Policy briefing

April 2013

Financial Conduct Authority
Risk Outlook and Business Plan 2013

Summary

The Financial Conduct Authority (FCA) has published its *Financial Risk Outlook* (FRO) and *Business Plan 2013-2014*. These are the organisation's first publications in its new identity ahead of legal cut-over from the former Financial Services Authority on 1 April 2013.

The FRO 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); behavioural factors (such as mis-selling); and environmental factors (such as the general economic climate). As well as identifying broad risks across financial service, the FRO details five priority risks for the coming year:

- Product design;
- Distribution channels;
- Payment and product technologies;
- Risky funding strategies; and
- Poor customer understanding of risk and return.

Alongside the FRO, the FCA has published its 2013-14 Business Plan. The plan, which is underpinned by the FRO, shows how the FCA expects to manage risks it has identified while meeting its objectives, which are to:

- Secure an appropriate degree of protection for consumers.
- Protect and enhance the integrity of the UK financial system.
- Promote effective competition in the interests of consumers.

This briefing looks at both publications and focuses in particular on the FCA's approach to risk, the identified key risks and how they will be tackled.

Follow the links for the: FCA Risk Outlook and FCA Business Plan 2013-14

Background

On 1 April 2013, the Financial Conduct Authority (FCA) officially came into being as part of the UK's reworked financial regulatory landscape. The FCA, along with the Prudential Regulation Authority (PRA), replaced the previous regulator, the Financial Services Authority.

The FCA will regulate approximately 27,500 firms and is responsible for conduct of business and market issues for all firms, as well as the prudential regulation of small firms (such as insurance brokerages).

Financial Risk Outlook

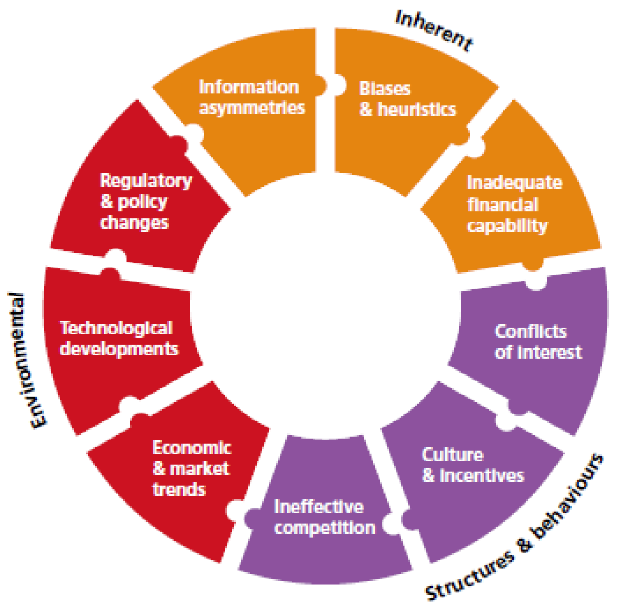
One aspect of the FCA's remit concerns conduct risk – both in terms of identifying the drivers of conduct risk and considering how such risks impact on financial services and consumers. In its first Risk Outlook (published 25 March 2013), the FCA not only considers the risks it foresees over the coming years, both to the market and its participants, but also provides a brief outline of its approach to risk.

The FCA will look carefully at product design and distribution, as well as consumer understanding. It will focus on both retail and wholesale conduct – especially as behaviours within wholesale markets can filter through to the wider financial world. In taking this approach, the FCA expects to be able to be more proactive in dealing with risk, where required, intervening at an earlier stage.

Drivers of conduct risk

In setting out its analysis of the drivers of conduct risk, the regulator identifies three key factors: inherent; structural & behavioural; and environmental (see figure 1).

Figure 1: Key risk drivers, taken directly from FCA *Financial Risk Outlook 2013*, p.10.



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 risks that have the potential to impact consumer protection, market integrity and effective competition. 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.

- Pressure on business models and strategies:
    - Creation of complex and niche products that exploit conflicts of interest and do not meet customer needs;
    - Over-exploitation of profitable market segments or groups of consumers; and
    - Increasing reliance on technology without a full understanding of the consequent risks and dependencies.
- Balancing prudential soundness and profitability with good consumer outcomes:
    - Cost-cutting without understanding the risks and dependencies;
    - Poorly managed strategies; and
    - Unsustainable strategies to attract funding promote risky behaviour.

- Misalignment of market performance:
    - Poor consumer choice as a result of poor understanding of risk and return; and
    - Pressure to make up for losses leading to firms taking on risky funding.

From these cross-market risks the FCA have identified five "Priority Risks" which will be the regulator's focus over the next year. An analysis of the risks and how they link to the business plan is provided later in this briefing.

Business Plan 2013-2014

The FCA's Business Plan is the most detailed document setting out the regulator's approach and strategy since the publication of *Journey to the FCA* last autumn.

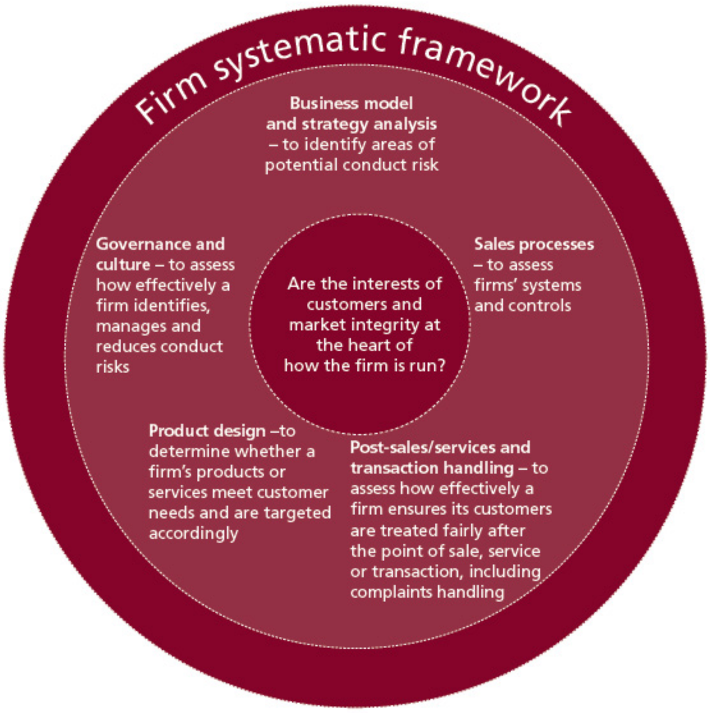
Strategic priorities

The Business Plan sets out how the FCA will meet its strategic priorities, which are:

- Mitigating the three key forward-looking risks from the RO – inherent factors, structures and behaviours, and environmental factors (see above).
- Dealing with its operational objectives of: delivering consumer protection, enhancing market integrity and building competitive markets.
- Addressing crystalised risks, such as PPI and issues surrounding LIBOR.

FCA overall approach to regulation

Figure 2: FCA Firm Systematic Framework. Taken directly from: FCA *Business Plan 2013-2014*, p.33.



The Business Plan provides information on how the FCA will supervise firms. As has been made clear in the run up to its creation, the FCA will take a proactive approach to regulation, looking to address issues before they impact consumers. There will also be a greater focus on business model and strategy analysis.

A new supervisory framework replaces the former ARROW system, comprises five key pillars: the Firm Systematic Framework, wholesale conduct supervision, issues and product work, event-driven work, and thematic supervision.

1. Firm Systematic Framework

As part of the FCA's supervisory framework, the regulator has created the Firm Systematic Framework (FSF). The FSF allows supervision to focus on the key conduct risks and covers all types of firm. It will consider potential harm to consumers as well as the impact a risk could have on the market. To begin with the FSF will be used with the largest retail deposit takers. Then it will extend to all firms in three of the four risk categories:

- large retail banking and insurance firms (which the FCA call Category 1 or C1 firms);
- firms in all sectors with a large retail customer footprint or wholesale market presence (C2), and
- mid-sized firms across all retail and wholesale sectors (C3).
- the FSF will not extend to Category 4 (C4) firms: retail and wholesale firms with a smaller footprint.

2. Wholesale conduct supervision

The FCA will take a "more assertive and interventionist approach" to risks cause by wholesale activities. This will include intervening when it believes that conduct could have a detrimental impact on consumers. The regulator is very aware what happens in the wholesale market can feed through to retail markets – and that risks within wholesale are driven by the same factors as those in retail (see figure 1).

3. Issues and product work

The FCA will also conduct firm-specific and industry-wide thematic reviews. They plan to undertake detailed work, with the support of industry practitioners, to investigate what causes poor behaviour and how standards can be improved. We await more details of this strand of work.

4. Event-driven work

The regulator will respond faster and more decisively to emerging problems regarding wholesale and retail conduct risks. They will have a consistent process to ensure that 'event-driven' cases (such as alleged misconduct raised by a whistleblower) are dealt with quickly and appropriately.

5. Thematic supervision

In 2013-14, they will be investigating incentive structures and corporate culture, as well as other perceived causes of poor conduct. Domestic policy initiatives, such as the general insurance add-on market study (which is concentrating on whether consumers being sold products that meet their needs).

Priority Risks

Having examined the "forward-looking cross-market risks" [summarised above], the regulator distilled these into just five "priority risks", and its Business Plan set out responses to them. While the forward-looking risks are important for longer-term analysis, the priority risks deserve closer discussion here.

Product design not responding to customer needs or long-term interests

The FCA warns about the risk of products and services not being designed in response to real consumer needs, or may be unnecessarily complex or lead to excessive prices for consumers or reduced access to financial services. They describe various situations in which this could manifest itself including:

- Exit obstacles if the product or service becomes unaffordable or unsuitable to the consumer as a result of changing needs or circumstances.
- Firms adopting economic or business conditions response strategies that support their own interests and not those of their customers. Similarly they over-exploit their existing customer base due to limited new business.
- Complex, opaque and over-priced products that are difficult to compare and have questionable long-term value.
- Consumers not fully aware of their financial needs and what products or product features would adequately serve these needs.

FCA response (from the Business Plan):

- **Product intervention:** implementation of this regime will see thematic reviews of product governance processes across both retail and wholesale markets to ensure appropriate consumer outcomes, and the FCA "will take tough action if standards are not adequate." Additionally, the regulator will start replacing existing guidance with rules to provide more legal certainty.
- **Mortgage arrears and forebearance management:** a key 2013 task will be a thematic review of firms' arrears handling procedures and their strategies for managing long-term arrears.

- **Asset management product design and oversight project:** this project will highlight the behaviours and practices of asset management firms specifically charging structures that harm consumers.
- **Competition expertise:** further to its new competition objective, the regulator will develop in-house expertise focusing on how to identify competition risks, early intervention, examining entry and exit barriers, and enhancing its knowledge of specific markets and issues through market studies.

Distribution channels not promoting appropriate transparency

The regulator warns that firms could exploit information asymmetries or fail to manage distribution chain conflicts of interest. This could lead to consumers being led to buy inappropriate products or services. Firms could use existing distribution channels to target consumers with additional products that they may not need. This could manifest itself as follows:

- consumers prevented from being able to make well-informed financial decisions or compare product because features, costs and incentives are not transparent.
- information asymmetries and conflicts of interest are not managed and consumers may be using misleading information.
- firms failing to re-assess the suitability of using existing distribution channels to push additional products onto consumers.
- Specific concerns such as Transition Management which use unclear fee structures and complex legal and pre/post-transition documentation can result in poor customer outcomes.

FCA response (from the Business Plan):

- **RDR implementation:** the FCA will be closely monitoring implementation by analysing individual sectors and the overall shape of the market ("macro" analysis), and analysing how individual firms adapt and their business models manage the associated risks ("micro" analysis).
- **Financial incentives project follow up:** in 2012, the FSA published guidance on risks arising from financial incentives after a thematic review showed that incentive schemes can cause mis-selling. Some firms have made significant changes to reduce risk. This year will see the FCA conducting a wider review to assess firm response to the guidance including assessment of whether more intense supervision work is needed.
- **Financial promotions review:** the FCA will review promotions across all financial sectors to ensure firms provide clear, fair and not misleading information, and will take action if this is not achieved. The FCA has a new power to ban financial promotions and publish details related to it, in hopes that this will deter firms from misleading customers.
- **Conflicts of interest:** the FCA Firm Systematic Framework (see above) is designed to help address conflict of interest issues, and this year will see the regulator applying this to the asset management sector. In 2012, the FCA undertook initial work on conflicts visiting firms and providing detailed feedback, and then communicating findings.
- **PRIPs regulation:** the European Parliament is currently debating the Packaged Retail Investment Products (PRIPs) regulation which sets out clear and standard rules across the various retail investment product regimes. The FCA will inform the UK government position to influence the final result in Parliament, and will also work with the European Supervisory Agencies on technical implementation.
- **Transition management:** this process allows improved performance through increased portfolio returns and better risk management for low-transition clients including pension funds, local authorities or other institutional managers. The FCA will undertake a project to review practices across the main TM industry to assess whether customers are being treated fairly.

Reliance on payment/product technologies

Technological systems and interfaces that firms rely on carry risks and dependencies, the mitigation of which might not be fully undertaken by firms. They highlight the following risks:

- potentially poor technology oversight that may lead to weak operational resilience and risks to service continuity. This includes systems unable to withstand growing transaction volumes.
- firms failing to capture market abuse such as money laundering, where individuals may, for example, take advantage of complex product structures or opaque payment systems to hide illicit funds.
- firms failing to consider the needs of different consumer groups in the development and marketing new technology-based services.
- consumers not adequately informed about how to protect themselves from financial crime or how to use technologies correctly. For example, mobile phone banking/payment services may have benefits for consumers. Firms should consider the potential risks to their customers when launching these services

FCA response (from the Business Plan):

- **Price comparison sites:** the FCA will review the risks that price comparison websites present to consumers and whether they comply with regulatory requirements.
- **New payment methods and mobile banking**: following an initial review of this in 2012, the FCA will intervene to ensure that firms offering such services are taking appropriate steps to protect consumers.
- **Market infrastructure**: the FCA will use its supervisory framework of regulated investment exchanges and multi-lateral trading facilities (MTFs) to assess whether the market infrastructure's operational risk management is sufficient to respond to the risks these new demands.
- **Payment Services Directive:** this is currently being reviewed by the European Commission. The FCA and the Treasury will seek changes to make it clearer and to promote competition and innovation, which should make the new Directive more able to embrace future technological change.

Risky funding strategies posing a danger to consumer protection

In response to market conditions and regulatory requirements, firms may use increasingly innovative, complex and risky funding sources and structures which could prove to be unsustainable and may not be compatible with firms' existing governance and oversight arrangements. The risk could manifest itself in the following ways:

- Firms' funding structures or sources of funding may adversely affect market integrity
- Firms' funding structures are predicated on products that have been developed and priced to meet investor demands rather than needs of the consumer of the product.

FCA response (from the Business Plan):

- **Capital Requirements Directive:** the FCA is the prudential regulator for a large number of investment firms currently covered by the Capital Requirements Directive (CRD). They will therefore need to implement the changes introduced in CRD IV.

Poor understanding of risk and return

There is a gap between consumer perceptions and real product performance which hamper accurate risk assessments, leading to poor financial decisions. Consumers' search for yield may incentivise them to invest in higher yielding but higher risk products. This risk could manifest itself in the following ways:

- Low consumer awareness of the risks associated with high-yielding products (including those offered by unregulated firms).
- Excessive focus on brand distracting consumers from product features and prevent shopping around for alternative options that may better serve their particular needs.
- Firms providing inaccurate or misleading risk-return assessments to consumers, limiting the information they need to make well-informed financial decisions.

FCA response (from the Business Plan):

- **General consumer strategy:** the FCA is currently establishing a detailed strategy to deal with the complex issues underlying this risk and decide how best to intervene. This will involve significant scoping and research work across the regulator, coordinated by their Policy, Risk and Research division.
- **Interest-only mortgages**: the FCA is investigating the maturity of interest-only mortgages, considering the risk of existing interest-only mortgage customers being unable to repay the amount due at the end of their term.

Timeline and Next Steps

	Q2 2013	Q3 2013	Q4 2013	Q1 2014
General insurance add-on products study		Assessment complete		
Retail investment advice	Guidance for firms during implementation as appropriate		Guidance for firms during implementation as appropriate	Guidance for firms during implementation as appropriate
Interest-only mortgages	Publication of results of initial review			
Mortgage arrears and forbearance management	Engage with selected lenders	Firm assessment visits	Report thematic findings	
Financial incentives	Initial review starts		Completion of review	
Mortgage Market Review	Online surveys			
Data requirements consultation	Readiness tracking results published	Workshops	Readiness tracking results published	
PPI redress	Results of review of complaint handling			
AIFMD	Policy statement			
LIBOR	New rules related to controlled functions come into effect			

Note: the FCA will also be undertaking reviews in the area of: Custody banks, Asset management fund fee structures, Conflicts of interest and Transition management. The regulator will confirm the dates related to these reviews but the work will fall within the year 2013/14.

Adapted from: Delivering consumer protection, Enhancing market integrity, and Building competitive markets, FCA *Business Plan 2013-2014*, pp.75-76.

Snapshot of Regulatory Reform (2013-2019)

Notes:
Life insurance is covered in "Retail investment, fund management, related"
* All dates are expectations only and subject to change
** Solvency II dates are subject to the current Omnibus II Directive negotiations

Year	Quarter	Reform	Retail deposits	Retail secured lending	Retail unsecured lending	General insurance	Retail investment, fund management, related	Wholesale investment, fund management	Wholesale insurance & related services	Markets (primary & secondary)
2013	Q2	UK: Implementation of new FSCS funding model (Apr)	●	●		●	●	●	●	●
2013	Q2	UK: Implementation of new LIBOR regime (Apr)					●	●		●
2013	Q2	UK: Implementation of referral fee ban in personal injury cases (Apr)				●				
2013	Q2	UK: Implementation of changes stemming from Consumer Insurance Act (Apr)				●	●			
2013	Q2	EU: Solvency II transposition deadline (Jun)**				●	●	●	●	
2013	Q2	EU: Legislative proposals on basic bank accounts, current account switching and transparency of fees and charges	●							
2013	Q2	EU: Legislative proposals for IORP Directive					●			
2013	Q2	EU: Legislative proposals for a European framework for MMFs					●	●		●
2013	Q2	EU: Legislative proposal to review PSD	●							
2013	Q3	EU: Implementation of AIFMD across member states (Jul)					●	●		
2013	Q3	UK: FCA to publish two reviews into money laundering	●				●	●		
2013	Q3	Global: FSB proposed publication of final recommendations on shadow banking sector (Sep)		●	●		●	●		●
2013	Q3	EU: Possible legislative proposals on long-term investments					●	●		
2013	Q3	UK: PRA implementation of new capital and liquidity requirements for credit unions (Sep)		●	●					
2013	Q3	EU: Possible agreement of Directive on mortgage credit		●	●					
2013	Q4	UK: Implementation of National Crime Agency (including economic crime unit) (Dec)	●	●	●	●	●	●	●	●
2013	Q4	EU: Possible agreement on PRIPs regulation	●			●	●			
2013	Q4	EU: Legislative proposals on UCITS VI					●	●		
2013	Q4	EU: Possible agreement on UCITS V					●	●		
2014	Q1	EU: Proposed implementation date for Solvency II regime (Jan)**				●	●	●	●	
2014	Q1	EU: Possible implementation of minimum capital requirements under CRD IV	●	●	●		●	●		
2014	Q1	EU: Possible agreement on IMD2				●	●		●	
2014	Q1	Global: FATCA withholding begins for certain payments (Jan)	●	●	●	●	●	●	●	
2014	Q1	EU: Proposed implementation date for FTT (Jan)						●		●
2014	Q2	UK: Possible implementation of new Platforms rules					●	●		
2014	Q2	UK: MMR implementation (Apr)		●						
2014	Q2	UK: Transfer of consumer credit and peer-to peer-lending regulation from the OFT to the FCA (Apr)		●	●					
2014	Q3	Global: Proposed implementation of US Volcker Rule (Jul)	●					●		
2015	Q1	Global: Revised implementation date for IFRS 9 (Jan)	●	●	●	●	●	●	●	●
2015	Q1	UK: Banking Reform Bill to receive Royal Assent (before end of current Parliament)	●	●	●		●	●		
2015	Q3	EU: Possible implementation of Directive on mortgage credit		●	●					
2015	Q4	EU: Possible entry into force of PRIPs regulation	●			●	●			
2015	Q4	EU: Possible implementation of revised market abuse regulation						●		●
2015	Q4	EU: Possible implementation of UCITS V					●	●		
2015	Q4	UK: Implementation of ILAS regime (end 2015)	●	●	●					
2016		EU: Possible implementation of revised MiFID/MiFIR					●	●		●
2016		EU: Possible implementation of IMD2				●	●		●	
2018		EU: Possible implementation of NSFR (part of CRD IV) (Jan)	●	●	●		●	●		
2018		UK: Full implementation of pensions auto-enrolment					●		●	●
2019		Global: Full implementation of CRD IV liquidity coverage ratio (Jan)	●	●	●		●	●		

Taken directly from FCA *Financial Risk Outlook 2013*, p.39.

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