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PROTECT, GROW, THRIVE

CONSUMER DUTY WHITE PAPER

Preparing for tomorrow, today

January 2022

INTRODUCTION

The Consumer Duty has been heralded as a true step-change for financial services regulation and for many, if not all firms, it represents a significant shift.

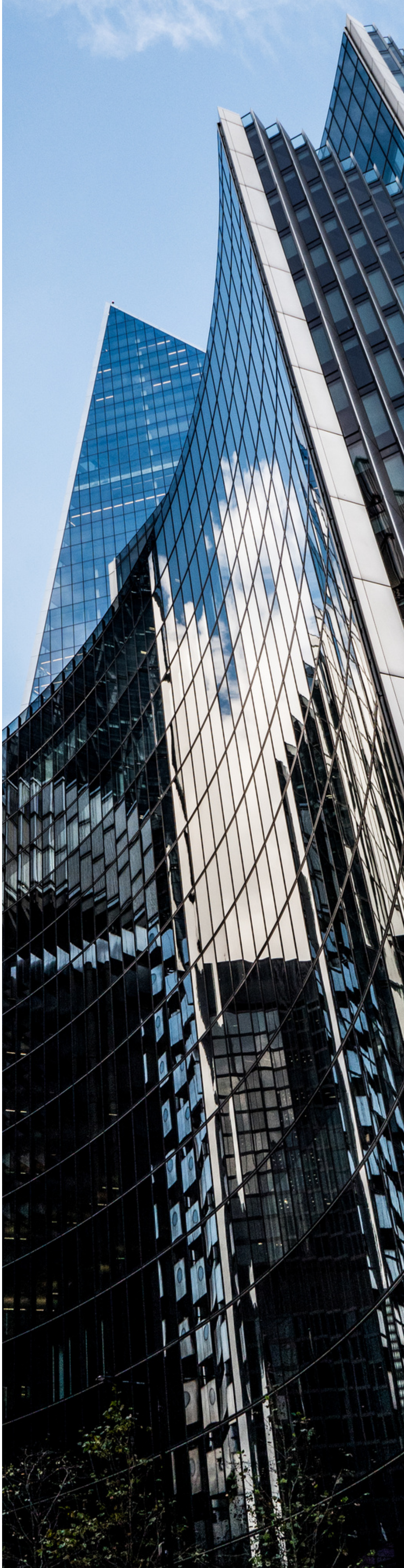
It comprises a **new Consumer Principle**, a comprehensive suite of **cross-cutting rules** and a clear **focus on outcomes** which together set clearer, higher expectations of firms across the product lifecycle.

It will require material changes for both manufacturers and distributors with the expectation that the focus on the delivery of good outcomes is at the centre of firms' strategy and business objectives.

There is a clear mandate from Parliament to make this change and the timetable, as set out, will be a challenge for firms.

Our goal through this paper, and beyond, is to support firms navigate this significant regulatory initiative, through early engagement, impact analysis and execution.

There is much for firms to do, preparing for tomorrow, today.



OVERVIEW

The FCA is consulting for a second time on its wide-ranging regulatory overhaul and evolution of outcomes-based regulation.

In May 2021, the regulator first published **'Consultation Paper 21/13: A new Consumer Duty' (CP21/13)** and the paper first mooted the introduction of a so-called "Consumer Duty" for financial services firms that dealt with end consumers.

The new duty proposed three specific components, namely:

1. A new **Consumer Principle** (Principle 12), which would be a new addition to the FCA's Principles for Businesses and be a natural extension of Principle 6 – namely that 'a firm must pay due regard to the interests of its customers and treat them fairly'.
2. A series of **cross-cutting rules** designed to support the new initiative.
3. **Four outcomes** setting out more detailed expectations for firms.

Through the new duty, which has been reported as one of the biggest advancements for consumers in more than 20 years, the FCA aims to "set a higher standard of consumer protection in retail financial markets, where firms compete vigorously in the interests of consumers." The FCA also wants to "drive a healthy and successful financial services system in which firms can thrive and consumers can make informed choices about financial products and services."

The FCA does not agree that they can meet their objective without new rules. The proposed new Principle - 'A firm must act to deliver good outcomes for retail customers' and the associated cross-cutting rules represent a clear shift in approach and a significant 'raising of the bar'.

The Consumer Duty is the latest stage in this evolution – and as will be outlined within this paper, the regulator is focused increasingly on behaviour, cultures and principles at play and is taking a much more active and open look at the wider value which firms deliver to customers – including more of a focus on product governance, pricing, communications, ongoing support and associated factors which underpin a competitive marketplace.

WHATS THE AIM?

Consumers continue to suffer harm and they also report a lack of trust in the financial services industry.

The Consumer Duty aims to bring about a fairer, consumer-focused, level playing field to the industry, which should result in less need for the FCA to intervene after things go wrong - reducing the extent to which consumers suffer harm.

In the FCA's 2020 Financial Lives survey, only 10% of consumers 'strongly agreed' that they had confidence in the UK financial services industry with a further 32% 'slightly agreeing'. Only 35% of respondents agreed that firms are honest and transparent in their dealing with them.

If the proposals go ahead, the regulator will be measuring whether consumers experience improvements across the following four outcomes:

OUTCOME 1 - FAIR VALUE

With a corresponding outcome relating to fair price and value

OUTCOME 2 - PRODUCTS AND SERVICES

With a corresponding outcome relating to product governance

OUTCOME 3 - TREATMENT

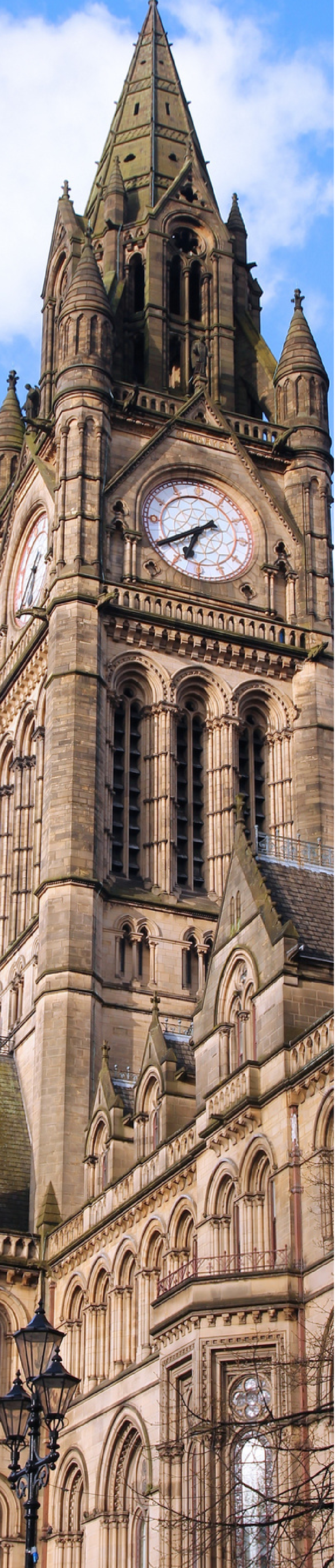
With a corresponding outcome relating to customer support

OUTCOME 4 - CONFIDENCE

With a corresponding outcome relating to customer understanding

The proposed Consumer Duty comprises a new principle, new rules and supporting guidance. The new Consumer Principle will replace Principles 6 and 7 for retail business and require firms to act to deliver good outcomes for retail customers.

The new cross-cutting rules will set out how firms should act to deliver good outcomes and therefore provide greater clarity on how to meet the new Principle.



The cross-cutting rules require firms to exhibit and evidence the following behaviours:

RULE 1 - ACT IN GOOD FAITH

RULE 2 - AVOID FORESEEABLE HARM

RULE 3 - ENABLE AND SUPPORT RETAIL CUSTOMERS TO PURSUE THEIR FINANCIAL OBJECTIVES

Under these proposals, firms will have a duty to make sure; their customers are receiving fair value and fair products, that they understand how to use their products/services and receive the support they need to do so.

Firms will also have to consider the needs of their customers – including those in vulnerable circumstances – and how they behave, at every stage of the product/service life cycle, extending their focus beyond ensuring narrow compliance with specific rules, to also focus on delivering good outcomes for customers.

The regulator has stated that the new rules will be backed up by assertive supervisory and enforcement action and that the Consumer Duty will be an integral part of their regulatory approach and mindset, from authorisation to supervision and enforcement. Sheldon Mills, Executive Director of Consumers and Competition, at the FCA, said **"...we expect firms to step up and put consumers at the heart of what they do and we'll be holding senior managers accountable if they do not."**

The duty will also help create an environment for healthy competition between firms, encouraging them to be innovative in developing products and services that meet consumers' needs.

Senior managers will need to ensure that they are producing good outcomes and that they have taken reasonable steps to meet the proposals. The interlinkage between the Consumer Duty and the Senior Managers & Certification Regime is significant as the SM&CR establishes clear senior management responsibility for compliance with the requirements and standards of the regulatory system.

THE RULES

RULE 1. ACTING IN GOOD FAITH

The FCA has explained how this behaviour reflects a standard of conduct characterised by honesty, fair and open dealing and consistency.

This behaviour is intended to take account of the asymmetry in the knowledge between firms and customers and the regulator has clarified that these behaviours are not intended to introduce a fiduciary duty between the firm and its customers that does not already exist.

Firms should ultimately consider how they engage with customers, beyond simply reviewing policy and process to ensure that good outcomes are supported. In our experience, acting in good faith has several levers.

Acting in good faith has been described by the courts as 'playing fair', 'coming clean' or 'putting one's cards face upwards on the table.'

It's a complex area – but in our view, firms should consider how they can evidence:

FAIRNESS– how can you ensure that the customer receives a fair outcome. For example, is it fair that new customers may be treated differently to longstanding customers?

HONESTY – a duty to act honestly is implicit in all areas of financial services. As an organisation, how do you ensure your sales practices, communications and ongoing servicing embed honesty? For example, do you disclose all commission arrangements with third parties to prospective customers?

REASONABLENESS – although not specifically defined, firms should consider how they can evidence reasonableness. For example, would an organisation consider it reasonable to assume that a lack of a response from a customer means that a complaint should be closed?

RULE 2. AVOIDING FORESEEABLE HARM

The regulator has provided examples of what would not be consistent with this behaviour – of avoiding foreseeable harm. For example, the FCA specifically states that firms should not seek to exploit customers inherent behavioural biases or lack of knowledge with regards to product design and servicing.

The regulator has noted that this will not mean that organisations should be expected to prevent all bad outcomes, however, reasonable steps should be taken to avoid foreseeable harm.

In this context – **'reasonable steps'** is considered a particularly high bar to meet and one which has been taken directly from the SM&CR requirements for Senior Management roles.

The requirement to avoid foreseeable harm is expected to be particularly difficult for firms that have a multi-channel approach or have many products. In this instance, firms should consider starting any assessments well in advance of the final rules being published in July 2022.

Firms should specifically consider:

Evidencing a robust approach to product design and distribution, based on empirical evidence of customer needs.

For example, a niche insurance product that has a very low claims frequency and is likely to provide duplicate cover to customers should be reviewed and actioned as it is at high risk of causing foreseeable harm.

Ongoing monitoring of product performance and making tailored interventions where harm may arise.

For example, an investment product which, due to its structure, no longer meets the client's risk appetite should be reviewed as it is at high risk of causing foreseeable harm.

RULE 3. ENABLING AND SUPPORTING RETAIL CUSTOMERS TO PURSUE THEIR FINANCIAL OBJECTIVES

Within the regulator's proposals, there is an acknowledgement that firms have a responsibility to support customers with regards to their decision-making process and pursuit of their end objectives, based on their knowledge of the customer and their individual circumstances.

This again seems to point to the regulator attempting to address the potential asymmetry in knowledge between firm and customer.

It also seeks to ensure a personalised experience for customers who are not 'execution only' and ensure that customers who may have a vulnerability or require tailored support, receive an expected level of service from firms.

Firms should consider:

Whether their product offering is appropriate for the customer or whether alternative products may be more appropriate.
For example, should a firm with multiple credit offerings prompt customers to change onto a more competitive internal product offering which meets their specific long-term needs?

How a product distribution strategy is supporting the customer's financial objectives.
For example, a CFD provider who is gaining market share and revenue through onboarding unsophisticated retail investors through social media channels, leading to substantive losses, is unlikely to meet customers financial objectives.

THE CONSUMER DUTY SETS HIGHER EXPECTATIONS OF FIRMS DRIVING A CULTURAL RESET WHICH LEADS TO ENHANCED CONFIDENCE IN FINANCIAL MARKETS AND FUTURE GAINS FROM INNOVATION

THE OUTCOMES

Firms should be able to evidence the four outcomes as noted within the consultation paper, to ensure the key underpinning elements of the Consumer Duty stand up to scrutiny.

OUTCOME 1. PRODUCTS AND SERVICES

Regulated firms will be well accustomed to the requirements around the governance of products and services, however, they should now be viewed through the lens of the Consumer Duty and associated rules and outcomes.

The FCA has also distinguished, as part of its consultation response, the different roles which product manufacturers and distributors have within the marketplace.

For **product manufacturers**, the emphasis will be to ensure product approval processes are aligned, the target market is understood and that characteristics of customers (for example, vulnerability) are factored into product design and testing. It is well known that the regulator remains concerned about how firms may sometimes exploit behavioural biases and certain practices (e.g. sludge practices, which provide excessive friction and hinder consumers from taking actions and decisions in their own interest).

Firms should ultimately be able to evidence a suite of management information to show that the product or service is performing as expected within the target market and to evidence the impact it is having on consumers.

For example, a low claims acceptance rate and a high proportion of customer complaints relevant to a product should trigger a review of performance.

For **distributors**, the requirements focus on ensuring that information is received and analysed from the manufacturer and that distribution arrangements are appropriate and are also regularly reviewed to ensure any harm can be mitigated, should it arise.

All firms should consider how they can:

- **Evidence that product governance frameworks are consistent with the expectations under the Consumer Duty**
- **Showcase a two-way flow of information, between manufacturer and distributor, to ensure products and services remain fit for purpose**
- **For manufacturers, ensure that management information (both qualitative and quantitative) are used to satisfy yourself that the distribution channels used are appropriate and meet the higher standards going forward**
- **Continuously assess the target market and ensure that products and services remain fit for purpose, not just at the outset, but for the duration of the client relationship**
- **Evaluate how distribution chains work and ensure that all parties involved are able to understand how each party contributes to serving the end customer**
- **Ensure the design, terms and marketing of products and services meet the ‘clear, fair and not misleading’ test**

OUTCOME 2. PRICE AND VALUE

The FCA has recently taken much more of an interest in product pricing.

We have seen price caps within the High Cost Short Term (HCST), Rent to Own (RTO) and the overdraft marketplace, as well as a real focus on pricing practices within General Insurance – which showed how price walking and aspects of cross-subsidy penalised customers who were likely to be in vulnerable circumstances.

Although the regulator has stressed that they are not a 'price regulator,' many today will question whether, in reality, that is still the case. The second outcome specifically shows the FCA's intent with regards to pricing and this goes beyond simply disclosure, but to the very heart of what constitutes a fair value exchange with customers.

The regulator has stated that they are not mandating that differential pricing should be abolished (where new customers may have different rates to existing customers), but that this should be clear and transparent. The regulator is much clearer around its dim view on opaque pricing practices and exploiting behavioural biases which make switching product or service providers more difficult.

Furthermore, the regulator has rightly acknowledged that firms should not simply view price as the be-all and end-all, and firms should look to evidence a multitude of factors that they believe justify why the customer obtains value through their relationship with the organisation.

Although the regulator will not stipulate detailed requirements for assessment with regards to value, in our experience, the following are key factors that firms should consider:

- **Low use of a product (for example, low levels of interaction, claim frequencies and acceptance)**
- **High commission levels (see Plevin)**
- **Excessive profitability**
- **Overly restrictive terms and barriers**
- **Excessive and/or unjustified exit fees**
- **High standing fees and charges**
- **High pricing complaint volumes**
- **Disconnect between product pricing and absolute performance**
- **Reversion rates which are significantly above introductory rates**

Firms should consider as part of any self-assessment, overlaying characteristics, such as those outlined above for each product against their target market.

More generally, we would advocate that firms look to review their holistic product governance process and ensure that it encapsulates a product value assessment. It is likely given the focus on price and value is relatively new at the regulator, that further discovery exercises will be conducted to understand value in the broadest sense.

Firms should consider planning and look at the read-across from other sectors which have already been impacted, to form an early view on value and pricing within individual product areas. Firms ultimately need to be confident that the pricing of products and services are appropriate and represent a fair value exchange.

OUTCOME 3. CONSUMER UNDERSTANDING

This outcome is very much focused on ensuring firms' communications support and enable consumers to make informed decisions.

Whilst the regulator has placed much emphasis on a firm's marketing activity and financial promotions, firms should consider the product lifecycle and all related aspects of customer communications as part of this outcome.

The FCA has also re-emphasised the need to ensure that behavioural practices are not exploited – for example, sludge practices, which introduce barriers to make it more difficult to switch or leave an organisation.

In our experience, firms should consider the following:

- **How are our communications enabling the customer to make a fair assessment of the underlying products features, risks and benefits?**
- **Are our communications tailored to our target market (e.g. wording and channel choice) and relevant to the sophistication of our customer base? Can they be understood by our average customer?**
- **As an organisation, do we introduce barriers (behavioural or actual) which may prevent a customer from achieving their aim? For example, do we force consumers to complain by letter only or insist on customers calling a central phone line to switch when new products can be purchased online?**
- **How do we monitor customer communications in real-time (e.g. through digital channels)?**
- **Where we have data to suggest customers may not fully understand a product (for example, not reading disclosures online) – how do we intervene as part of the journey?**
- **What management information do we collect around our communications with customers and how have we adapted our communications as a result?**
- **Ultimately, how well do customers understand our products and service and how will we test 'understanding' going forwards?**

With more and more customer journeys originating and taking place online, it is imperative that firms also consider how they evidence customer communications and disclosures as part of the online journey and use insight to support customer interactions.

With data becoming ubiquitous and much more emphasis being placed by firms on new customer origination and targeting through data, the regulator will want to see firms place some of that emphasis on using data to support new and existing customers to receive a good outcome as part of the product lifecycle.

Finally, it is important to note that this outcome is not intended to replace any existing obligations relating to communications with customers or disclosures which are required.

OUTCOME 4. CONSUMER SUPPORT

The FCA has been clear with firms through its consultation that organisations should meet consumers needs, not just at the outset, but throughout the customer journey. Many respondents to the consultation noted that firms all too often focussed on pre-sale and were often under-resourced with regards to ongoing servicing or were unable to support customers at their hour of need.

A good example of this would be for customers who have taken out boiler cover insurance, it seems reasonable for customers to be able to expect a swift call out, especially in winter. However, firms all too often have not capacity planned adequately for colder winters or other unexpected surges, which has frequently left customers, quite literally, out in the cold.

This is a step-change again for organisations. Previously, many market participants would have considered the experience of customers, to be at least, a competitive dynamic on which firms would compete. The regulator is now being quite clear. Firms should ensure that customer service processes do not impact customers – either directly, through a cost outlay, or indirectly, through having to invest significant time and effort to reach the outcome they desire.

The regulator has also been explicit – customers should be able to exit a product or service as easily as they have purchased it. There is a clear steer here around ensuring competitive market dynamics are not distorted by behavioural practices employed by firms. The concern again here, is that consumers who are less able to engage in the market, such as vulnerable customers, are likely to be unfairly impacted by such practices.

Firms should consider the following as part of evidencing this outcome:

- **What are our average response times (e.g. call handling, complaint resolution, call out, onboarding, offboarding, outages) and how does this compare to expectations?**
- **Is our customer journey designed around ensuring customer inertia (e.g. do we introduce barriers to exit)?**
- **How does our cost of acquisition differ from the cost of servicing – is this balance reasonable or skewed too much towards onboarding new customers?**
- **How can customers engage with our organisation – do we limit channel choice or do we adopt an omni-channel approach?**
- **Overall, do we provide support throughout the product life-cycle / customer journey to meet customers needs and expectations?**

HOW TO PREPARE

As reported by the FCA, for many firms, this will require a significant shift in both culture and behaviour, as well as changes to policy, processes, and reporting.

Given the aggressive timetable, we would encourage firms to start planning early, to include:

- **Education** – engaging in the debate, raising awareness and upskilling senior and relevant stakeholders
- **Governance** – determine the appropriate lead within your organisation and the likely resource required (project team, key stakeholders etc)
- **Resource** – set aside dedicated resources for a working group/task force
- **Impact assess** - identify critically affected areas of the business with an initial impact assessment on material workstreams
- **External support** – project management, training, assurance

With the successful implementation of the Consumer Duty likely to stem from the second line, we would recommend Risk and Compliance taking the lead in planning and coordinating the programme of activity, with the first line take a leading role in ensuring successful implementation.

We would also advocate designing multiple workstreams, which follow the customer journey across your organisation and overlay the principles, outcomes and rules outlined within the consultation. By performing outcomes testing at each stage of the customer journey, firms can evidence the extent to which cultural drivers such as senior management engagement, decision making and staff reward structures are delivering good outcomes for customers.

The FCA expects to confirm the final rules by the end of **July 2022** with implementation in **Quarter 3 2022**. For many firms with multiple products, services and distribution models, meeting the deadline for implementation is likely to pose a challenge, particularly given current workforce shortages and other business priorities.

Firms will need to consistently focus on consumer outcomes and put customers in a position where they can make effective decisions. They will also need to assess the extent to which, and how, they are acting to deliver good outcomes both now, and in the future, across the four outcomes. This will include the needs for the senior managers in firms to evidence these and the steps they have taken to meet the proposed requirements and cross-cutting rules. We would encourage firms to be prepared for closer scrutiny and challenge on these issues.

The duty also serves as a timely reminder of revisiting what we term the 'five pillars' – namely the lenses which we apply to the Consumer Duty and which feature heavily within the FCA's approach to supervision:

- **Business model and strategy [Firm wide]** - encapsulating how the firm will meet the consumer principle and cross-cutting rules
- **Culture, governance and controls [Firm wide]** – showcasing how the business will meet the cross-cutting rules and objectives more broadly
- **Product design and approval [Product specific]** – incorporating an individual product assessment focussing on design and value
- **Sales [Product and firm specific]** – looking at customer understanding through the process
- **Post-sales / servicing [Product and firm specific]** – showcasing support through ongoing servicing

In the context of the pillars above, the FCA has also referenced within the consultation paper the 'access, assess, act' framework.

To ensure all products are fit for purpose, firms should specifically look at the entire customer journey, as outlined within the pillars above, but also not lose focus on the wider questions of business model, strategy, culture and governance which in many ways underpin the Consumer Duty.

Firms will likely struggle most with the concept of 'value' as well as the cross-cutting rules. In many ways, these points can be wrapped up within the sections on business model and strategy, however, firms should still undertake individual product assessments to demonstrate how each product adds value to the end customer.

HOW CAN SQUARE 4 HELP?

Square 4 are able to support firms with their approach to the Consumer Duty in the following areas:

- **Gap analysis:** to understand the requirements of the new Consumer Duty and provide a road map to successful implementation
- **Training and development:** support with the training and upskilling of staff by adapting and developing existing programmes to embed change brought about by the Consumer Duty
- **Product and service design costs:** setting up processes for ongoing governance and reviewing existing product lines against product and service design and value structures
- **Customer support and amending journeys:** reviewing and amending customer service processes and systems to meet the expectations under the Consumer Duty
- **Customer understanding:** supporting with reviewing both new and existing customer communications
- **Annual assessment:** supporting the Board with its annual report assessing whether it is acting to deliver good outcomes for its customers which are consistent with the duty
- **IT and digital customer journeys:** supporting with the digital transformation required to meet the obligations of the duty. This could, for example, include reviewing the online customer journeys and making amends to processes

The regulator recognises that this will be a significant investment of time and effort for organisations and early planning and organisation will be key to ensure the expectations are effectively implemented and embedded over the long term.

ABOUT THE AUTHORS

MATTHEW DRAGE

Matthew specialises in regulatory risk and conduct regulation, having worked as a supervisor at the Financial Conduct Authority (FCA) and within two of the 'big four' professional services firms.

Most recently, he was the Advisory Director at Huntswood and acted as the firms Skilled Person.

Matthew is a Fellow of the International Compliance Association (ICA) and is a member of the Chartered Institute for Securities & Investment (CISI).

PAUL SCOTT

Paul is a proven leader of business, people and in managing high profile regulatory issues. Paul was previously Compliance Director at one of the UK's leading high street banks and has worked in leadership roles within consultancy organisations.

He also spent 7 years in Supervision at the UK's financial services regulator.

Paul has a thorough understanding of the regulatory environment and the key issues on the agenda of Boards.

ABOUT US

OUR STORY

Square 4 was founded with the vision to support people and businesses to grow and thrive across the evolving spectrum of governance, conduct, financial crime, and operational risk. We are an advisory and resourcing business that leverages technology and expertise to design bespoke solutions across our core service lines of:

- Governance, risk, and compliance
- Fraud and financial crime
- Technology solutions
- People

Across the team, we have extensive experience incorporating the 'big four' professional service firms, industry regulators, leadership roles within Financial Institutions, and other outsourced learning, resourcing and consultancy providers.

0845 139 4444

hello@square4.com

48 Warwick Street,
London, W1B 5AW

CONTACT US

MATTHEW DRAGE
Managing Director - Conduct Lead

t: 07500 991 222
e: mdrage@square4.com

PAUL SCOTT
Managing Director - Governance Lead

t: 07809 391 508
e: pscott@square4.com

ZEIN AL-BADER
Managing Director - Training Lead

t: 07834 805 664
e: zal-bader@square4.com

Square 4 Partners Limited
48 Warwick Street,
London, W1B 5AW
0845 139 4444
hello@square4.com
square4.com