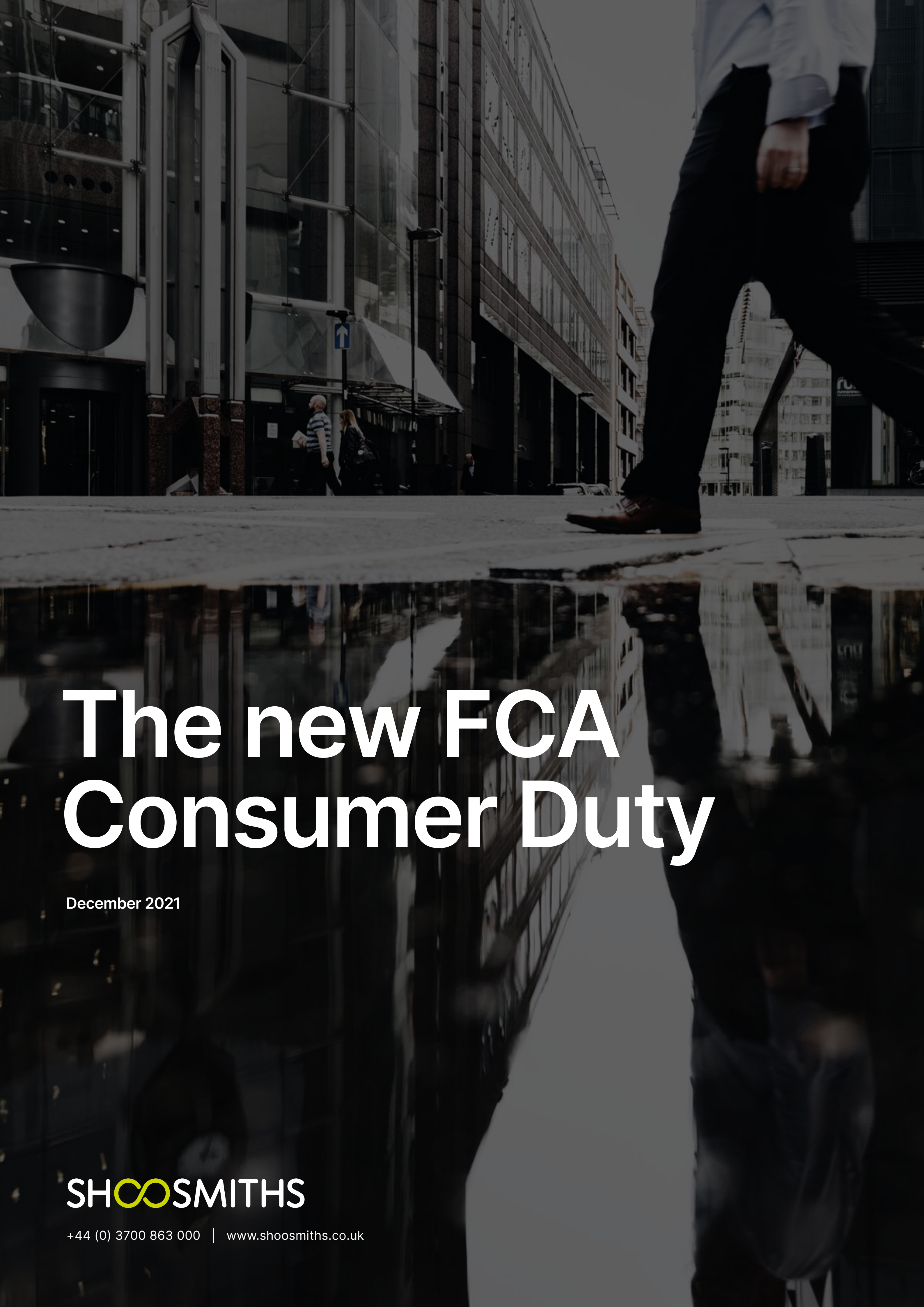

The new FCA Consumer Duty

December 2021

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Introduction

On 7 December 2021, the Financial Conduct Authority (FCA) published its feedback and second consultation paper on the proposed introduction of a new regime, which will set clearer and higher expectations for firms' standards of care towards consumers: the Consumer Duty. This follows the FCA's first consultation paper in May 2021.

The FCA wants to see a higher level of protection for "retail customers", where firms are competing vigorously in the interests of those customers. A new Consumer Duty will set higher expectations for the standard of care that firms provide to retail customers.

In essence, the FCA want to see firms putting themselves in their customers' shoes, asking themselves questions such as:

- Would I be happy to be treated in the way my firm treats its customers? or
- Would I recommend my firms products and services to my friends and family?

In June 2021, after drawing on insights from clients and analysis from our group of specialists, we welcomed the opportunity to respond to the FCA's first consultation paper. The response represented our thoughts, as legal and regulatory advisors, on how the proposals would affect our clients and the broader financial services market.

Our specialists have been digesting the second consultation paper and considering its implications for various financial services sectors. We will be working with clients to help them understand the impact of the draft Handbook changes and draft guidance included in the consultation paper, so that they can formulate their responses to the second consultation – and get ready for implementation.

It is the intention of the FCA to finalise its rules on the Consumer Duty by 31 July 2022, with firms expected to implement the Consumer Duty in full by 30 April 2023. In view of this, all firms connected with the provision of financial services need to have a clear understanding as to the extent to which they may be affected by the introduction of the new regime.

Consumer Principle

A firm must act to deliver **good outcomes for retail customers.**

Cross-cutting Rules

Firms must:

1. act in **good faith** toward retail customers.
2. avoid **foreseeable harm** to retail customers.
3. enable and support retail customers to pursue their **financial objectives.**

Four Outcomes

1. Product and services
2. Price and value
3. Consumer understanding
4. Consumer support

The Consumer Principle

The FCA initially consulted on two versions of the Consumer Principle. The FCA has now decided on the first version:

"A firm must act to deliver good outcomes for retail customers"

It is proposed that the Consumer Principle will be introduced as Principle 12 of the FCA Principles for Business. It will apply only in relation to "retail customers". Where the Consumer Principle applies, it will disapply:

- Principle 6 (A firm must pay due regard to the interests of its customers and treat them fairly); and
- Principle 7 (A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading)

This is because the Consumer Principle will apply higher standards of conduct than Principles 6 and 7. Principles 6 and 7 will still apply to firms who are not dealing with retail customers, in accordance with the existing rules and guidance in the FCA Handbook.

The Consumer Principle means the FCA expects firms to consistently focus on consumer outcomes and on putting consumers in a position where they can act and make decisions in their own interests.

The FCA has made it clear that this represents a shift in its oversight of firms. This should be reflected in firms' governance, product development and decision-making, monitoring of products and customer journeys throughout the whole lifecycle and critically in a firm's record keeping. In particular, the FCA will be focusing on firms who exploit behavioural biases in their product design or communications and the presence of sludge practices in customer journeys.

Behavioural bias is where the human mind leads a person to make a decision which is mistaken. In financial services terms, this means a customer will make a different decision based on how information is presented to them, for example, where the benefit of a product is displayed more prominently than the risk to that product.

Sludge practices are barriers to a customer taking a decision which is right for them or an obstacle which leads to a customer changing their mind, for example, a customer deciding to cancel a product, but only being able to do so by sending a letter to a firm.

The cross-cutting rules

In May 2021 the FCA consulted on three cross-cutting rules. In the December consultation paper the FCA has finalised these rules, with some changes. The rules are:

1. A firm must act in good faith towards retail customers
2. A firm must avoid foreseeable harm to retail customers
3. A firm must enable and support retail customers to pursue their financial objectives

The FCA's analysis in the second consultation paper, as well as the draft Handbook rules and the FCA's draft guidance, provide more information about what these mean in practice, and give examples of when firms would and would not be complying with the cross-cutting rules.

Four outcomes with a focus on tackling consumer harm

The four outcomes represent the key elements of the firm/consumer relationship; how firms design, sell, service and price products and services, and the key contact points along the customer journey. The behaviour and actions of firms for each of these outcomes are instrumental in enabling consumers to meet their financial needs. If done right, they can be drivers of improved financial wellbeing.

The FCA has amended some of the language around the outcomes, in light of feedback to the original consultation.

The four proposed outcomes are:

1. **The consumer understanding outcome:** communications equip consumers to make effective, timely and properly informed decisions about financial products and services.

   For example: A firm seeks feedback from its customers on the first anniversary of a product purchase. The survey responses highlight that a high number of consumers say that they have paid unexpected fees in the first year. The firm should reconsider how understandable their initial product communications are and make appropriate changes and remediate if appropriate.

2. **The products and services outcome:** products and services are specifically designed to meet the needs of consumers and sold to those whose needs they meet.

   For example: A consumer credit firm designs a lending product with late payment fees. The target market includes consumers who are likely to be less financially resilient. The firm identifies that a sizeable proportion of its customers are not making payments on time and are paying substantial sums in late payment fees. The firm concludes that the product is not meeting the needs of its target market as they are paying far higher fees than the firm had anticipated, resulting in unaffordable borrowing rates for these customers. The firm suspends sales of the product while it reviews these consumer outcomes, whether the product is meeting customer needs, and whether it should reposition the target market or product design.

3. **The consumer support outcome:** customer service meets the needs of consumers, enabling them to realise the benefits of products and services and act in their interests without undue hindrance.

   For example: Customer telephones their bank to transfer money from a savings account into a current account, to avoid going overdrawn. The customer waits on hold for a long time but is unable to get through to an agent to make the transfer. This results in the customer going overdrawn and incurring charges.

4. **The price and value outcome:** the price of products and services represents fair value for consumers taking into account:

   - the nature of the product or service, including the benefits and their quality
   - any limitations that are part of the product/service
   - the expected total price customers will pay, and
   - any characteristics of vulnerability in the target market for the product or service

   For example: The FCA will expect firms to be able to show that they have made an assessment and can demonstrate why they consider that the relationship between the price and benefits is reasonable.

Impact on the Financial Services Sector

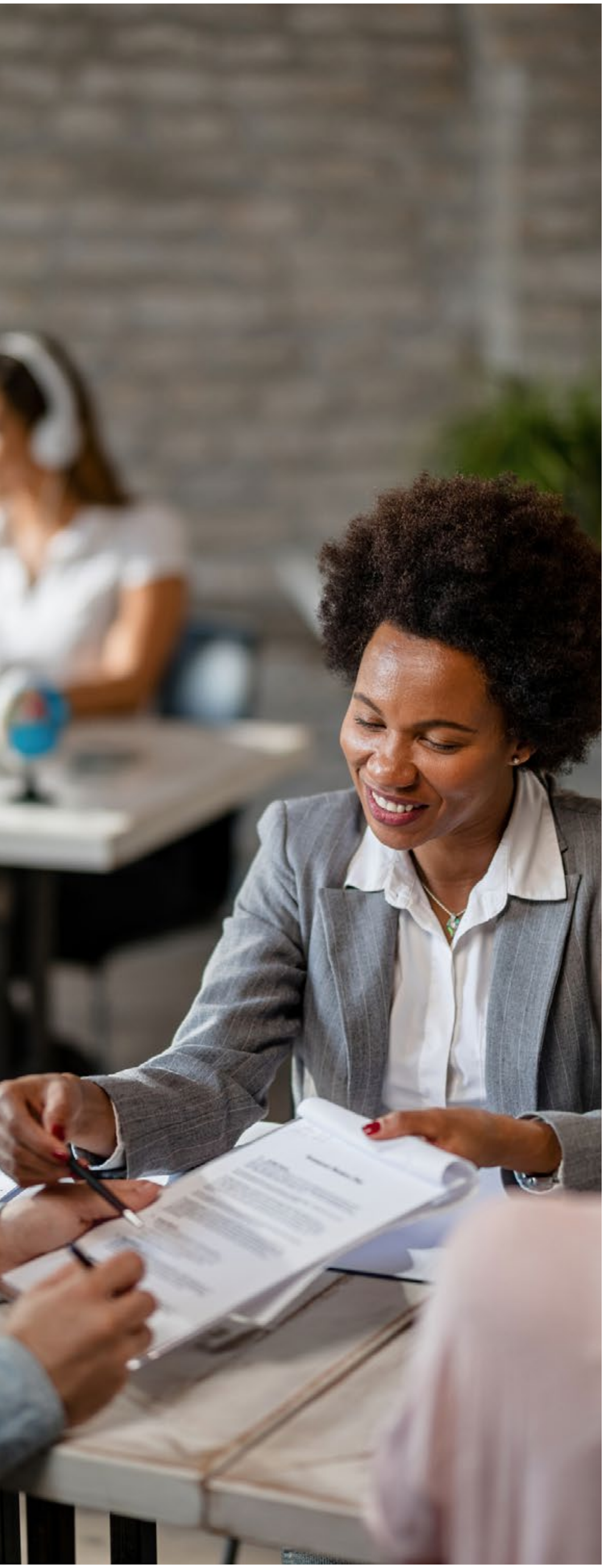
Retail Banks

The introduction of the Consumer Duty will require retail banks to consider and assess each part of the customer lifecycle and to analyse whether the outcomes at each stage meet customer expectations.

There are a range of matters where retail banks will need to consider whether the outcomes are fair and appropriate. Examples of these are set out below

- Are retail banking products fairly designed and do they achieve the customers desired outcome?
- Do retail products provide fair value?
- Are communications to retail customers about products tailored to take into account:
  - The characteristics of the retail customers intended to receive the communication
  - The complexity of the product
  - The communication channel, and
  - The role of the firm (e.g. advice or information only)
- Are all customers treated equally irrespective of whether they are an old or new customer?
- Is there an appropriate level of customer support?
- Are customers fully supported when they suffer a fraud and, in the case of authorised push payments, how does this dovetail into the contingent reimbursement scheme?
- What steps do retail banks take to protect customers from fraud?
- How do retail banks ensure data security? What steps do they take to educate customers on the importance of not disclosing data to third parties?
- Are the range of fees charged on products (including but not limited to exit fees) fair and reasonable and have they been disclosed in a fair, clear and not misleading way?
- What considerations come into play when exiting a customer relationship?
- What steps does the retail bank take to monitor the customer journey to ensure that the outcomes are appropriate?

Some specific considerations for the retail banking products offered by banks are set out later in this note.



Consumer Credit

The focus on better consumer outcomes runs through the FCA's proposal for a new Consumer Duty. The FCA has cited poor practices that hamper good decision-making, or that exploit behavioural biases and vulnerabilities, leading to products that are poor value or not fit for purpose, unacceptable customer service, and information that misleads consumers or fails to help them understand what they are signing up to. As market offerings become more complex and digitalisation increases the speed of transactions, consumer decision-making becomes even harder.

The proposed Consumer Duty will set the standards for firms in all retail markets including consumer credit. Firms will have to have a greater focus on consumer outcomes and act to enable these. They will need to test what happens when consumers use their products and services. If credit products are causing financial harm or are not delivering the right outcomes, firms will need to fix this.

The customer understanding outcome poses a particular challenge for consumer credit firms. Consumer credit legislation sets out very prescribed disclosure requirements which are not particularly easy for consumers to understand. A big question for consumer credit firms will be how can they best present information to equip customers to make informed decisions whilst catering for the diverse needs of their customer base. In the second consultation paper the FCA comments that it will continue to work with the government to consider adopting a more principles-based, outcomes focused approach to the consumer credit legislation requirements.

If you consider the rise of Buy Now Pay Later (BNPL), this is a product that can have important benefits for consumers, but it also carries risks and the potential for harm by potentially exploiting behavioural biases. Are customers aware of the small print on BNPL or do they just see the "Pay Later" headline and sign on the dotted virtual line? The new Consumer Duty places importance on firms to take time to explain the product, and test, to ensure customers understand the terms and conditions. Credit firms including BNPL providers will need to prioritise customer understanding rather than solely focusing on speed, frictionless journeys, and sales conversion rates.

Wealth and Asset Management

Wealth and asset managers are already subject to a wide range of regulatory duties and those firms which operate under advice permissions are currently obliged to comply with specific rules, for example the “client’s best interests” rule under the Conduct of Business Sourcebook. For that reason, there has been an assumption on the part of some in the retail investment sector that the impact of the Consumer Principle will be much more limited. As we anticipated it is now clear that this is not the case and the implications are significant. For example, it is evident that the Consumer Duty will require wealth and asset managers and advisers to assess not only the level of understanding of their investment products and services provided but also their competitiveness, the transparency of fees and the quality of outcomes provided with new obligations being imposed on those who design investment products or are involved in their provision and operation.

Financial advisers will be required to consider carefully both their target market in general and their individual customers in the design and delivery of initial and ongoing advisory services and ensure that communications meet the communication outcome rules and that charges meet the price and value outcome rules for each individual customer. Firms will need to consider whether the overall costs, taking into account all product and distribution charges in the distribution chain, provides fair value. This will apply not only in relation to new business, but existing client relationships.

There will be higher standards imposed in relation to engagement with the customer, clarity of communications and disclosure. Where ongoing advice fees are charged the FCA will expect those not only to be justified but also to relate to the actual provision of meaningful ongoing advice which the client requires and where the cost of that advice is clearly understand. Greater disclosures with regard to the impact of fees are likely to be required. Fee structures based on the size of an investment or pension portfolio or annual “advice” fees as standard are likely to be increasingly difficult to justify.

Platform providers will be required to obtain information to understand the value assessment and whether the remuneration received will result in a product not providing fair value. Fund managers will be expected to develop funds to meet the needs and characteristics of a target market, with an appropriate distribution strategy and a charging structure that provides fair value.

A new approach is likely to be required to the management of conflicts of interest. It will be increasingly difficult to rely simply on the disclosure of a conflict to a consumer. The starting point for consideration will necessarily have to be whether the existence of the conflict inhibits in any way compliance with the Consumer Duty.

The FCA has stated that the Consumer Principle does not mean that consumers are to be protected from risks that they understood and accepted but has made it clear that consumers can only take responsibility if they have the information and support they need to be able to make informed decisions. However, the extension of the Consumer Duty to those who are involved in the manufacture and supply of financial products to retail clients will broaden the range of firms who are required to take account of the new rules and will extend their legal and regulatory responsibilities significantly.

Payment services

The Payment Services Regulations 2017 regulate the provision of payment services to all types of customer. However, the FCA intends that, for the purposes of the Consumer Duty, a "retail customer" will be a consumer, micro-enterprise or charity (as defined in the Regulations). What this means, essentially, is that:

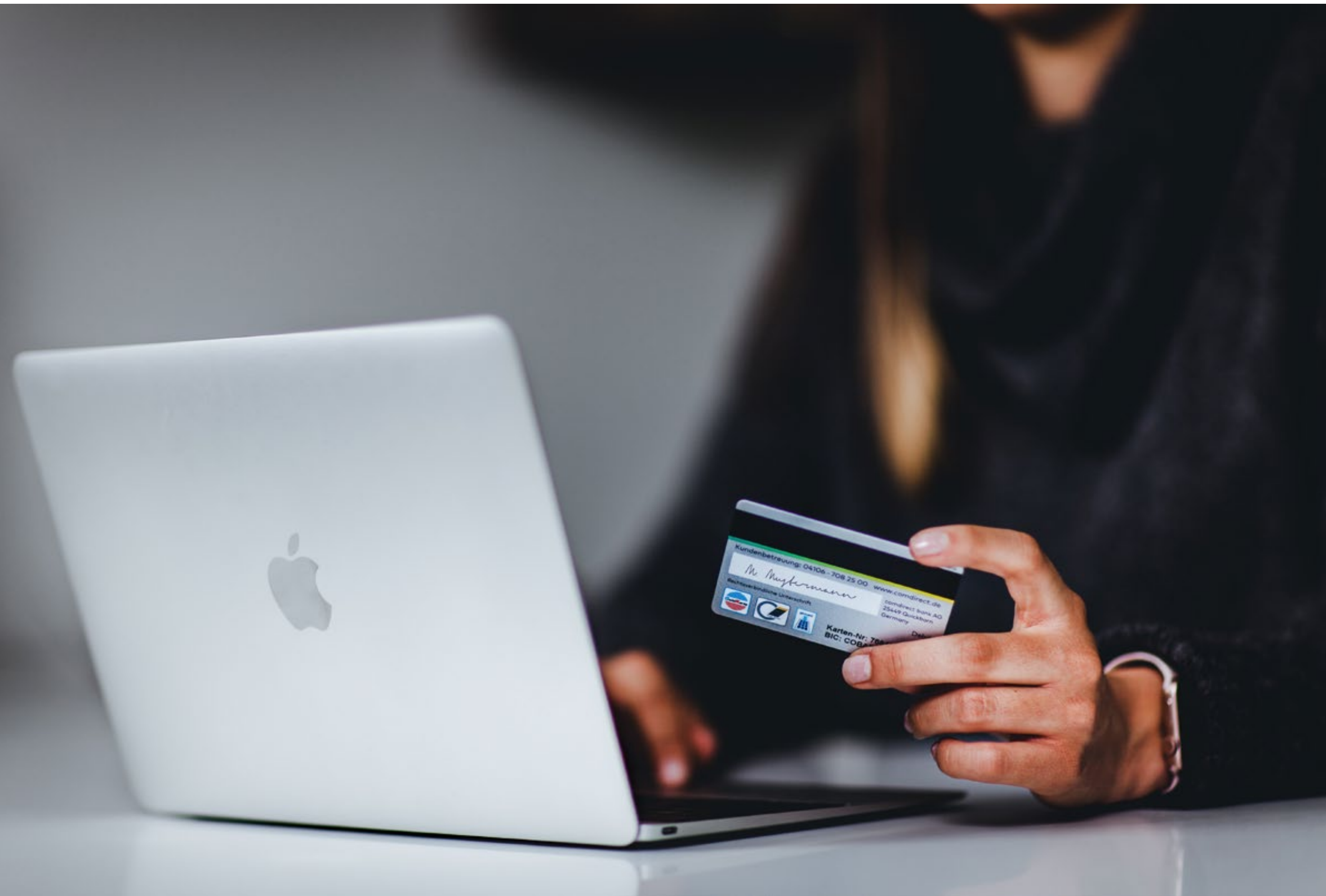
- consumers, micro-enterprises and charities will continue to enjoy the full protections of the Regulations and will also be protected by the Consumer Duty
- other customer types (e.g. larger corporates) will be protected by Principles 6 and 7 as at present, but not by the Consumer Principle (and therefore, not the Consumer Duty). They will still be able to opt out of certain protections under the Payment Services Regulations, via the "corporate opt-out"

Firms who provide payment services activities in the context of a product which is subject to other rules overseen by the FCA – such as a current or savings account, a credit or charge card, or a running account credit agreement – should consider their compliance with the Consumer Duty in that broader product context.

Payment and e-money institutions whose products are not subject to broader FCA rules – such as many e-wallet providers, payment initiation service providers and account information service providers – will have to take a different tack in understanding how the Consumer Duty affects their business.

Some topics that firms should consider (there are others) include:

- Do your onboarding journeys comply with the Consumer Duty? For example, is information clearly disclosed at the right time, in a clear way? Is there is a risk that a digital onboarding journey "rushes" customers through onboarding, without giving customers time to consider whether your product or service is the right one for them? If there are points of friction during the journey, do these assist the customer (giving them more time to think, for example), or do they have a negative impact?
- If you are a digital service provider, do customers have effective means of exercising cancellation / termination rights, and getting in touch with you to flag and resolve problems, which are consistent with their digital relationship with you?
- To the extent that your services depend on support from third parties (such as technical service providers), are you confident that the services provided by the third parties support your ability to comply with the Consumer Duty? For example, do you have robust controls around downtime management, and adequate service levels and monitoring in place to help you deliver good outcomes for your customers?



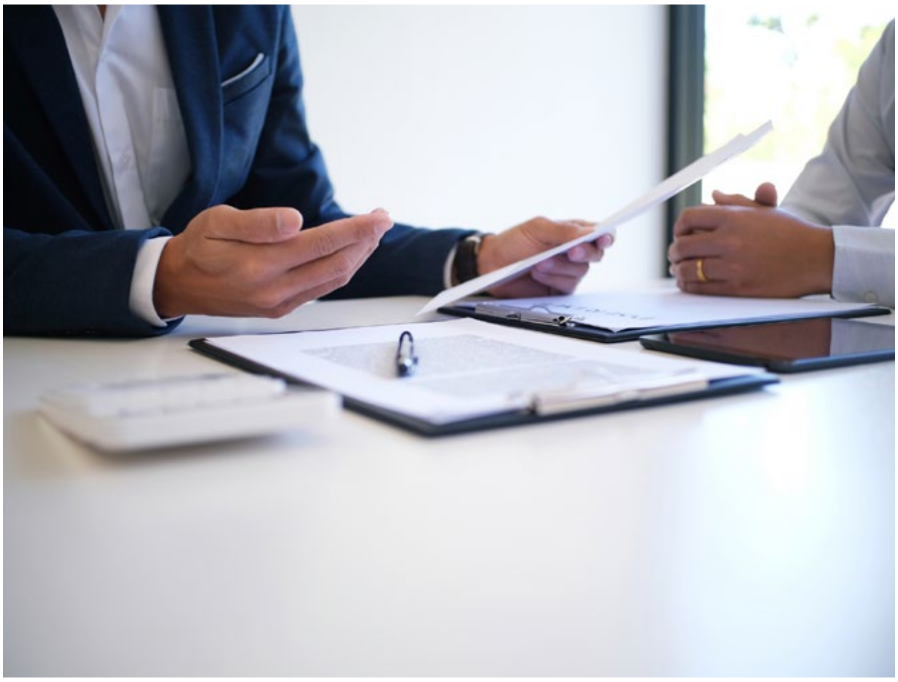
Insurance distribution

The FCA's proposals state that firms' communications are meant to consistently support consumers by enabling them to make informed decisions about financial products and services. This broadly means that firms will be expected to ensure that customers are given the information they need, at the right time, and presented in a way that they can understand. But also it is important to note that this outcome is intended to capture all of the firm's communications with customers across the full lifecycle of a product and/or service, for example, communications about renewals which have previously been a big focus for the FCA.

The products and services outcome primarily seeks to build on the existing product governance requirements for firms; for example, in the design process, the FCA expects firms to take account of aspects of the product that may deter customers from acting in their interests, i.e. unclear exclusion policies, complex claim processes etc. The FCA also focuses on the role of distributors, including those in the distribution chain that do not have a direct customer relationship. The scope of the Consumer Principle is intended to cover all parties in the distribution chain for retail customers, but in a manner proportionate with their influence on the design, operation, and distribution of the relevant product/service.

The proposals on customer service are intended to apply to all aspects of the firm's relationship with customers. In insurance, we expect that this outcome will broadly focus on the post-sale aspects of the customer's interactions with the firm and that customers should be able to access the benefits of their product/services and should not be hindered from acting in their own interests. This could be firms introducing significant friction in insurance claims processes or not adequately resourcing customer facing departments resulting in customers not using the product/service.

The final outcome focuses on products and services that do not represent fair value, where the benefits consumers receive are not reasonable relative to the price they pay. This means firms will need to be able to demonstrate that the benefits of their products and services are reasonable relative to their price. In practice, this will require firms to document price assessments so that they can demonstrate why they considered the price reasonable relative to the benefits of the product or service; for example, a Concierge service, which is only used by a handful of customers and of that handful, the feedback received is less than complimentary is unlikely to be fair value.



If we consider how customers buy, use, or renew insurance, these experiences can be very different;

- when purchasing with a provider for the first time, customers are met with a plethora of questions, information, and terms & conditions, just navigating, and reading through these is a task, let alone fully understanding what they are buying. If we take two specific examples, the recent pandemic has tested everything we thought we knew about travel and small business insurance and who knew that most "Platinum Insurance" comes with a "Concierge Service" that on average adds £18 a year to the premium and cannot be taken off. How do firms test how customers are using these services and either remove them or make them clearer at the outset
- when using insurance, on the face of it and assuming you are covered the process appears easy; but where in the small print is the requirement for 100 individual photographs of spoiled freezer food on a claim that may not even reach over your excess limit; how useful is this cover, sounds good but how useful?
- when renewing insurance, the world of "auto renewal" is still alive and kicking; firms have made some progress here to signpost a comparison with last year's premium but no mention of the "Concierge Service" you didn't use or the claim you tried to make but couldn't.

Firms should be testing the outcomes of last year's insurance cover and how this has worked for a sample of customers and making practical/material changes where appropriate. How many firms review a sample of individual customers over the last 12 months to gain a holistic view of how;

- clear communication is
- useful products are
- well services perform
- reasonable the price is compared with the value

Mortgages

In the second consultation paper, the FCA has clarified that the Consumer Duty will apply in relation to customers falling within the scope of the Mortgages and Home Finance: Conduct of Business Sourcebook.

This means that the Consumer Duty does not extend to unregulated buy-to-let mortgages, or commercial lending. One exception to note is that the FCA has said that where the mortgage book is unregulated but a regulated firm is acting as the administrator, then the Consumer Duty will apply in an "appropriate and proportionate manner".

- The Consumer Duty will also apply to firms involved in distribution chains, as well as certain wholesale firms. In the context of regulated mortgages, this means that the following firms should also consider their obligations under the Consumer Duty: mortgage brokers; and
- mortgage administration or debt collection firms who have direct contact with customers

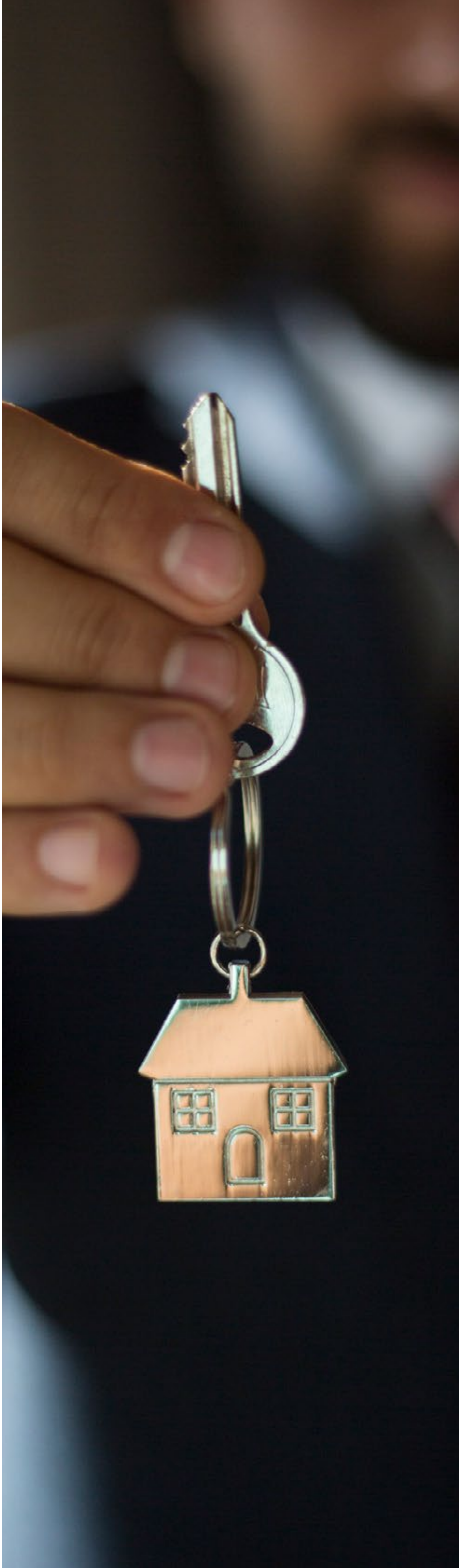
In relation to mortgage brokers, the proposed changes to the FCA Handbook set out rules and guidelines concerning the roles and responsibilities of manufacturers and distributors of products. Mortgage providers and mortgage brokers should look at their contractual arrangements to make sure that they reflect the requirements and aims of the draft FCA Handbook changes set out in the second consultation paper.

While mortgage providers need to consider all aspects of the Consumer Duty in detail, the fact that mortgages involve a long-term arrangement with customers means that their treatment does differ from some other financial services products. Although the Consumer Duty is not retrospective in its application, the FCA has set out proposed rules and guidance on how to assess contracts held by existing customers, and proposes different treatment for ongoing products compared to closed products, i.e. those no longer being sold.

In addition to considering how current and new products are sold to new customers, firms will have to consider the impact on existing customers. In some instances, this may involve resolving a tension between differing statements from the FCA.

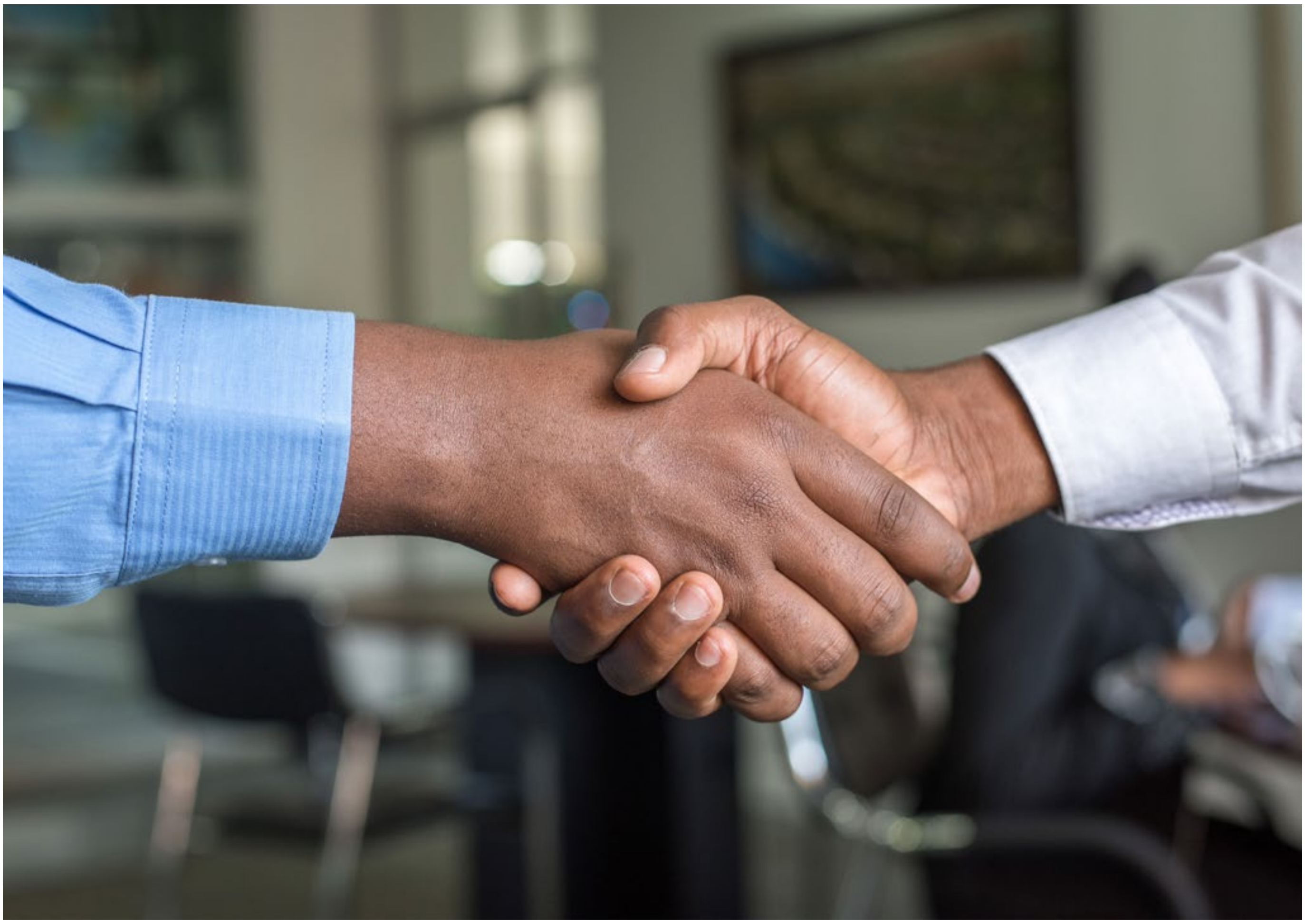
For example, the FCA recognises on the one hand that firms are not expected to give up any contractual rights they had a firm expectation of being able to enjoy – which suggests, for example, that firms can still enforce early repayment charges if a customer chooses to switch. However, the FCA does expect firms to consider other ways to prevent harm for existing customers, for example by making changes to the mortgage agreements. The FCA gives the example of assisting a customer to switch to a new product or service.

How firms resolve the tension between these statements will be for firms to consider at an outcomes-based level, taking account of the Consumer Principle and the need to achieve good outcomes for customers.



How can we help?

1. Support you to provide a stronger focus on customers' interests and outcomes that goes beyond a narrow focus on compliance with the rules. We can help you to consider the Consumer Duty at every stage of your policies, processes, training, and performance metrics, identifying and filing any gaps.
2. Help you to get it right in the first place; particularly when designing products and services. We can support you to place greater emphasis on putting customers in a position where they can make decisions to meet their needs.
3. Support you with an independent view on your Financial Promotions to ensure they are fair, clear, and not misleading.
4. Work with you on your existing products to understand the impact on your existing customer relationships and documentation and update your existing customer terms and conditions.
5. Support you in reviewing your in-life products to consider whether any changes are required for in-life customers.
6. Provide clarity on where responsibilities lie between you and other parties in the distribution chain and an understanding of the outcomes the regulator expects.
7. Support you to monitor and test customer outcomes and guide you through the process of learning from the results and adapting your practices as appropriate. Putting you in the position to provide information and data to the FCA, to evidence the outcomes of monitoring and testing activity.
8. Perform shadow skilled person reviews reviewing your customer outcome framework and record keeping.
9. Help you review third party arrangements, including distribution and service agreements, with the aim of ensuring these help you comply with the Consumer Duty.



Why Shoosmiths

Shoosmiths LLP is a major UK law firm, comprising 210 partners and over 1,600 lawyers and employees. The financial services sector is one of our key areas of focus: we support financial services firms ranging from new starts and FinTechs to major banks, building societies, lenders, investment companies and insurers. With offices in 13 locations across the UK, we provide advice on English, Scots and Northern Irish law and act for financial services firms in each jurisdiction.

What sets us apart is the way we deliver our services – clients tell us that we get the "people bit" right, listening and investing in the relationships which are at the heart of great service.

We're ready to think differently and deploy our collective experience to meet and exceed each client's expectations.

We are here to help

We are committed to ensuring we provide support to all our clients, helping them to understand how the proposed changes will affect them and assist them in becoming compliant. For more information on the new Consumer Duty, please visit out dedicated hub: Consumer duty hub. The hub contains our podcasts and articles on this developing subject and will post details of the Consumer Duty Event planned for the New Year in our London offices.

Please do not hesitate to contact any of our experts to discuss the new Consumer Duty and how it may impact your business.

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FCA consumer duty timeline

May 2021
FCA published first consultation paper

30 July 2021
Consultation period closed

7 December 2021
FCA published second consultation paper

15 February 2022
Second consultation period closed

31 July 2022
FCA expect to publish their policy statement summarising responses and making any new rules

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