability of business conditions with the limited liability of owners of businesses². However, since limited liability, as a form of business organisation, yields many social benefits which outweigh the cost associated with business failure these costs are worth bearing from a social point of view. Under this view, Farepak's customers are the unfortunate bearers of these costs in this instance.

Neither of these analyses is valid. Both neglect the hybrid nature of this business model.

Hybrid Nature of the Business Model

Christmas Hamper saving schemes combine catalogue and voucher based retailing with community/family/workplace network based savings mechanisms for, predominantly, women on low incomes with limited access to mainstream savings institutions. The hybrid nature of this model renders both an FSA-type regulatory solution and the 'unsecured creditors' analysis inappropriate.

FSA-style regulation of such organisations would probably result in the replacement of the family/community/workplace based collection system with a more professional and regulated system, which would raise the cost of operating the system and might lead to its collapse. Moving to a professional collection system might also destroy much of the social value of such savings schemes.

This social value derives from the social circumstances of the customers of such Christmas Hamper schemes. It is these social circumstances which make these consumers among the least able to bear the costs of such business failure. Thus the case for regulating this market is grounded, in part, on the nature of its customers. They are predominantly women whose family income is low and who have limited access to alternative means of saving. The sums of money saved through Christmas Hamper schemes represent these individuals' only (or predominant) savings. Thus the first basis for regulation is the disadvantaged position of many of the savers.

² Company directors have a range of duties under the Companies Act 2006 (which comes into force fully in October 2008). These duties have been codified under the Act. It may be appropriate to give Directors additional duties where they run companies of the hybrid nature discussed below.

The saving is made possible through the support of the family/community/workplace network. It is a modern development of the traditional Scottish working class 'menage'³ which had its counterparts elsewhere in the UK and throughout the world⁴. FSA-type regulation, by requiring professionalisation of the collection process, may destroy the support mechanism which currently underpins the system.

It might also destroy the trust between saver and collector that derives from the family/community/workplace collector network. Thus even if compliance costs were not high, the change in collectors that might follow on from regulation might reduce participation in the system by introducing moral hazard, which is low under the current system. The family/community/workplace based network characteristic of the collection system may enhance trust in the security of the current collection system. Collection by strangers might undermine such trust and reduce participation in the scheme.

On the other hand, the savings scheme nature of this business format probably exposes its customers to greater risk of loss than consumers who make full payment (or pay a deposit) ahead of delivery of goods. Typically under a Christmas Hamper scheme customers will begin payments up to 10 months before delivery of the goods is to be made. Thus they are exposed to the risk of business failure over a longer period than customers of other types of retailer.

The second ground for considering regulation is, therefore, the length of time the customers are exposed to business failure of the hamper company. This further differentiates customers in Christmas hamper schemes from the generality of unsecured consumer creditors. In addition, the lengthy period over which payments are made into the scheme is also the attraction of it to the customers.⁵ Small weekly contributions built up over a 45-week period accumulate to a relatively large sum to be spent for Christmas⁶.

Furthermore, savings schemes customers are probably less likely to have the protection afforded by paying by credit/visa debit card, which other unsecured consumer creditors might have, where the sum paid is over £100.

Alternatives to FSA-style Regulation

Public policy considerations have resulted in various forms of regulation designed to protect those who make financial outlays such as deposits or payment contributions which might be at risk. Some require such funds to be kept in a separate fund. Others involve an industry fund.

³ Chambers 20th Century Dictionary: 'ménage :..... (Scot.) benefit society'.

⁴ For example the susu of Ghana and similar arrangements elsewhere in sub-Saharan Africa.

⁵ The 'value for money' of these schemes is an important issue, and some form of clear 'wealth warning' may be appropriate, but evidence from other markets does not indicate that this consumer information is particularly effective in tackling information asymmetry.

⁶ For example, weekly payments of £2.20 over 45 weeks generate a High Street voucher with a face value of £100.

An example of a regulatory intervention utilising an industry fund is the Pension Protection Fund brought into force by the Pensions Act 2004. All company pension schemes are required under this legislation to contribute to a Fund to protect company pensioners should their former employer become insolvent and the pension scheme be unable to meet payment of benefits equivalent to those under the Fund.

This is in effect a form of insurance which is made possible by the large number of company pension schemes, relatively few of which become insolvent in any year. Similar schemes exist in the travel and holiday industries. However, the small number of Christmas Hamper companies makes such a scheme inappropriate since it would require very large contributions from each company⁷. A direct insurance scheme has the problem that companies cannot insure against actions which only they can take. This is adverse selection.

The Housing Act 2004 provides for a tenants' deposit protection scheme, which is compulsory for all landlords in England and Wales⁸. Such deposit protection will be provided either by placing the deposit in a secure fund or by the landlord taking out insurance.

However, such deposits are not payments for the services provided by the landlord but security against non-payment of rent or damage being done to the property. It cannot then be seen as part of the landlord's working capital. Similarly, solicitors are required to keep moneys paid by clients in advance of purchase of property or payment due to clients from sale of property in client accounts which are separate from the firm's business accounts. These are not payments to the solicitors for services but money held by solicitors on behalf of clients to speed up transactions between clients and third parties.

Payments made by Christmas Hamper scheme customers differ from both of these, as they are payments towards the actual purchase of goods from the hamper company and thus, legitimately, might be seen as working capital of the retailer. Consequently, there would seem to be a need for such funds to be usable by the company in the conduct of their business. But the nature of the customer savings part of the business model would appear to give the companies access to these funds well in advance of their need for them. Yet this is what appears to expose the customers to the risk of failure on the part of the company.

⁷ The Hamper Industry Trade Association has only 4 remaining member companies, following the collapse of Farepak. The Association requires its members to lodge a £100,000 bond. However, this provides almost no protection to consumers, given the small proportion of any member's sales that this represents. It is also not available to unsecured creditors as it is a 'good faith' gesture for incoming business according to the CHTA to prevent easy entry to the trade association. The SCC has made an official complaint to the OFT regarding what they see as misleading claims for this bond by the HITA.

⁸ At the time of writing this scheme has not yet come into operation. There is also provision under the Housing (Scotland) Act 2005 for such a deposit scheme to be introduced in Scotland, but this is unlikely to be in place for some time.

The OFT runs an approved Code of Practice scheme.⁹ This system of self-regulation set within core principles established by the OFT has some general attractions in allowing consumers to identify fair dealing businesses, but it cannot deal with the key questions of risk discussed above.¹⁰

Financial Structure and Requirements of Christmas Hamper Companies

Further analysis of the means by which customers of Christmas Hamper companies may be protected against the loss of their savings requires a detailed analysis of the financial model underlying the operation of the companies themselves.

The companies appear to receive a steady inflow of payments in the 10-month period prior to the point at which they are required to deliver goods and vouchers to their customers. Their outlays for much of this period must be limited to the costs of catalogue printing and distribution and administering the receipt of customer payments from collectors. At some stage they will require to enter into contracts with the suppliers of physical goods and vouchers and make payments towards their purchase.

It is to be presumed that the costs to the hamper companies of these goods and vouchers is significantly below the catalogue price of the goods, and the redemption value of the vouchers generates a profit margin for the company. The company also presumably gains a return in the form of interest (or reduced borrowing) on consumer payments in excess of the sums required for the aforementioned activities. Payment of commissions to, or discounts on purchases of, collectors will also reduce the company's margin.

The regulatory question to be asked here is whether it is possible to safeguard at least part of the customers' payments without reducing the hamper companies' profits below that which is necessary to make remaining in this line of business attractive to them.

Conclusions

The analysis of the regulatory options for the Christmas Hamper industry suggests that:

⁹ The aim of the Consumer Codes Approval Scheme is to promote and safeguard consumers' interests by helping consumers identify better businesses and to encourage businesses to raise their standards of customer service.

The scheme consists of two co-dependent stages. Code sponsors complete Stage One by making a promise that their code meets the core criteria in principle. They can then move on to Stage Two where they have to demonstrate, with evidence, that their codes deliver on that initial promise. OFT endorsement is given, and promotion to the consumer begins, once the burden of proof has been met by the code sponsor. (Source: Office of Fair Trading Website)

¹⁰ The SCC has made a formal complaint to the OFT over what it sees as misleading statements by some hamper companies that they have signed up to an OFT approved Code of Practice.

- The customers of Christmas Hamper companies are a vulnerable sector of the community who need to be protected
- The community/family/workplace network based system is of social value
- An FSA-type regulatory system is likely to have high compliance costs and is unlikely to be compatible with a community/family/workplace network based collection system
- Any regulatory system needs to recognise that customer savings in this hybrid business format generate working capital for the hamper companies
- Further development of the regulatory options requires a detailed empirical analysis of the financial model underlying hamper company operations in order to establish whether it is feasible for a portion of customers' savings to be held in a protected fund until payment is required by retailers and manufacturers of catalogue items.

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