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FSA RETAIL CONDUCT RISK OUTLOOK

Client Briefing

FSA's Retail Conduct Risk Outlook 2011 – key points

The FSA published its Retail Conduct Risk Outlook (RCRO) for 2011 on 28 February. In previous years, the FSA has produced a Financial Risk Outlook, but this new report, coupled with a Prudential Risk Outlook (PRO) to be published in March, form the FSA's priority setting for 2011. The PRO will consider the wider macroeconomic environment and other trends relevant to prudential risk and financial stability.

The RCRO looks at how market trends translate into conduct risk, which can result in poor outcomes for consumers, and also presents views on current, emerging and potential risks to consumers. The behaviour of firms is key and this is referenced against current market conditions, relating to, for example, product advice or post-sales service. The RCRO outlines all high priority retail conduct issues which will be addressed in the FSA's next annual Business Plan, to be issued later this month. Although the RCRO addresses immediate risks it also gives an indication of the likely priorities for the new Financial Conduct Authority (FCA) by highlighting potential issues that it hopes to prevent from occurring through dialogue with firms and consumer representatives.

It is essential to be aware of the contents of this outlook as they will form the basis of discussions with the market on risk and give an insight into the FSA's supervisory focus. The FSA state that "the RCRO is a key component in the FSA's consumer protection strategy to identify risks earlier, proactively intervene earlier in the product chain and prevent customer detriment."

We have created this briefing for clients to provide an overview of the RCRO's content and highlight some of the key themes.

The RCRO is split into two chapters, covering the current environment and the risks.

Chapter A: The environment

To set the scene for the risk discussion in Chapter B, the first chapter of the RCRO addresses the macroeconomic background and outlook for households, the regulatory background and outlook, the supply of financial products and consumer experience.

Macroeconomic background and outlook for households

This section of the RCRO discusses key macroeconomic trends that are most relevant to consumers. It is noted that the current UK economy has resulted in vulnerability for consumers in relation to, for example, job expectations. The main trends that are identified are related to:

- ▶ household income, expenditure and savings, with the decline in household income over the
- ▶ recession alongside increased savings, due to household pessimism relating to the general
- ▶ economic outlook – all within an environment of low interest rates, equity volatility and a struggle to
- ▶ reconcile the desire for yield against the need for security;
- ▶ increased household accumulation of financial assets;
- ▶ household debt, which focuses on the dramatic tightening of the mortgage market and the pace of household deleverage; and
- ▶ the potential impact of the current low interest rate, with the potential for shocks if interest rates rise.

Regulatory background and outlook

The main developments in regulatory change are highlighted here, with the RCRO looking at changes that affect a broad part of the industry and also those changes targeted at specific industry segments.

There is a focus on consumer protection measures such as the Retail Distribution Review, the Mortgage Market Review, the new EU regime for packaged retail investment products, the latest UCITS regulations (UCITS IV) and ongoing EU reviews of the Markets in Financial Instruments Directive and the Insurance Mediation Directive. The FSA's recently issued Discussion Paper on proposals for increased product intervention is also referenced here.

Prudential measures that have a possible side effect on conduct of business involving retail customers are also noted. Particular reference is made to the Basel III Framework and other liquidity reviews with potential to impact firms' behaviours in the retail sector. Solvency II is also referenced in the context of its fundamental reform of risk management and capital adequacy rules for the European insurance industry.

Wider measures in terms of how firms engage with their customers are also noted. Workplace pension reform, requiring employers to enrol all eligible employees into a pension and contribute to it, from 2012 and creation of the National Employment Savings Trust (NEST) are highlighted, as is the Independent Commission on Banking which is expected to produce its final report by the end of September this year. The FSA note that this may propose structural measures into how risk can be reduced and competition increased in banking.

Firms and the supply of financial products

This section of RCRO provides a sector specific trend analysis on the supply of financial products by firms and the impact of the financial crisis. The sectors covered are:

- ▶ retail banking and building societies (improved capital ratios, much reduced mortgage lending; structural changes on margins in both lending and deposit taking etc.);
- ▶ asset management (record inflows seeking yield in a low interest rate environment, growth in ETFs, Absolute Return and other funds and innovation in distribution channels (platforms) and some market consolidation);
- ▶ life insurance (challenges posed by falling asset values and low interest rates and net outflows overall and Solvency II expected to increase consolidation);
- ▶ general insurance and protection insurance (changes in distribution channels; focus on Payment Protection Insurance (PPI) misselling); and
- ▶ retail intermediaries (“highly competitive” sector but Retail Distribution Review (RDR) expected to impact / “improve the sustainability of the sector”).

Consumers and demand for financial products: important segment-specific effects

To address the different impacts on different customer segments of trends in the macro-economy, this section looks at specific dimensions of customer diversity. The four dimensions referenced are the unequal distribution of ownership of financial assets; the different impact of a low interest rate environment on different customer segments; potentially different risk/return preferences for different customer segments in relation to low returns on low risk assets; and variations in consumer priorities by age.

Chapter B: The risks

The risks outlined in the RCRO are categorised in Chapter B into current issues, emerging risks and potential concerns. The risks are seen as retail conduct risks that the FSA believe require both firm and supervisory focus immediately and over the next few years. Therefore firms should take note of this information and bear the FSA's views in mind in planning their future activities. For ease, the identified risks, which are elaborated on in the RCRO, are listed as follows:

Current issues where the associated risks have already caused problems for customers:

- ▶ complaints handling in major banks;
- ▶ unfair terms in mortgage contracts;
- ▶ the treatment of mortgage customers in arrears;
- ▶ payment protection insurance and similar alternative products;
- ▶ the sales and marketing of structured investment products; and
- ▶ the sales and marketing of structured deposits.

Emerging risks where there is evidence of poor conduct in firms and a belief that the issue could grow, but little or no evidence to date of widespread consumer detriment:

- ▶ responses to the banking conduct regime;
- ▶ transition to the RDR implementation;
- ▶ systems and controls' weaknesses in the network model of Independent Financial Advisers;

- ▶ the use of platforms;
- ▶ portfolio advice services, discretionary portfolio management and advice on distributor influenced funds;
- ▶ firms' reward policies and practices;
- ▶ investment risk profiling;
- ▶ with-profits funds operation;
- ▶ the increasing popularity of complex investment products: traded life policy investments, exchanged traded funds and other exchange traded products, and self-invested personal pensions; and
- ▶ unregulated collective investment schemes.

Potential concerns seen as risks that may emerge in the future, given the possible impact of environmental factors noted earlier and firm behaviour:

- ▶ fee income generation in banking: private banking and wealth management, protection products and potential PPI replacements, and packaged accounts;
- ▶ the bundling of investment and deposit products;
- ▶ cost-cutting and efficiency improvement initiatives;
- ▶ cross-selling;
- ▶ business model change following the RDR;
- ▶ firms' responses to other regulatory developments; and
- ▶ tax changes and their implication for financial products.

The FSA gives further explanation on each of these actual or perceived issues in the remainder of Chapter B, outlining work either already undertaken, being undertaken or planned in respect of each risk.

Conclusion

Whilst there is little that is "new" in the RCRO for anyone who follows FSA pronouncements diligently, the RCRO does offer an extremely useful overview of the FSA's (and therefore also the FCA's) agenda for coming years. It is clear that in such a dynamic environment the FSA's Consumer Protection Strategy of earlier identification of conduct risks; increased intensity of supervision of the conduct of larger retail firms and an increased focus on product intervention and active use of a greater range of enforcement and other regulatory tools where poor conduct is identified will continue to be implemented with vigour.

Once again, the RCRO provides a clear indication of the FSA's direction of travel for the year(s) ahead and firms doing business with retail customers would be wise to direct resource and emphasis accordingly.

We hope you find the briefing of interest, and if there are any questions, do not hesitate to contact your usual contact(s) at Addleshaw Goddard.



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