CLIFFORD CHANCE

Briefing note October 2013

The FCA – 6 months on and the inexorable rise of the Thematic Review

The FCA celebrated its first six months as a regulator on 1st October 2013 – a suitable time to review some of the key emerging themes.

One clear change has been the use of thematic reviews – the FCA has made it very clear to firms that it considers the use of these reviews to be a fundamental part of its supervisory approach. As at the date of this article, eight detailed reports have been issued by the regulator and have looked into various issues, such as mobile phone insurance, automatic renewal in fixed-term bonds and PPI complaints handling. Despite the range of subject matter and industry focus, a number of key themes have become apparent and there is a pattern to how these reviews are conducted and how the thematic work is used.

This article aims to look at some of these themes and patterns with a view to enabling firms to anticipate and prepare for reviews and to mitigate the risk of enforcement action.

FCA areas of focus

The thematic reviews undertaken to date fall within two main categories:

1. **Product-led reviews**

These reviews have investigated specific products where the FCA are concerned that there are issues with product design and governance. The reviews have often been initiated following a pattern of increased FOS claims and media scrutiny.

Product reviewed include motor legal expenses insurance (MLEI), mobile phone insurance (MPI), auto renewal in fixed term bonds and unit-linked funds.

2. **Process (including sales) reviews**

These reviews investigate the processes and procedures around what is being described as the customer "journey" through the life of the product – from the sales process through to claims and complaint handling. They have also reviewed areas of conflict or where there is a lack of transparency.

These reviews have included the mobile banking review, RDR implementation and the general insurance complaints handling review.

At the heart of all of the reviews, however, is a desire to limit the risks of poor product design and mis-selling. The legacy of PPI is all-pervasive as the regulator is clearly seeking to be proactive in its efforts to avoid another mis-selling scandal by addressing issues far earlier than perhaps they have done so previously. This requires firms to be more proactive themselves in identifying regulatory risk and ensuring that they have the procedures in place to monitor and mitigate these risks.

The expectation is that firms will place customer and systemic integrity at the forefront of their organisation and be able to demonstrate this through their product governance and distribution processes. In other words, firms must monitor "conduct risk".

Impact of new regulatory objective

Another key theme is the impact of the new FCA objective – **to promote effective competition in the interests of consumers**. This has been interpreted as demanding a proactive regulatory approach in order to achieve good outcomes for consumers across the market. The consumer is at the heart of this regulatory analysis which demands that the consumer is not only aware of but understands fully how a product should operate. Only when they understand a product, will they make rational decisions and choose or switch to the products best suited to their needs and providers who offer customer service and good value products.

In a number of speeches and articles, the FCA have demonstrated their concern that customers do not read terms and conditions, do not always review and shop around for products and can be driven by inertia. This takes us to another key theme – the use of "behavioural economics" in the decisions made by the FCA and its choice of areas to review.

This focus has led to a revised regulatory approach and theoretical basis for analysing how products are sold and how customers expectations and needs should be met.

So, as the FCA have said, they have been looking into markets where they consider "ineffective competition is leading to poor outcomes for consumers" and using their "regulatory powers to make any changes [they] think would improve market competitiveness".

The new statutory objective has triggered the advent of "Market Studies" - where the FCA will undertake a review of a particular market in light of this objective. An example is the current market study into "add-on" insurance. Here, the regulator is investigating whether there is effective competition for add-on products, and if not, why not.

There is also a concern over low-cost products where there is a "significant" profit margin for the firm distributing the product.

The results of this new approach can be seen in the choices of the thematic reviews undertaken – and in some cases the thematic reviews directly relate to the wider market studies. They consider products where, in their view, there is a mismatch between what the consumers may need cover for (or, the cover consumers believe they have) and what the cover actually provides (such as MPI and MLEI). The reviews (based on an analysis of conduct risk and behavioural economics theory) conclude that the products should be designed to meet the consumers' needs and therefore product design amended accordingly.

To summarise, three key themes have emerged from the first six months of the FCA's regulation:

- The new statutory objective to promote competition requires a proactive approach from both regulator and firms.
- Behavioural economics theory underpins the FCA's approach and firms need to review their product design and governance processes in this light.
- Conduct risk needs to be understood and monitored by firms.

Why does behavioural economics matter?

It is telling that Martin Wheatley, the FCA chief executive, chose behavioural economics as the topic of his first speech after the FCA came into operation. Two papers have since been issued by the FCA on the subject and some clear guidance provided on its impact on the FCA's regulatory approach.

The quotes below give a flavour of this impact:

On "caveat emptor":

"*'Buyer beware' becomes hard to defend when unsophisticated customers are buying seriously complicated financial products, where the risk of failure is far more dangerous than a decision in the supermarket to buy three bananas instead of one.*"

"*There are questions that many investors simply will not ask because they are humans, not automatons.*"

On consumer decision-making:

"*We want the regulatory system to use behavioural economics to ascertain whether people are being put off switching products through inertia, inattention or even the simple fear of regret from making a wrong decision.*"

On legal and compliance....:

"*We're not just asking: Is this product compliant? Does it tick every legal box? But actually: is the outcome good? Is the market competitive? And is fair treatment of consumers designed into products and culture?*"

The FCA have been very successful in applying this change of ethos to the actual day to day regulation of firms. The following section looks at the

Key issues

- Thematic reviews are, and will continue to be, a key regulatory tool
- Conduct risk and behavioural economics are key themes
- Firms can anticipate areas of possible regulatory focus and plan ahead
- Product lifecycle is a key focus

thematic reports themselves and demonstrates how the FCA have used this process to deliver change through a variety of techniques.

What do the reports tell us?

What typically happens following a thematic review?

- FCA will engage with the in-scope firms through the use of questionnaires, meetings and conference calls. The FCA will then provide feedback following the review. Firms have been expected to further review and consider revising their products, processes and other arrangements in light of this FCA guidance.
- In a number of cases, one or two firms have been referred to enforcement for potential rule breaches and fines have been imposed.
- Firms may receive "private censures" (see below).
- Individuals may be required to "attest" to existing processes and future conduct (see below).
- The FCA then warn the industry that follow-up work will be undertaken (and sometimes provide a timescale) to check if firms have acted on guidance. If continuing problems occur, further action will be considered.
- The FCA reports give clear and specific examples of what is considered to be "good" and "bad" conduct .

Past practice or conduct which may be considered "conventional" is no defence. As mentioned above, the FCA approach, based on putting consumer expectation at the forefront of firms' agendas, means that product governance needs to be reviewed afresh.

Two of the regulatory tools mentioned above are, if not new, recently reinvigorated parts of the armoury:

- Private censures – the FCA may issue a private censure to firms and individuals instead of proceeding to more formal enforcement procedures. There is no requirement to demonstrate a rule breach – but the FCA will tend to use this approach when they consider that a firm would not have taken a particular course of action if it had not been for the FCA's intervention. In effect, it amounts to a "yellow card" as it will be taken into account when assessing the regulators' response to any future issues.
- Attestations – these require individuals to formally attest (and, therefore, take responsibility) for a particular area. This is designed to ensure board level involvement in the process and personal accountability for any future misdemeanours.

Once again, some general themes can be adduced from the detail of the thematic review reports themselves:

- Internal governance is fundamental to best practice. There are a number of references to the need for the board to be actively engaged in the approval process and compliance monitoring.
- The management of conflicts of interest will be the subject of continuous scrutiny from the regulators.
- Communications with customers in relation to products must be consistent – significant weight is attached to the customer's expectations and his journey. As referred to in the quotes set out earlier in this paper, the concept of "caveat emptor" is "mortuus".
- Products need to be both understandable and transparent - it is not the consumer's fault if they do not read the fineprint.

How to get ahead?

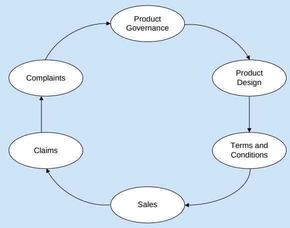
The FCA has spoken continually about "good" and "bad" firms and their approach to business. So, how can you be a "good" firm in their eyes?

Issues to consider/areas to monitor include:

- FOS statistics: which products/processes are going to the FOS? Can lessons be learned/processes adapted?
- Monitor customer complaints and identify themes/product concerns, again with a view to these new regulatory imperatives.
- Monitor consumer blogs and consider engaging in your own market research.
- Monitor all steps in the "product lifecycle" including the role of any third party service providers in the chain.

The Product Lifecycle

In the MPI thematic review report, the FCA described how they considered the risks to consumers during six clear stages of the "product lifecycle".



- Review claims management information to spot trends. Is a high proportion of certain types of claims being rejected? The FCA have highlighted that firms should do this as part of good product governance.
- Review product governance procedures. Is behavioural economics theory taken into account (whether you believe in it or not)?
- Read all Thematic Review reports – even though they may not be in areas of business you are involved in. There are common themes and firms can reasonably expect a similar approach to analogous situations more relevant to them.
- Read the FCA speeches – in many ways these have replaced the "Dear CEO" letters as the method for communicating regulatory developments to the market.

If anything, the final point above shows the change in approach in a nutshell: the FCA is not speaking to firms in isolation, it is addressing the market more generally. After its first six months, the financial services industry should not be in any doubt that regulation has changed and firms may well need to adapt their behaviours to meet this challenge.

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