

THE FCA CONSUMER DUTY: PRACTICAL IMPLICATIONS FOR MARKET PARTICIPANTS

The Consumer Duty aims to raise the bar for consumer protection across financial services by requiring UK-regulated firms to act to deliver good outcomes for retail customers. It will apply from 31 July 2023 for products and services that remain open for sale or renewal and its impact is already being seen on structured debt transactions involving regulated loan portfolios. In this article, we provide an overview of when the Consumer Duty applies, and the practical implications for structured debt transactions.

What is the FCA Consumer Duty?

The Consumer Duty aims to set higher and clearer standards of consumer protection across financial services and requires firms to take a consumer-focused and outcomes-based approach to compliance. There are three main elements to the new Consumer Duty, comprising:

- a new Consumer Principle, that “a firm must act to deliver good outcomes for the retail consumers of its products”;
- cross-cutting rules supporting the Consumer Principle; and
- four outcomes, relating to the quality of firms’ products and services, price and value, consumer understanding and consumer support.

The Consumer Duty rules and guidance are drafted in a product-agnostic way and overlay on top of existing sector-specific rules (such as MCOB for regulated mortgages and CONC for consumer lending). As such, they are supplemented by additional non-Handbook FCA guidance (FG22/5) to help firms interpret, implement and apply the Consumer Duty in practice.

Who Does the Consumer Duty Apply To?

The Consumer Duty applies to FCA regulated firms that carry on “retail market business” – including regulated activities and ancillary activities carried on by a firm in a distribution chain which involves a retail customer. The definition of a “retail customer” for this purpose varies by sector to align with the scope of existing sector-specific rules (such as MCOB for regulated mortgages and CONC for activities relating to consumer lending).

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Key Issues

- The FCA Consumer Duty will introduce new requirements for UK-regulated firms to deliver good outcomes for retail customer, from 31 July 2023 for open products and 31 July 2024 for closed products.
- There is already a focus on Consumer Duty compliance in the context of due diligence and related contractual protections for purchasers.
- While rules do not technically apply to unregulated purchasers, the FCA indicates that sale to an unregulated purchaser should not result in worse customer outcomes.
- Purchasers and financiers in forward flow structures might be co-manufacturers of products, by virtue of rights that influence retail customer outcomes.

The market approach to addressing Consumer Duty issues on structured debt transactions is still developing but it is hoped that a cohesive approach will emerge for day-to-day compliance points.

Activities or products that fall under an exclusion from regulation are out of scope. For example, this means that for mortgages, the Consumer Duty does not apply to unregulated buy-to-let contracts or large business customers, following the application of MCOB. However, in practice, structured debt transactions may involve mixed portfolios of regulated and unregulated loans. Accordingly, some firms are considering a broader implementation of Consumer Duty requirements, for consistency across whole portfolios. In the consumer space, buy-now-pay-later loans are generally exempt products today, and will continue to be exempt with respect to the Consumer Duty. It should be noted, however, that buy-now-pay-later products are expected to be brought within the scope of regulation following the scope of regulation following the recommendations of the Woolard Review in 2021. For more details on the ongoing HMT consultation on the proposed draft legislation for buy-now-pay-later products, please refer to our February 2023 briefing entitled *“Regulatory developments in the buy-now-pay-later space: HMT consultation on proposed draft legislation for BNPL products”*¹.

The Consumer Duty rules and guidance also make clear that the retail customer need not be a direct client of the firm for the Consumer Duty to apply. Therefore, even firms that do not have any direct retail clients need to assess whether they are carrying on retail market business by virtue of being in a “distribution chain” involving retail customers. FCA guidance indicates that a key element of this assessment is whether the firm can “determine or materially influence” retail customer outcomes. We discuss below how this may apply practically in the context of structured debt transactions.

Practical Implications for Structured Debt Transactions

Addressing regulatory risks arising from potential future Consumer Duty breaches

There is an increasing focus on Consumer Duty compliance in the context of due diligence and related contractual protections for purchasers. For example, the Consumer Duty represents a new set of regulatory obligations, breach of which could lead to the FCA requiring redress or remediation to be undertaken in a manner impacting the value of the portfolio.

Although the Consumer Duty does not seek to retrospectively impose Consumer Duty standards to origination processes, ongoing administration and treatment of customers is still within scope even for products that are considered “closed” (i.e. no longer open for sale or renewal) as at 31 July 2023. This will inevitably lead to more industry focus on the ability of originators and third-party servicers to ensure consistent and positive customer outcomes even when certain issues may stem from the time of origination rather than post-origination servicing, which is explored in further detail below.

In light of the above, it is likely that market participants will place greater emphasis on data and document completeness and availability as part of due diligence processes, as financiers and purchasers consider the implications of the Consumer Duty on the nature and scope of information they consider to be material for a transaction. Regulated acquirers of portfolios will need to place particular focus on such issues when agreeing servicing contracts.

¹ <https://www.cliffordchance.com/briefings/2023/02/regulatory-developments-in-the-buy-now-pay-later-space--hmt-cons.html>

Consumer Duty rules for portfolio sellers and purchasers

The FCA sets out its expectation that (regulated) firms that purchase books of regulated loans should continue to review customer outcomes to “ensure consistency and provide appropriate levels of consumer protection”. The FCA is also introducing rules that require the seller to provide information to the purchaser of a book of regulated loans (and requiring a regulated purchaser to gather relevant information from the seller) to help the purchaser comply with the Consumer Duty. Therefore, it is likely that relevant agreements (including servicing agreements if the purchaser is not itself going to service the portfolio) will need to be considered carefully from this perspective. Such consideration will be particularly pertinent in the context of portfolio sales by sellers looking to divest themselves fully of a position and exit a specified market, as there is likely to be little (if any) ability to request further information from a seller following migration of the regulated loans.

There remains an ongoing discussion around how regulated and unregulated sellers and buyers of portfolios ensure ongoing compliance with the Consumer Duty post-sale or, as applicable, acquisition of a portfolio of loans. On one end of the spectrum is the well-trodden path of requiring a chain of deeds of covenant or similar extending through to subsequent assignees and transferees. On the other end is relying on pre-existing covenants relating to general compliance with applicable law and/or reference to a prudent lender standard. As the market develops its approach to the application of Consumer Duty to transactions, this is likely to be a key area of attention for firms as they consider how best to address the FCA’s focus on ensuring no worse customer outcomes arise due to a sale of a portfolio. It is likely that at least initially, participants lean towards the more conservative approach of requiring at minimum a specific reference to Consumer Duty to address the point more explicitly, and to show the FCA that minds have been turned to consideration of the Consumer Duty’s implications.

Portfolio acquisitions by an unregulated purchaser

The FCA’s Consumer Duty rules and guidance apply only to FCA-regulated firms, meaning that unregulated firms are not subject to the Consumer Duty. This is a consequence of the limits of the FCA’s rule-making powers (as much as any policy decision by the FCA on the scope of the Consumer Duty). While HM Treasury will have powers granted under the Financial Services and Markets Bill to respect to which the FCA could make rules that even bind firms not authorised by them, there have been no plans announced to make use of this regime for the Consumer Duty.

However, the FCA strongly encourages unregulated purchasers of loan portfolios to act in a manner consistent with the Consumer Duty, despite the fact that the FCA does not strictly have powers to require this. In practice, many such unregulated firms sit within groups containing regulated firms or are otherwise subject to some level of control by regulated entities. The presence of a regulated firm in the group could act as an incentive to effectively require unregulated firms to comply even though they are not technically in scope particularly if decisions are taken at a business level across different legal vehicles.

Forward flow structures and co-manufacturing considerations

Firms entering into forward flow arrangements should also consider whether these may involve the purchaser acting as a co-manufacturer of the relevant loans.

FCA rules define “manufacturers” as firms that “create, develop, design, issue, operate or underwrite a product or service”. In its policy statement, the FCA explains that multiple firms may be involved in the manufacture of a single product, in which case the firms are “co-manufacturers”, and gives the example that “intermediaries may be co-manufacturers, for example if they set the parameters of a product and commission other firms to build it”. In the context of forward flow arrangements, purchasers will need to consider if they may be co-manufacturers (alongside the originator) particularly if they set parameters of mortgage loans or other products they agree to purchase.

Firms that purchase loan books may also be classed as “manufacturers”, according to FCA feedback in Policy Statement PS22/9, which explains that “while firms that purchase books of closed products or services from the original manufacturer do not originate or design a product or service, they would be managing, operating or carrying out activities in relation to the book, which means they would be classed as manufacturers”. However, this statement does seem to assume that the purchaser takes an active role in managing or servicing the portfolio, so particular consideration will be needed as to how this analysis applies where the purchaser does not also take on any servicing role, or manage, operate or carry out other activities relating to the purchased loans.

In practice, whether a firm should be considered a “manufacturer” in the context of a forward flow transaction will depend heavily on the types of rights afforded to a purchaser or financier and how they link to consumer outcomes, and whether the level of rights granted is sufficient for the purchaser or financier to determine or materially influence those consumer outcomes. In addition, the circumstances of a particular originator (including, for example, availability of other sources of financing) and the context in which purchaser/financier rights are exercised may also be relevant. Therefore, firms should consider the specific facts of each forward flow arrangement and determine whether they are appropriately classified as a “manufacturer”.

Application to closed products

The Consumer Duty will apply not only to new and existing products and services that remain open to sale or renewal (referred to as “open” products), but also to the way firms continue to service existing products that are no longer open for sale or renewal as at 31 July 2023 (referred to as “closed” products). Firms will have an extra year to comply with the Consumer Duty with respect to closed products, meaning the Consumer Duty will apply to closed products from 31 July 2024. The FCA indicates that it does not consider this application of the Consumer Duty to closed products and services to be retrospective. Rather, its focus is on how firms continue to operate and service those existing products. However, this gives rise to various complexities, some of which the FCA addresses in its policy statement and final guidance on the Consumer Duty. For example, in relation to the “price and value” outcome, the FCA indicates firms should “be confident there is a reasonable relationship, on an ongoing basis, between the price the customer is paying and the benefits of the product or service”. However, firms

can look at the whole picture, including whether the product was transparently sold and whether customers are able to exercise choices to switch or exit from the product and are supported in their ability to do so. Where firms identify that a product is no longer fair value, the Consumer Duty rules confirm that firms do not need to amend vested contractual rights to address this. In this context, the FCA's finalised guidance indicates that vested contractual rights include fees and charges already due or which fall due on occurrence of a contractually specified event (for example, exit charges). Therefore, it appears that the FCA does not expect firms to give up their rights to early exit charges – although it notes they “would be free to do so”.

However, firms are expected to “take appropriate action to avoid causing foreseeable harm and provide fair value. For example, they could consider changing non vested fees or charges, where doing so would not impact on any vested rights, providing additional support or information to customers, or offering forbearance, such as a pause in payments.” Where the issue arises in respect of a vested right to fees or charges, the FCA suggests firms could instead “provid[e] greater flexibility on how customers can engage with a product or assist... a customer to switch to a new product or service that does not have the same issues”. However, these alternative mitigation actions may not be practical in all circumstances.

Timing and Next Steps

As noted above, the FCA Consumer Duty will apply from 31 July 2023 to open products and from 31 July 2024 to closed products, though the FCA sets out interim deadlines it expects firms to work towards in Policy Statement PS22/9 on the Consumer Duty. In particular, the FCA expects:

- all impacted firms should have agreed their implementation plans which should have been approved at board or senior management level by the end of October 2022; and
- product manufacturers should have shared information with distributors by the end of April 2023 to enable distributors to meet their obligations under the Consumer Duty.

Once firms have identified in-scope business and activities, their implementation will then need to focus on ensuring that both the high-level duty and more detailed rules and guidance are implemented through systems, controls, policies, procedures and other documentation across all in-scope business and products. The FCA's indications have been that it generally expects to see active engagement with the Consumer Duty, and expects regulated firms to evidence intended changes to policies and processes as a result of implementing the Consumer Duty.

FCA Engagement

From its policy statement, the FCA indicates that it intends to take a fairly hands-on approach to supervising firms' implementation of the Consumer Duty. For example, the FCA states it may ask firms to share copies of their implementation plans, board papers and minutes with their supervisors and prepare to be challenged on their contents. Therefore, robust planning, record-keeping and internal governance will be important in meeting FCA expectations on Consumer Duty implementation.

The FCA also reminds firms of their notification obligations under Principle 11 and SUP 15 in the FCA Handbook. In particular, the FCA indicates it expects firms to notify and engage with the FCA if firms:

- are considering withdrawing or restricting access to products or services in a way that will have a significant impact on vulnerable customers or overall market supply,
- identify significant breaches of existing rules (including Principle 6 on treating customers fairly) as part of their implementation of the Consumer Duty, or
- believe they will not be able to complete their implementation of the Consumer Duty on time (and notes that firms should take a risk-based approach to implementation by prioritising work that is likely to have the biggest impact on consumer outcomes in this case).

Looking Forward

Generally, we expect the FCA to take an early intervention approach to supervision and enforcement of the Consumer Duty, by signposting areas of focus and potential concern. Consistent with this approach, the FCA provided feedback on firms' implementation plans on 25 January 2023, identifying examples of poor and good practice. Key messages from the FCA emphasise the need for effective prioritisation of implementation in areas where risk of poor customer outcomes is highest, a mindset-shift to focus on substantive consumer outcomes and warning against assuming existing policies and procedures will suffice, and for firms in distribution chains to ensure they have engaged with and shared information as needed with other firms in the chain in time.

The FCA has also published various sector-specific "Dear CEO" letters from February and March 2023 on key issues for firms in sectors including (a) mortgage lenders and administrators, (b) consumer credit lenders, and (c) debt purchasers and administrators, to consider in implementing the Consumer Duty. Among other things the FCA highlights its expectations for firms to support customers impacted by the rising cost of living, and reminds firms of their obligations in the context of portfolio sales to unregulated entities. The FCA also indicates that it expects high-cost lending back books may contain high levels of existing redress due to unaffordable lending historically and that, where this is the case, firms should act to mitigate consumer harm arising from this emerging risk.

With the deadline for the Consumer Duty fast approaching, and as market participants turn their minds to the practical implications of the Consumer Duty on both their businesses and transactions, it is hoped that the market will land on a cohesive approach to the more day-to-day compliance points – although it is inevitable that a degree of divergence will continue for some time on the more fact-dependent aspects of the regulations.

Addendum

Following publication of this article, the UK Mortgage Charter has been published and a majority of market participants have committed to the principles thereunder. The UK Mortgage Charter interplays with certain provisions of the Consumer Duty and firms will be required to overlay such considerations with their regulatory obligations under the Consumer Duty.

The FCA has set out how it expects firms to comply with the Consumer Duty when offering customer options to temporarily reduce their capital repayments or extend the term of their mortgage under the UK Mortgage Charter agreed in July 2023 between a majority of UK mortgage lenders, the UK government and FCA. In particular, the FCA emphasised the need for firms to properly explain the benefits, risks and costs of the options, to avoid causing foreseeable harm to customers and ensure that customers understand the risks and consequences of their choices. However, if a customer insists on a course of action that the firm regards as harmful they are not required to prevent it.

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