CONSUMER DUTY

Revolutionary or redundant?

CONTENTS

What to explore in this document

FEATURED CHAPTERS

In this document we begin to unpick potential consequences of the new Consumer Duty.

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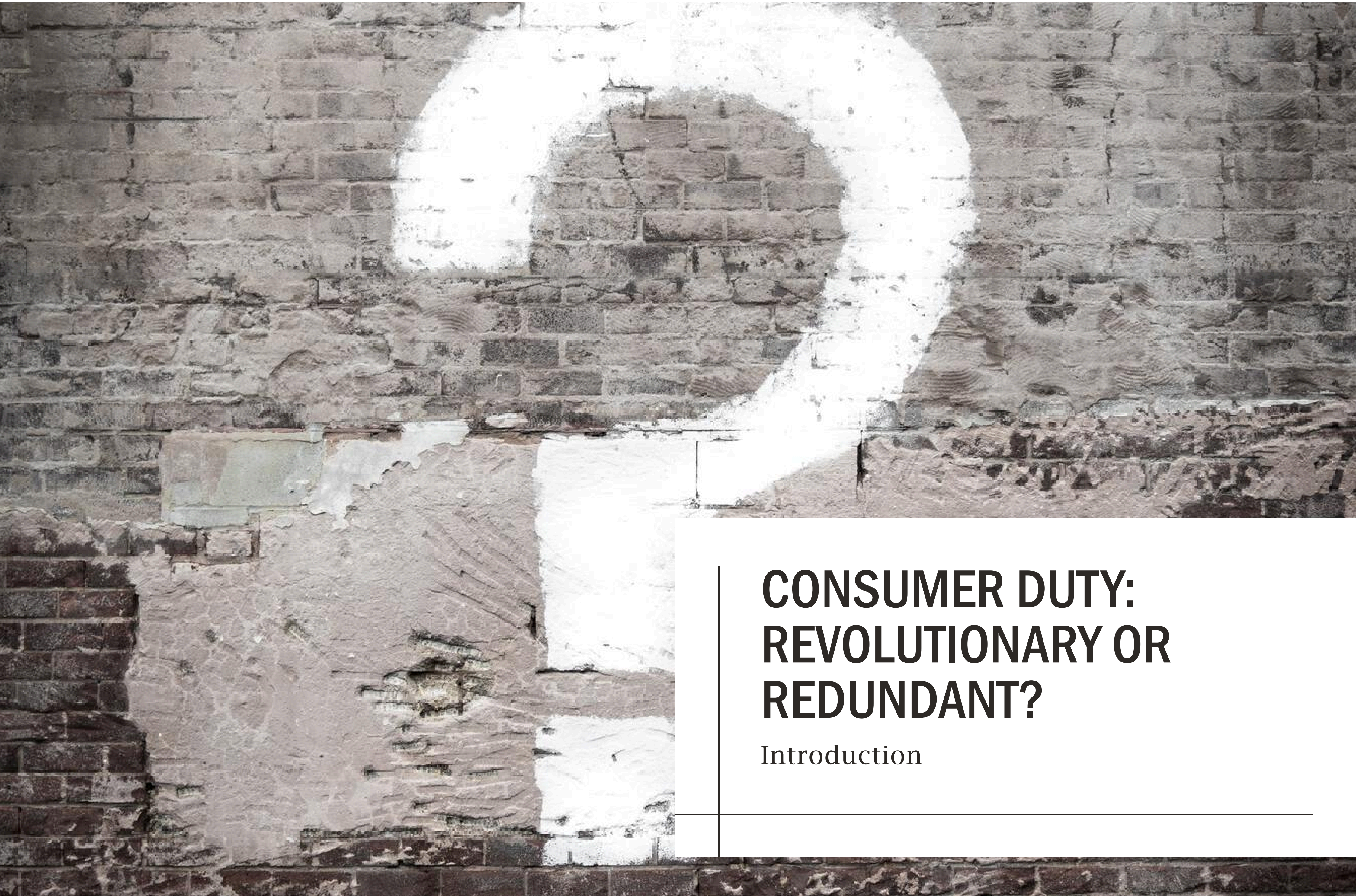

CONSUMER DUTY: REVOLUTIONARY OR REDUNDANT?

Introduction

THE FCA HAS RECENTLY PUBLISHED A CONSULTATION ON A NEW 'CONSUMER DUTY' FOR FIRMS. IN SUMMARY, THE FCA IS NOT HAPPY WITH MANY OUTCOMES IT OBSERVES IN RETAIL FINANCIAL SERVICE MARKETS AND WANTS TO SET HIGHER STANDARDS.

The Duty sets out a Consumer Principle ('act to deliver good outcomes for retail customers'), three cross-cutting rules ('act in good faith', 'avoid foreseeable harm', 'enable and support customers to support their financial objectives') and four outcomes (governance, price and value, consumer understanding, consumer support).

Unsurprisingly, when the FCA published its initial proposals for a Consumer Duty last May, this triggered a wide-ranging debate across the industry. At issue were the options on the specific wording of the Principle, the potential unintended consequences of a private right of action, and more broadly, the impact of the proposed Duty in terms of its benefits for consumers and costs for industry. Suffice to say, views varied widely, and our report for the FCA's Practitioner Panel set out the challenges of robustly quantifying the impact of the proposals.

The current consultation looks to close some of those debates, including the wording of the Principle and the potential for a private right of action. The FCA has also set out an extensive set of proposed handbook rules and guidance that will underpin the Consumer Duty. Now that we have a consultation that sets out the details of the Duty in full, we can start to focus on what it all means and how revolutionary it could be. A full assessment of the impacts of the Duty remains impossible, but we can start to unpick potential consequences by asking three key questions:

1. **What is really new** in the Consumer Duty, and where might firms not be (at least explicitly) compliant?
2. **What does demonstrating compliance look like**, and will existing conduct frameworks and processes be enough?
3. **What customer outcomes might actually change** due to the new Duty?

Each question is taken in turn in the chapters that follow.

WHAT DO YOU THINK THE CONSUMER DUTY WILL BE?

Revolutionary

Redundant

SEE RESULTS

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CONSUMER DUTY: WHAT IS NEW?

Chapter 1

At the highest level, the Consumer Principle to 'act to deliver good outcomes for retail customers' is hard to argue with. Hopefully, most firms would agree that it is indeed what they seek to deliver for their customers. Equally, much of the detail of the new Duty should look familiar to most firms. Making sure products are designed to meet customer needs, having identified target markets, regular reviews of products, fair pricing and value, ideas about good communications. None of that is novel.

In answering what is new, we can start with what we see as three key strands of FCA thinking that the Duty is bringing together:

- The first strand is a focus on **making the demand-side work well**. We've seen that evolve from 'simple' disclosure requirements to more sophisticated interventions better grounded in behavioural economics, like text alerts linked to overdraft usage.
- The second strand is a **focus on outcomes**, where we have seen, for example, the FCA reflect extensively on pricing and fair value exchanges.
- The third and final strand is **ensuring accountability**, as seen through reforms such as the Senior Managers and Certification Regime.

We'll take each briefly in turn.

MAKING THE DEMAND SIDE WORK: KNOWING YOUR CUSTOMER

The Duty marks the next stage in the FCA's journey away from inputs (have we sent that letter?) to outcomes (do customers understand?). There is a clear step-up in the expectation that firms are doing everything they can to make sure customers do not just have the correct information, but understand it well enough to make the best decisions they can. All of this is in service of making the demand-side of markets work well.

Firms need to demonstrate that customers understand, but the Duty is also clear about the effort firms need to support customer understanding. Firms have to ask themselves whether the same standards are applied to communications to deliver good outcomes as those to generate sales and revenue.

There's another critical aspect in which the Duty raises expectations about knowing your customer: the Duty expects firms to know (and demonstrate) how customers behave, the biases they might be subject to and how they navigate around those to deliver good outcomes. You can't avoid foreseeable harm (a cross-cutting rule) if you don't know what foreseeable behaviour customers might exhibit.

From our experience, this is likely to be a significant mindset shift for many firms. Even where firms today are trying hard to communicate effectively, the FCA's diagnosis (paraphrased) that communications are designed by financial service specialists for financial service specialists rings true. It also isn't uncommon to see potentially poor outcomes deflected by pointing to letters and other communications to customers, and that may no longer wash.

The upshot is that we could see a great deal more focus, investment and creativity on communications. Perhaps one day in the not so distant future we will see some creative agencies working out how to make the key terms of a mortgage (such as interest rate, SVRs, fees) more immediately obvious and understandable.

FOCUS ON OUTCOMES: PROVING YOUR VALUE

The Duty continues the FCA's focus on fair pricing and value. Much of what is in the Duty is not new, and its spirit can be found in

recent guidance on issues such as price discrimination. But in an area that is inherently subjective, further guidance and reflection is valuable.

To that end, there is reflection in the Duty on how to approach such assessments and potential benchmarks including costs, benefits and wider market prices. There is also a recognition that some of the standards in competition law and economics are likely to be relevant for assessing pricing and value.

There is also clarity that higher costs and risks can be reflected in pricing, but still must be fair. In other words, customers have to get a sufficient benefit from the product. Our sense is that this is likely to be further focus on the provision of services (such as credit) to the 'marginal' customer. That may prompt some searching conversations about whether, say, a customer regularly using their (relatively expensive) overdraft is really receiving a good outcome.

There is a more general theme from the Duty that firms need to be able to articulate what it is that customers get out of the product and what a 'good' outcome is. That should not be difficult for most retail products, but it is not necessarily how we observe all firms thinking about it today. And it may be tricky for say, the marginal customer accessing credit, to articulate clearly that the value they derive is sufficient for the (relatively high) price they pay.

ENSURING ACCOUNTABILITY

Finally, it is very clear that the FCA intends the Consumer Duty to continue pushing greater accountability onto senior managers in firms. In particular, the FCA sets out expectations on the oversight provided by Boards. From our experience, such oversight is not in itself novel. Boards should already be providing an oversight function on fair treatment. But the degree of oversight expected seems to us greater than what is currently done.

HOW BIG A CHANGE IN EXPECTATIONS DO YOU SEE THE DUTY BEING?

- A significant change
- A modest change
- Little or no change

SEE RESULTS

Oversight under the Duty needs to be completed annually, to cover outcomes, new and emerging risks, evidence of poor outcomes and root cause analysis, actions taken and the compatibility of future strategy with good outcomes. Moreover, the Board needs to be agreeing actions to address any issues and changes to strategy. There is a lot in there, especially for diversified business models. Working out how to facilitate effective Board scrutiny, oversight and debate over whether 'good outcomes' are being achieved is going to be a key new challenge.

CONCLUSIONS

The Duty can be seen to bring together and advance key elements of FCA thinking. That includes 'knowing your customer': how they behave and whether they really understand the product; a focus on outcomes and being able to assess the prices customers pay and the value exchange they receive; and accountability, with greater focus on Board oversight over whether firms are delivering 'good outcomes'.

In the next chapter we'll focus on what compliance might need to look like.

DEMONSTRATING COMPLIANCE WITH THE CONSUMER DUTY

Chapter 2

Chapter 1 drew out some of the key new requirements and standards we see in the Duty. In this Chapter we will explore how compliance might need to change to ensure firms can demonstrate they meet the Consumer Duty.

In considering compliance, the first thing to recognise is that the Consumer Duty is building on a long history of regulating the conduct of firms to make sure that customers are treated fairly. All firms should already have processes, frameworks and governance that seek to meet existing requirements for their particular business. These should naturally be a foundation on which to build new requirements.

But the Consumer Duty could require significant changes to what those frameworks look like. From our experience working with existing frameworks, we see three key potential changes, which we'll summarise as **expanded scope**, **new evidence** and **better explanation**.

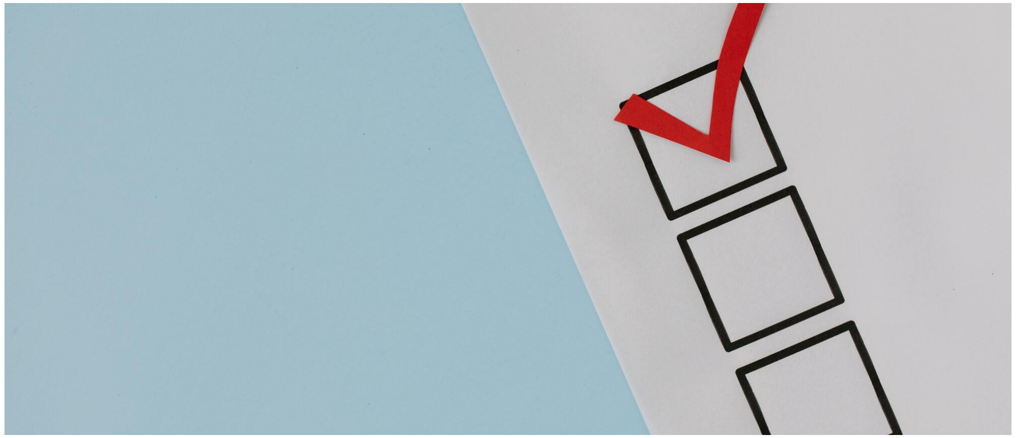
EXPANDED SCOPE

As discussed in our previous post, there are new requirements in the Consumer Duty, effectively new questions that firms need to answer and which need to be incorporated into the tools, guidance and processes that teams use to assess their products. In our previous post we set out how there will be greater expectations around 'knowing your customer' and demonstrating that they understand, as well as 'proving your value' and demonstrating fair pricing and value exchange.

To make this more concrete, a few questions that these standards raise for us, that are unlikely to be fully addressed in many current frameworks:

- **What is reasonable to know about our customers** and are we clear about how we use that information to deliver good outcomes?
- **Do we understand how customers behave?** Do we understand relevant consumer biases that may lead to harm? Are we confident we do not exploit them?
- Are **key communications** to customers **as good as those used for marketing** / commercial purposes? Do they undergo the same processes / investment?
- Does our **monitoring** of **communications outcomes** provide sufficient **evidence that they are understood?**
- What is our **assessment of value?** What does it draw on?
- For **products that serve 'marginal' customers** (e.g. high credit risk customers), are we **satisfied that the benefits to those customers still outweigh the cost?**

These questions cover a mix of product design, customer understanding and pricing and value, though they are not exhaustive. The upshot is we'd expect most firms will need to be doing a gap analysis to reflect on where current frameworks fall short.



NEW EVIDENCE

Given the expanded scope and higher expectations of the Consumer Duty, it is no surprise that elements of the new standards are likely to require new forms of evidence.

In particular, the focus on customer outcomes means evidence will often need to shift from inputs (do we send letters) to outcomes (did customers understand their choices and decisions). Some of that will likely be in place, but we suspect many firms will also need to significantly develop their management information around aspects such as demonstrating customer understanding, and dashboards that assess pricing / margin outcomes and outliers.

BETTER EXPLANATION

Finally, the focus on outcomes, and the reality of complex financial service products, means demonstrating good outcomes requires the distillation of large volumes of evidence, insight and considerations into a coherent narrative that can be assessed and debated. In our experience, there is an inevitable tendency towards 'tick box' compliance in any regulatory field, and the Consumer Duty clearly pushes against it.

Another way of saying this is that many of the standards set by the Consumer Duty cannot be addressed in simple 'yes / no' terms. Firms need to have frameworks and processes that enable them to produce clear explanations of their products, their value, the outcomes they produce and why on balance they meet the Duty.

All of which may ultimately serve the purpose of facilitating effective Board oversight. As covered in the previous chapter, it is evident that the FCA's expectations around what Boards see have risen. Most firms will likely need to think carefully about Board oversight will work in future, and how they can distil the outputs of their governance processes (all the evidence and insight) into a condensed enough format that still facilitates effective scrutiny.

HOW BIG A CHANGE IN COMPLIANCE DO YOU EXPECT FROM THE DUTY?

- A significant change
- A modest change
- Little or no change

SEE RESULTS

CONCLUSIONS

Chapter 2 set out areas of greater expectations from the new Duty, including knowing your customer, knowing your value and ensuring accountability. Here we see that this is likely to flow through to firms' approach. Current conduct processes may need to expand their scope, incorporate new forms of evidence and be able to produce better explanations of customer outcomes and why they are judged to be 'good'.

So far all of this covers requirements and processes. These are important, but leave hanging what might actually change for customers? We'll cover thoughts on that in the final chapter.

WHAT MIGHT THE CONSUMER DUTY CHANGE FOR CUSTOMERS?

Chapter 3

Chapter 1 set out what is new in the Duty, and Chapter 2 explored how compliance may need to change for firms to demonstrate their alignment to the Duty. In this final chapter we look at the most important issue of all: what might change in practice for customers?

Previous chapters were very much about the first order effects of the proposed Consumer Duty. That is, the direct process and governance changes that may flow from it. But ultimately such changes are only meaningful if they result in better outcomes for customers.

We cannot say with any certainty at this stage whether the Duty will succeed. But if it does, we can consider where some of the most material changes in customer outcomes might be. We see a few broad thematic areas where change might be most likely, though recognising that the Duty covers a wide range of different markets, and the impact will inevitably vary.

CHANGING COMMUNICATIONS

It seems likely that the focus on customer understanding could lead to a shift in the way firms try to communicate and engage their customers. It seems likely we see better designed letters, with key information better displayed and communicated. That may diminish the existence of so-called 'sludge' practices the FCA is concerned about.

But that can only go so far, so more interesting will be to see how much pressure there is for firms to innovate and find better ways of engaging (or 'nudging') customers. We've seen some innovation already, sometimes regulatory driven. A prominent example is the FCA's requirements for text messages for overdraft usage. That has proven to be quite a powerful nudge, as it is timely and has a clear and simple action for customers to take.

One of the tensions we will see play out is whether this sort of innovation, and better communication more generally, is impeded by existing (often prescriptive) regulation on exactly what needs to be communicated to customers.

CHANGING PRICES OR PROVISION

The focus on price and value is, we suspect, unlikely to change much for the 'average' customer in most markets. What it is more likely to do is focus attention on 'outliers' and the value they receive. This applies in principle to all retail markets, but we would expect to see it play out in markets where there is greater risks of potential consumer harm, such as credit provision and investments.

That might mean better prices for some of these customers, or it could mean withdrawal of provision if the product becomes unviable. In the case of the latter, a key future debate will be whether that is in fact in customers' interests.

CHANGING PRODUCT DESIGN

Most speculatively, products themselves could undergo changes. One trend we could see is product simplification. If firms are under pressure to make sure customers understand their choices and decisions, they might ultimately find they have to simplify. That could take the form of simpler pricing structures or fewer conditions or even simpler functionality.

These changes, as with others, could lead to better customer outcomes, but may equally have unintended consequences or trade-offs. A prime example of the latter is the recently introduced rules on general insurance pricing. That requires in essence renewal pricing that is no more than new business pricing, and an end to 'price walking'. The change benefits many longstanding customers on expensive deals, but is likely to lead to higher prices for the most engaged customers who switch every year. Making such trade-offs may become more common place as the Duty takes root.

DO YOU THINK THE DUTY WILL DRIVE AN IMPROVEMENT IN CUSTOMER OUTCOMES?

- Yes, a lot
- Yes, a little
- No, not at all
- It may make them worse

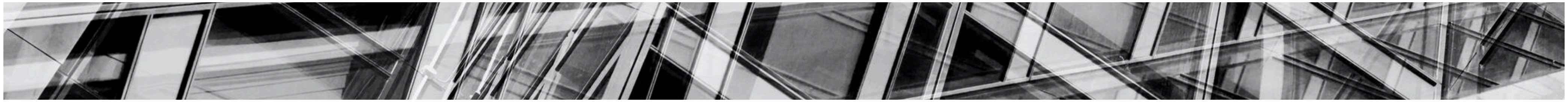
SEE RESULTS

CONCLUSIONS

The heading of this paper posed a question: whether the Consumer Duty is a revolution or redundant?

It is clear that the FCA intends the Duty as a revolution, and there are elements of the Duty that may raise standards for many firms, particularly in demonstrating customer understanding and customer outcomes. These expectations will in turn drive a revolution for many firms in their compliance processes. There is likely to be a great deal for many firms to do to expand the scope of issues they consider, gather more data and insight on customer behaviour or understanding or the prices they pay, and to provide all that in a format that facilitates scrutiny at the most senior levels of the firm.

Whether it is a revolution that delivers better customer outcomes remains to be seen. But one thing is certain: success will be contingent in good measure on the clarity of its expectations - hence the Duty consisting of more than 120 pages of rules and guidance. But this remains abstract. Beyond the written rules, it will be crucial that implementation includes transparent direction, guidance and feedback between industry and the FCA on what ‘good’ looks like. The FCA’s suggested timetable would put April 2023 as the start of the Duty. If that remains unchanged, there is a great deal to do in a short space of time.



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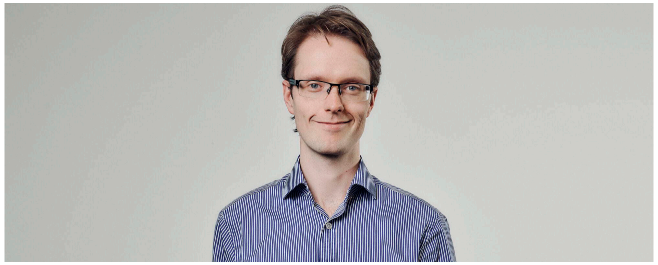

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