TMA COMPLIANCE CONSUMER DUTY SUPPORT

TMAclub

When I started in compliance (which, I now hate to admit, was at some point in the mid-1990s) regulation was a relatively simple affair. In the intermediary world it covered only investments and the handbook contained a relatively modest number of rules. These were sent to us periodically by the regulator in a paper binder (or occasionally, in updates via fax) – and those rules told us fairly specifically what to do.

As individual compliance officers, we needed to know what the rules were. The internet didn't really exist - so we learnt them from the book and took a geeky professional pride in knowing them (although I'm not totally sure the word 'geek' had been invented then either).

Over the intervening 25 or so years two things have been constant: the regulations have always been in a state of change and those changes have always had the effect of expanding and hardening the regulatory environment.

Some of these changes have been in the form expansions of reach (into mortgages, protection, general insurance and consumer credit for example) or technical legal alterations brought about by European legislation (in our market, the Insurance Distribution Directive and the Mortgage Credit Directive in particular).

Others, though, have been more philosophical – like the huge 'Treating Customers Fairly' implementations in the late noughties. These are designed by regulators to force changes in the way that the industry thinks about regulation. Changes of this type are often the most difficult to implement (they are inherently subjective) and the ones that can present us with the greatest regulatory danger (because the regulators subjective interpretation can be fluid and different to the one you originally expected).

CONSUMER DUTY

FCA's recent consultation in respect of a new Consumer Duty is proposing exactly this kind of philosophical change. It is designed to address their ongoing concerns about customer harms arising from poor practices in some Financial Services Sectors.

The roots of Consumer Duty are in Behavioural Science. It will create a new Principle which will require firms to 'act to deliver good outcomes for retail customers' and a set of rules requiring firms to act in good faith towards retail customer, to avoid causing them foreseeable harm and to enable and support them in pursuing their financial objectives. It will also add (voluminous) new rules and guidance relating to Products and Services, Price and Value, Customer Understanding (think financial promotions and other communications) and Customer Support (think post-sale service).

Whether or not you agree that this is the best or most efficient way of addressing the FCAs concerns (consistent with most of the industry, our responses to the consultations said we think that more effective supervision of the existing rules by FCA would have got us there more easily) doesn't really matter: the changes are certainly going to occur.

What will this mean in our market? No doubt some of this will become clearer in the coming months. But right now we can be fairly certain of a renewed focus on financial promotions and communications and much greater need (for all participants in the market – including intermediaries, providers and lender) to explicitly justify the value of costs of their products and services, to evidence good faith and consideration of foreseeable harm and customer support in decision making will also likely follow.

See our summary of the proposed rules structure on the following pages.

You can read more at https://www.fca.org.uk/news/press-releases/fca-introduce-new-consumer-duty-drive-fundamental-shift-industry-mindset

WHAT DO THE PROPOSED RULES LOOK LIKE?

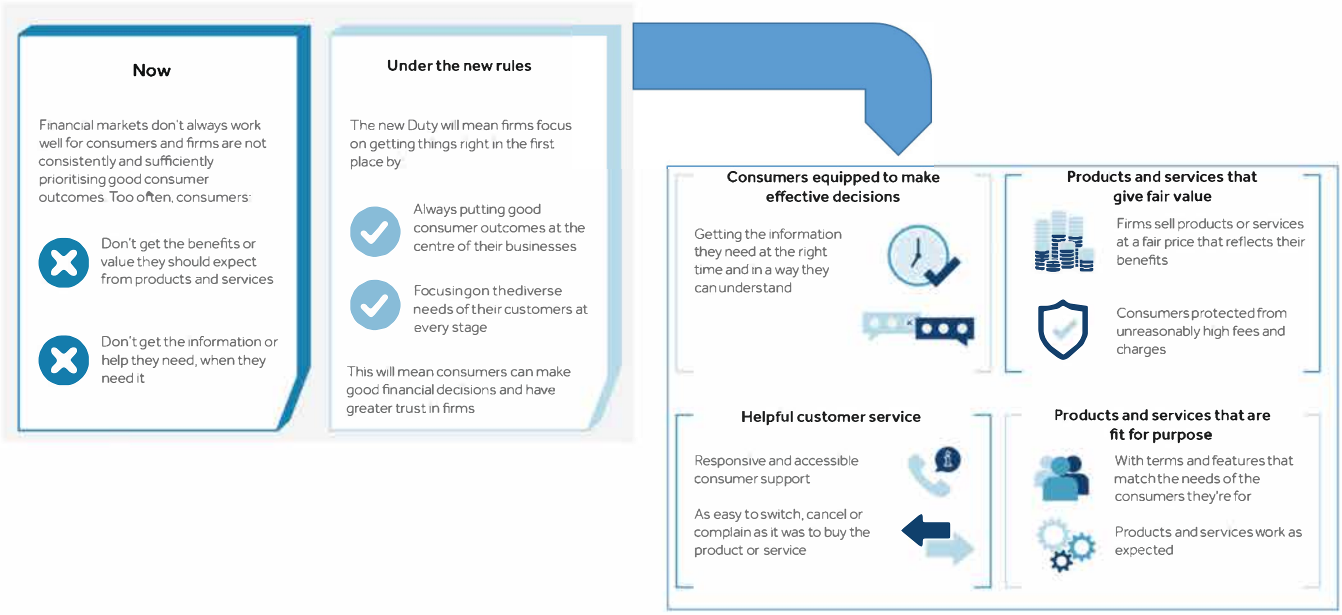
The implementation of a new Consumer Duty is a major FCA initiative, and one that will have a significant impact of regulation over the coming months and years. The FCA's stated aim is to 'drive a fundamental shift in industry mindset'. In this article we look at the proposed rules framework

WHAT PROBLEMS ARE THE FCA TRYING TO SOLVE?

The FCA want to see a higher level of consumer protection in retail financial markets. FCA's view is that consumers do not always get products and services which meet their needs or which provide the outcomes that customer may reasonably expect.

FCA say that they also continue to see practices that cause consumer harm (where products and services are not fit for purpose), with consumers who are in vulnerable circumstances being at greatest risk of.

The following info graphic (source: FCA - www.fca.org.uk) shows what they are trying to achieve.



HOW ARE THE RULES GOING TO CHANGE?

The proposed 'Consumer Duty' will bring in a new principle and new rules which will set higher and more explicit expectations and standards of care for firms in respect of consumers. The proposed structure will specifically include a new, high level, 'Consumer Principle' -

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

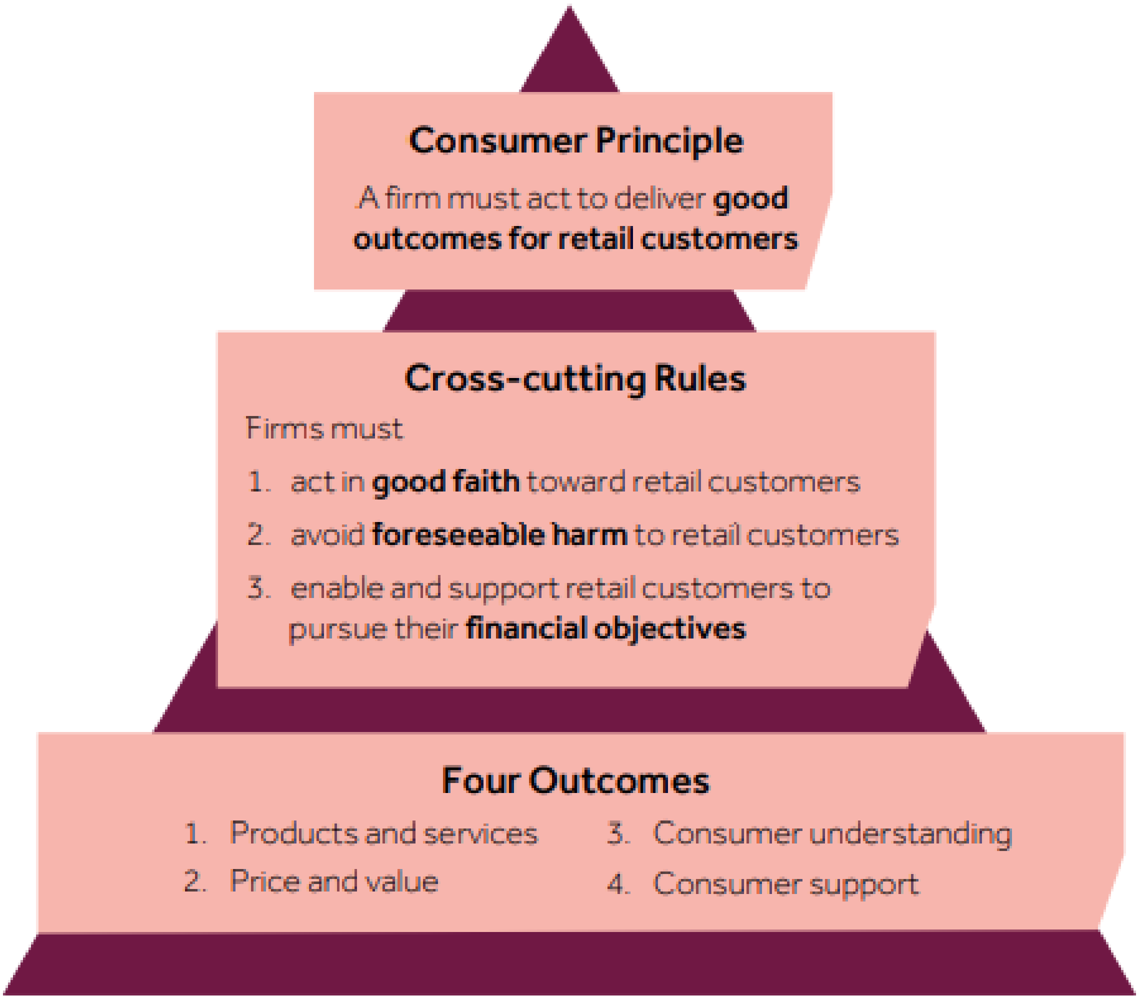
Underneath this there will be a set of three, new 'Cross Cutting Rules' (which means they will apply to all activities in respect of retail customers. These are; firms must...

- act in good faith toward retail customers
- avoid forseeable harm to retail customers
- enable and support retail customers to pursue their financial objectives

And finally, the Consumer Duty proposed four 'outcomes' of Products and Services, Price and Value, Customer Understanding and Customer Support. More detailed rules and guidance have been drafted to support each of these outcomes.

The proposed structure would specifically include a new, high level, 'Consumer Principle' along with lower level rules covering communications, products and services, price and value.

We should expect the changes proposed in this consultation to have a meaningful impact on the way in which FCA regulate firms – and hence how we need to organise and arrange our internal systems and controls.



CONSUMER DUTY STRUCTURE

NEED COMPLIANCE SUPPORT?

We have a team of highly-eperienced compliance personnel, who are experts in all aspects of the regulatory environment.

Find out more about the Bespoke Compliance Support Packages we have available.

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BEHAVIOURAL ECONOMICS - HOW RATIONAL ARE YOU?

FCA has been interested in Behavioural Economics for a number of years, but the proposed new 'Consumer Duty' rules show their first major step into building explicit rules and guidance based its theories and findings.

WHAT IS BEHAVIOURAL ECONOMICS?

The short answer goes something like this…

Most of traditional economic thinking has been based on 'neo-classical' economics. A central assumption of this is that humans are rational and will make decisions based on all the information available to them. So, it theorises, decision making can be improved just by making available better (or more) information. The current FCA regulatory framework is heavily based on this theory – hence the large focus on disclosure ('tell the customer more, they will make mistakes less.')

Findings from Behavioural Economics says that this isn't necessarily true – and that humans actual decision making is highly sensitive to context, to mental short-cuts ('heuristics') and to sub-conscious biases. Importantly, Behavioural Economics has shown that these responses are predictable. Behavioural Economics, therefore, studies how we really make decisions and how context, environment or specific presentation of information might impact the outcome.

HOW WIDE SPREAD IS THE USE OF BEHAVIOURAL ECONOMICS?

More widespread than you might realise. The government has been using findings from the 'Behavioural Insights Team' (the 'nudge unit') for more than a decade to try to improve outcomes on various fronts. If you know where to look, you can see their influences all over – from the wording of tax letters to signs on the underground to entire pension policy.

SO THIS IS THE USE OF 'NUDGES'?

Correct. Once the finding from Behavioural Economics are understood, you can start to create contexts, environments and presentations ('nudges') that are more likely to get you the outcome that you want.

WHY DOES THIS MATTER TO FINANCIAL SERVICES?

It matters for two main reasons. Firstly, FCA think that some firms have taken findings from Behavioural Economics and applied them in ways that harm customers. These so called 'sludge' practices can be used to create contexts or 'choice architectures' which either stop customers easily doing things that the firm don't want them to do (like making the process for cancelling plans difficult, confusing or frustrating) or make it more likely that the customer will make a mistake in their decision making.

Try cancelling a free TV streaming trial (10 sub menus, circular menus, calls to call centres that don't answer, a set of 'are you sure messages') to see this in action.

Secondly, FCA believe that firms might not understand enough (or maybe don't think enough) about behavioural responses – and how these might affect outcomes. Their proposed rules in respect the Consumer Duty are designed in part to address this.

SO LET'S DO AN EXPERIMENT...

A fun thing about Behavioural Economics is that it relies on our intuitive responses. So it can be easy to test some of the theories on ourselves. Try these questions – and think about your immediate response. See the answers to see what your answers say about how rational you are:

Q1. You have the offer to receive £10 today. Or to receive an amount with certainty one year from now. What amount would you need to be offered one year from now to choose that option instead of getting £10 straight away?

What about in two years?

Q2. The Shard in London is 1016 feet tall. How tall is the tallest tree in Canada?

Q3. You arrive at a petrol station with cash and a credit card. The sign says 'There is a 1% surcharge for paying by credit card'. How likely are you to pay by cash?

What if the sign said '1% discount for paying cash'?

ANSWERS

Q1 ANSWER.

If your intuitive response to the question is typical then you would probably have come up with a number around £20 for year one. But almost certainly not a number as high as £40 or even £30 for two years.

This doesn't make sense in a normal economic sense – and it makes you a bit irrational (according to classic economics at least). Even with inflation at 7%, an amount of say £11 or £12 should easily be worth more next year than £10 today. This is known as 'present bias' – we disproportionately prefer 'right now' to 'later'. But we tend care much less about 'later vs later still'.

When giving advice, the bias might lead customers to disregard longer-term disadvantages or costs in favour of their immediate goal. For example, they might pay little attention to the disadvantages of mortgages running for long terms retirement, or of having inadequate protection if it means they can get a mortgage now.

Q2 ANSWER.

The tallest tree in Canada is around 200 feet tall. On average, when the question is presented in this context (i.e. with a big number discussed immediately before it) people over-estimate the height of trees. If the question had been posed with a small number example before it (even one totally unrelated to height – like 'how many Ronnies were there in the two Ronnies') people would tend to under-estimate the size of trees! It's a trivial example – but this type of understanding of how customers respond to information (say in communications, promotions or advice processes) can clearly impact outcomes – both positively and negatively.

Q3 ANSWER.

Behavioural Science shows that people respond disproportionately strongly to potential losses than to potential gains ('Prospect Theory' is the central, and best known expression of this).

The important thing about these two questions is that they are imparting exactly the same information: a card transaction will cost you 1% more than a cash transaction. But most people find the 'surcharge' frame would be more motivating than the discount (research almost always shows that people dislike surcharges more than they like discounts). So if you wanted people to pay by card (and pay the extra) you would use the 'discount for cash' frame. If you wanted people to pay cash you would use the 'card surcharge' frame.

As above, this shows the importance of framing in communications and interactions. FCA's concern is that some firms might be using these techniques 'for bad' rather than 'for good' – and it is those approaches they are trying to stamp out.

ADVICE AND COMPLIANCE IN NUMBERS

£17,000 – *The approximate amount a 45 year old customer in perfect health would save by taking a typical £150,000 mortgage to age 65 rather than to age 70. The saving is made up of decreased interest and reduced protection costs created by the shorter term. The savings will be higher for customers whose protection is loaded. The number highlights the importance of careful discussions with customers about term and of the benefits of blended protection and mortgage advice.*

24.21% *- UK inflation for the year 1974. Interest rates peaked at 17% between 15 November 1979 and 03 July 1980.*

As inflation ticks up, it is important to make sure that our advice considers and carefully documents affordability and the customer's ability to handle future interest rate rises. Longer fixed rates offer greater long-term protection for customers whose affordability is tight and hence for whom interest rate rises pose the greatest affordability risk. This needs to be balanced against initial affordability.

£2,157 per month *– the cost of a 25 year repayment mortgage for £150,000 at the interest rate of 17% referenced above. Most people would pay less than £700 a month today.*

0.5% - 1% *- the fraud intervention rate on applications reported by most lenders. The numbers have reduced slightly from a COVID peak – but still mean that almost all mortgage broker firms will encounter fraud attempts on applications from time to time.*

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Operational Compliance Director
TMA Club

NEED SUPPORT?

CONTACT OUR BROKER SUPPORT TEAM ON **0330 303 0236**.

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