

## FCA Risk Outlook and Business Plan 2014

The Financial Conduct Authority (FCA) has published its *Risk Outlook* and *Business Plan 2014-2015*.

The Risk Outlook sets out the FCA's approach to assessing conduct risks within financial services. It identifies three primary drivers of conduct risk: inherent factors (such as supply-side failure); structures and business context (features of the sector's design, processes, embedded culture that result in certain market outcomes); and environmental conditions (outside of the sector and customers that cause them to adapt their approaches).

The Business Plan sets out how the FCA plans on dealing with the key risks identified within its *Risk Outlook*, whilst also providing details on how it plans to meet its operational objectives of securing protection for consumers, enhancing the integrity of the UK financial system, promoting effective competition in the interests of consumers.

Follow the links for the: [FCA Risk Outlook 2014](#) and [FCA Business Plan 2014-15](#)

### Introduction

“Embedding cultural change in a firm that acts in the interest of consumers is the essential next step if firms are going to regain trust from their consumers. Cultural change may take years to achieve but every positive step towards embedding a culture which places consumer interests at the heart of the business will ensure the protection of consumers, market integrity and effective competition. A culture and strategy within firms that promotes these outcomes is in all our interests – particularly given London's importance in global markets as a centre for finance. The cumulative impact of actions – for example market abuse, which diminish the integrity of our markets – may challenge this role. As the regulator we can promote good and tackle poor behaviours through enforcement actions but firms and market participants need to take responsibility in maintaining the integrity of our markets through their own actions. Millions of people are employed by the financial sector and a vast majority of these individuals do not undertake activities or exhibit behaviours that require the FCA to intervene.”

John Griffith-Jones, Chairman, Financial Conduct Authority

### Risk Outlook

The FCA's second Risk Outlook follows a similar approach to its first one. It starts by identifying the drivers of risk, then sketches out a risk landscape of how changing conditions have interacted with consumer and firm behaviour and threaten the regulator's objectives, and then draws out seven forward-looking areas that it will be pursuing in its overall risk plan.

### Drivers of conduct risk

In setting out its analysis of the drivers of conduct risk, the regulator uses the same model it developed in 2013 around three key factors: inherent; structural & behavioural; and environmental (see figure 1).

**Inherent factors:** are identified as a combination of supply-side market failures, such as poor provision of information from a firm, and demand-side weaknesses, including customer inertia. These factors are often exacerbated by poor consumer financial capability.

**Structures and behaviours:** which have evolved to profit from lack of consumer awareness and also market failures. Culture, be it within a particular firm or an entire industry, is a key factor for the FCA and the CII expects that the regulator will focus particularly on this area.

**Environmental conditions:** include economic conditions and trends, regulatory changes and any technological developments.

### The risk landscape

In analysing the contributing factors to risks within financial services, the FCA has identified a number of cross-market pressures that have the potential to impact consumer protection, market integrity and effective competition. These are:

- Pressure on business model sustainability.
- Balancing profitability, shareholder returns and cost base with consumer outcomes.
- Misalignment of expectations with underlying fundamentals.

As well as these cross market pressures, the FCA has recognised several areas of forward-looking focus which have the potential to impact on the regulator’s objectives. In order to mitigate the risks, the FCA recognises that regulatory action will not be enough: firms and consumers will also be expected to play their part. The FCA’s Business Plan also covers these risks and sets out actions they plan to take over the coming year in relation to these potential factors.

#### ***Culture and controls continuing to threaten market integrity:***

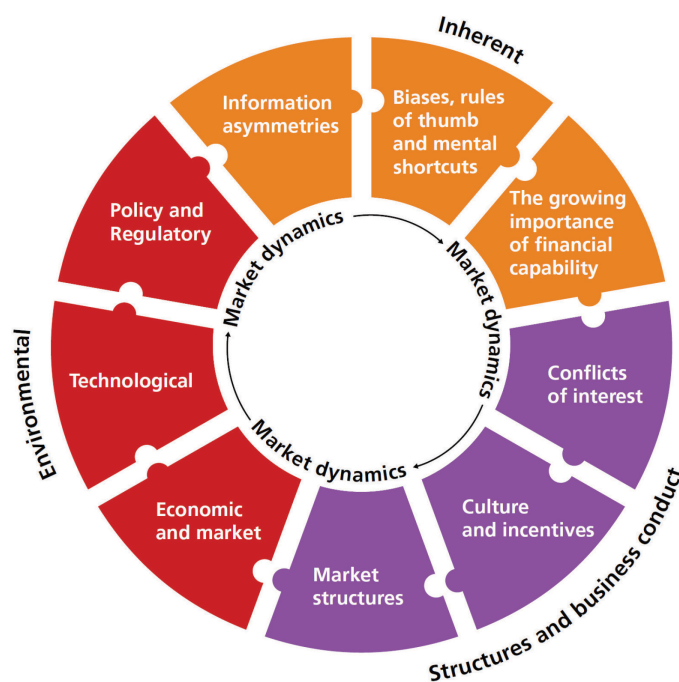
- Poor culture and controls continue to threaten the soundness, stability and resilience of financial markets and transparency of the price formation process.
- While wholesale market participants may be able, to a greater or lesser extent, to protect their own interests and those of their immediate clients at a transactional level, poor conduct in these markets can feed through in the retail market and the aggregate impact of poor conduct can undermine the integrity of markets.

**FCA action** The work of the FCA will focus on those areas where it is not seeing the level of change expected. Several thematic reviews will be carried out to address potential issues in firms’ conduct including managing the performance of staff (following on from the FCA’s work on financial incentives).

#### ***Retirement income products and distribution delivering poor outcomes cause risks to consumer outcomes over the long term.***

- Currently decumulation products require consumers and firms, developing products, to consider risks such as expected longevity, inflation, interest rates, guaranteed periods, and volatility of assets/investments available for drawdown.
- This can create challenges for firms and consumers alike judging the suitability of different decumulation options, leading to consumers buying or being sold, unsuitable products at prices that are not affordable or that do not serve their needs.

Figure 1: Key risk drivers, taken directly from FCA Risk Outlook 2014, p.8.



- Behavioural biases can play a role in these decisions. For example, consumers may have insufficient knowledge to be able to make a decision in their long-term interest, on how to use their pension savings.

**FCA action** The FCA will be undertaking further work into retirement income products, such as annuities, particularly in light of the 2014 Government Budget announcements. As part of this, the regulator will carry out supervisory work on sales practices in the annuities market.

#### ***Growth of consumer credit leading to unaffordable debt***

- Rapid growth of consumer credit could lead to unsustainable debts as households face an on-going squeeze on their spending power. Although there have been some recent positive economic signs (e.g. falling unemployment, a decrease in inflation, stronger growth), significant pressures remain on households' spending power.
- As economic conditions improve, growing consumer and lender optimism is likely to increase borrowing by consumers more generally. However, as household debt remains relatively high and is growing, there is increased risk that this further consumer credit borrowing will be unsustainable for some, particularly for households with already high levels of debt.

**FCA action** The FCA plans to look at the short-term lending market and the processes in place, in particular relating to the treatment of those borrowers who get into difficulty.

#### ***Rapid and substantial house price growth giving rise to conduct issues***

- As demand for housing rises, and in the absence of sustainable housing supply, house prices could rise further relative to incomes and rents.
- Weakening underwriting standards: in a rapidly growing market, over confidence in future price growth could lead firms to gradually loosen underwriting standards to maintain a share of the growing market. In addition to the increased term extensions observed through current lending, lenders could start to reduce the cost of living data, or accept a higher proportion of bonus payments, commission or income from second jobs to stretch affordability assessments.
- Impact on affordability of interest rate rises: as discussed earlier, house price gains are likely to be reflected in more sustained recovery which will over time lead to gradual rises in interest rates.
- Mis-treatment of consumers exiting from forbearance: rising house prices (coupled with interest rate rises) could see lenders taking a much tougher line with consumers who are in default or forbearance as the carry cost becomes too great.

**FCA action** The Mortgage Market Review (MMR) aims to help to limit unaffordable lending practices. During 2014/15 the FCA will review how the market has responded to the MMR, including how firms give advice to consumers.

#### ***Terms and conditions may be excessively complex***

- Complex terms and conditions could lead to consumers not understanding the protection their product offers, unable to compare different products or encountering problems as a result of unclear

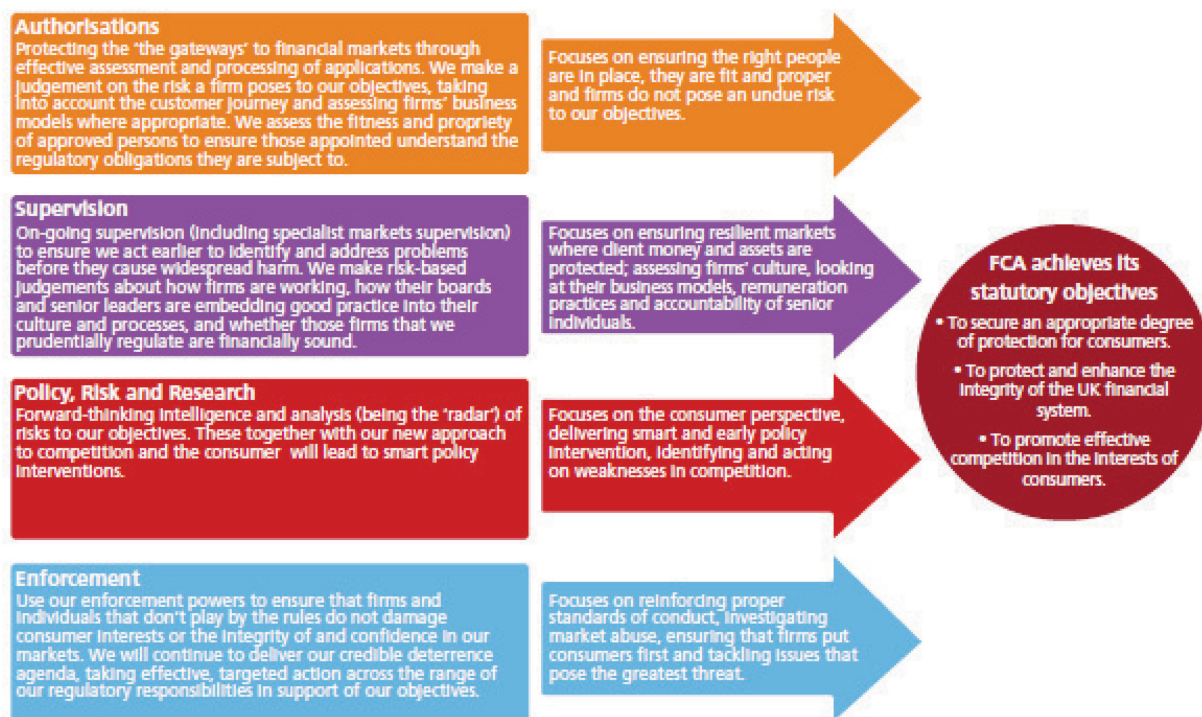
**FCA action** The FCA will look at whether consumers have the amount of protection they believe they have and what they can do about changes in terms and conditions. It also plans to look at whether complexity is compounded by marketing.

#### ***Large back books may lead firms to act against their customers' best interests***

- Firms could extract value from their existing customers by targeting inertia resulting in poor outcomes.

**FCA action** In 2014/15, the FCA plans to examine whether life insurance firms are operating historic (often termed 'legacy' or 'heritage') products in a fair way and whether they have adopted strategies that are not in the best interests of existing customers. It will also complete its market study into cash savings accounts.

Figure 2: FCA's regulatory approach in dealing with forward looking risks



## FCA focus areas for 2014-2015

The FCA's Business Plan reaffirms the regulator's three operational objectives (to secure **protection for consumers**, to enhance the **integrity of the UK financial system**, and to promote **effective competition** in the interests of consumers) and sets out the activities it will undertake to meet these goals. As well as its ongoing conduct supervision activities within financial services, the FCA also has a number of new strands of work for 2014/15, the most pertinent of which is the integration of consumer credit regulation into the FCA's remit. The Business Plan also highlights the key risks to the FCA meeting its objectives. Details of all of these are given below:

### Headlines

#### New responsibilities

- **Regulating consumer credit** – the FCA takes over the regulation of consumer credit from the Office of Fair Trading on 1 April 2014. 50,000 consumer credit firms will be brought into the FCA's regime, doubling the number of firms it watches over.
- **Changing the approved persons regime** – the Financial Services (Banking Reform) Act 2013 makes changes to the regime and introduces a Senior Managers Regime in deposit taking institutions and a Certified Persons Regime for those not covered by the Senior Managers regime who perform roles that might involve harm to the firm or consumers. A consultation on proposals is expected.
- **Preparing to enforce competition law** – working towards April 2015, and the assumption of powers to enforce competition law in financial services concurrently with the Competition and Markets Authority (CMA).

#### Other key activities

- **Enforcing rules** – Raising standards of behaviour in the financial services industry by making clear the consequences of non-compliance and the benefits of doing the right thing remains central to our approach. The FCA is committed to using its enforcement tools effectively to help it achieve its aims and objectives.
- **Thematic reviews** – Key areas of focus this year include the treatment of customers in life insurance.

- **Retail Distribution Review** – post-implementation review utilising research carried out throughout the year. The RDR will be measured against its original objectives and there will also be work on expectations gap and advice boundaries.
- **Implementing the Mortgage Market Review** – The majority of changes came into effect on 26<sup>th</sup> March 2014.
- **Prudential requirements for personal investment firms** – Consultation on a 15 year time limits on complaints to the Financial Ombudsman Service.
- **Payment Protection Insurance** – focusing on how well firms analyse consumer complaints.
- **Reforming pensions** – in the light of auto-enrolment, developing new policies to protect pension savers. Also an increased focus on the market for retirement products.

## Protecting consumers

The FCA will continue its work to ensure that firms have embedded a culture promoting fair treatment of consumers and market integrity. This will be through its ongoing supervisory work and through thematic work to investigate specific issues. The FCA's *Business Plan* sets out some of these more specific activities by market:



### **Long-term savings and pensions**

#### **Effective due diligence for retail investment advice**

We will look at whether investment advisers are carrying out appropriate due diligence to ensure that consumers are sold suitable products and services.

#### **Sales practices at retirement**

We will carry out work looking at sales practices that consumers experience at retirement, the results of which will feed into our wider work on retirement income products.

#### **Fair treatment of long-standing customers in life insurance**

We will assess whether firms are operating historic (often termed 'legacy' or 'heritage') products in a fair way and whether they have adopted strategies that exploit existing customers.

#### **Governance of with-profit funds**

We will review whether firms have effectively implemented the changes we made to our with-profits rules in 2012. We will assess how adequate their with-profits governance arrangements are for a particular aspect of their business.

#### **Use of in-house funds in wealth management firms**

We will assess how wealth managers and private banks effectively control the conflicts of interest that arise when client assets are invested in in-house investments.

#### **Risk at client take-on in contract for difference providers**

We will assess the risks arising from the client take-on procedures in firms offering contract for difference products.



### **Mortgage and consumer lending**

#### **Forbearance practices and the treatment of customers in arrears in the high-cost short-term lending market**

We will review the arrears management processes of high-cost short-term credit firms and how customers are treated when they are in financial difficulty.

#### **Suitability of advice in debt management firms**

We will look at the suitability of advice given by debt management firms, including how incentive structures and the use of lead generators may affect consumers.

#### **Mortgage Market Review (MMR) post-implementation testing**

We will review areas such as how firms are implementing our new affordability rules and how they give advice to customers. We will also look at how firms may be finding ways to avoid the rules.

#### **Hybrid equity release products**

We will look at the development of hybrid equity release products as a potential solution to the interest-only maturity issue.

#### **Maturity of interest-only mortgages**

We will look at a sample of smaller firms to determine if customers are being treated fairly in line with the guidance we published in August 2013.

#### **Governance over mortgage lending strategies**

We will review governance, risk management and strategies of the firms with recent risk appetite changes across a sample of the lender population.



### **General insurance and protection**

#### **Commercial claims**

Building on findings from current retail claims work, we will consider whether commercial customers' expectations are met in the claims process, where poor behaviour could have a wider impact on trust in the market, as well as leading to poor customer outcomes.

#### **Cover holders**

We will look at distribution chains in firms that operate in wholesale markets, but also looking through to the impact on retail and small commercial customers. We propose to look into the key risks in complex distribution chains and the mixed responsibilities in them, including the cultural risks relating to product design, sales and post-sales handling. We will also aim to improve the way intermediaries identify and manage conflicts of interest.

#### **Premium finance**

We will review insurers' and intermediaries' sales practices and disclosures when selling premium finance to consumers alongside general insurance products. This follows on from our previous work on commercial premium finance and aligns to our new responsibility for the regulation of consumer credit from April 2014.

#### **Motor legal expenses insurance**

We will ensure that firms have embedded the recommendations we made in 2013 in this market.

#### **Mobile phone insurance**

We will ensure that firms have embedded the recommendations we made in 2013 in this market.

#### **Protection of client money by small firms**

We will look at the extent to which firms are currently holding client money without the appropriate permissions and protections.



## Cross-sector

### Managing the performance of staff

Following our work on financial incentives we will look at how firms manage the performance of their sales staff and whether pressure put on staff (through, for example, sales targets) increases the risk of mis-selling.

### Resilience against cyber attack

In response to the Financial Policy Committee recommendation, we will work with the Treasury, the Prudential Regulation Authority (PRA) and the Bank of England to assess and test the Financial Services Critical National Infrastructure's resilience to cyber-attacks.

### Visibility of IT resilience and risks at board level

We will assess how far individual firms have progressed against the feedback they were given after our 2012 'dear chairman' exercise. We will do this jointly with the PRA and the Bank of England. The aim is to assess how well firms manage their own exposure to risks, to what extent IT risks are discussed at board level, and whether boards have the skills and expertise to challenge executive decisions.

## Enhancing market integrity

- **Enhancing whistleblowing** – Following an increase in whistleblowing activity during 2013, the FCA plans to consider trends and identify under represented sectors where efforts can then be made to encourage people to come forward. It will also look at how to implement the recommendations of the Parliamentary Commission on Banking Standards that relate to whistleblowing.
- **Implementing EU legislation** – During 2014/15 the FCA will continue its work to implement the Alternative Investment Fund Managers Directive (AIFMD) and its preparations towards implementing the Markets in Financial Instruments Directive (MiFID). The revised regimes aim to protect investors by improving standards and transparency.

## Building competitive markets

- **Studying the market** – The FCA will continue to undertake market studies and has announced that it will complete its work into income products at retirement. There will also be studies into competition in the wholesale market and aspects of the consumer credit market.

## Messages for firms from the Risk Outlook

The FCA expects firms to engage with the analysis and messages in the Risk Outlook document and assess the relevance to their own business models and strategies – from the products they design and their distribution to the oversight and use of technology and funding strategies. Firms should reflect on how the wider environment will not only affect their growth in particular markets but may also affect existing strategies in place and perhaps alter the conduct risks for existing consumers.

Firms should look at their business models, strategies and structure to critically assess whether they are effectively identifying and managing the root causes and drivers of risk set out in the Risk Outlook. They should also identify the relevance of the risks set out here – including the seven areas of focus – and critically assess whether they apply to their own business and how they could play a role in resolving these in a way that is fair to consumers, enhances market integrity and promotes effective competition.

Firms need to ensure they are putting the consumer and the integrity of markets at the heart of their business models and strategies.

## Current and planned thematic work and market studies

	Work begins	Expected end
<b>Long-term savings and pensions</b>		
<b>Pensions reform</b>	Q1 2014	Start Q2 2015
<b>Retirement income study</b>	Q1 2014	End Q2 2015
<b>Advice models</b>	Q1 2014	Q2 2015
<b>Crowdfunding</b>	Carried over	End Q2 2014
<b>Review of post-RDR adviser charging</b>	Carried over	Mid Q1 2015
<b>RDR post-implementation review</b>	Q2 2014	End 2015
<b>Fair treatment of longstanding customers in life insurance</b>	Q2 2014	Q4 2015
<b>Effective due diligence for retail investment advice</b>	Q3 2014	Q1 2015
<b>Mortgages</b>		
<b>MMR post-implementation review &amp; testing</b>	Q1 2014	End Q2 2015
<b>Governance over mortgage lending strategies</b>	Q1 2014	Q3 2014
<b>Maturity of interest-only mortgages</b>	Q1 2014	End Q3 2014
<b>Hybrid equity release products</b>	Q4 2014	End Q1 2015
<b>General insurance and protection</b>		
<b>GI add-ons</b>	Carried over	End Q3 2015
<b>Cover holders</b>	End Q2 2014	Mid Q4 2014
<b>Premium finance</b>	Q3 2014	Q3 2014
<b>Commercial claims</b>	End Q3 2014	End Q1 2015
<b>Protection of client money by small firms</b>	End Q3 2014	Mid Q1 2015
<b>Other</b>		
<b>Resilience against cyber attacks</b>	Q1 2014	End Q3 2014
<b>Visibility of resilience and risk at board level</b>	Q2 2014	End Q1 2015
<b>Managing the performance of staff</b>	Q2 2014	End Q1 2015