

# A SIGNIFICANT OR INCREMENTAL SHIFT?

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# 2021

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The way in which retail financial services markets are regulated in the UK is perhaps unique. The conduct regulator, the Financial Conduct Authority (FCA), has strong powers and in recent years has been intervening more in retail markets. It is now consulting on a new “Consumer Duty” that it believes would set higher expectations for firms’ standards of care towards consumers. This would continue the existing trend towards focusing directly on the outcomes of concern, as opposed to the inputs and processes that drive these outputs. While the FCA’s intent is clear, working through the detailed rules to follow, and how the wider regulatory system reacts over time, will greatly influence the impact on outcomes for customers and regulated firms alike.

## CARING FOR THE CONSUMER

The FCA believes the new Consumer Duty will place higher expectations on firms and expects the new duty to complement the array of regulatory tools at its disposal in service of meeting its strategic objective of making markets work well; specifically, the duty should help bring together the FCA’s consumer protection and competition objectives. As part of the consultation over the duty, views are also being sought on how a private right of action could support or hinder the success of the proposals and their intended impact on firms, consumers and markets.

The proposed Consumer Duty would be a package of measures comprised of:

- A new **Consumer Principle** providing an overarching standard of conduct. This is likely to be worded around either delivering “good outcomes” to customers, or acting in their “best interests”;
- A set of “**Cross cutting Rules**” requiring firms to:
  - take all reasonable steps to avoid causing foreseeable harm to customers;
  - take all reasonable steps to enable customers to pursue their financial objectives; and

- act in good faith; and
- Four “**Outcomes**” that support the Consumer Principle by setting clear expectations for a firm’s culture and behaviour. These expectations will be set out in forthcoming rules and guidance. The FCA’s public thinking to date in each of the four areas is summarised in the following statements:
  - 1 **Communications** equip consumers to make effective, timely and properly informed decisions about financial products and services.
  - 2 **Products and services** are specifically designed to meet the needs of consumers and are sold to those whose needs they meet.
  - 3 **Customer service** meets the needs of consumers, enabling them to realise the benefits of products and services and act in their interests without undue hindrance.
  - 4 The **price** of products and services represents fair value for consumers.

The consultation covers the introduction of the new Consumer Principle and proposals for the scope and structure of the underpinning rules and the outcomes the FCA should seek to deliver. The detailed drafting of the rules themselves is beyond the current scope and will follow in a later consultation in 2021, along with a published cost-benefit analysis.

## EVOLUTION OR REVOLUTION?

The FCA is explicit in the consultation paper about its intentions, saying the new Consumer Duty will “require all firms to focus on the actual outcomes experienced by consumers, and act in a way that reflects how consumers actually behave and transact in the real world, better enabling consumers to access and assess information, and to act to meet their needs and financial objectives”.

The increased emphasis on “actual” outcomes is seen to represent a shift from the existing system of regulation. The intention is to produce ‘better’ regulation, either directly by reducing the degree of customer harm that takes place in the first place, or indirectly by improving the oversight and enforcement processes used to monitor and regulate financial services markets.

Stepping back, zeroing in on outcomes may appear to be quite a radical departure from some of the FCA’s earlier approaches (and those of its predecessor, the Financial Services Authority), particularly the way in which the FCA has applied its competition objective. In the years following the introduction of this objective, supervisory methods and conduct regulation focused on compliance against a series of inputs described in various (lengthy) handbooks. A whole series of market investigations were carried out by the FCA’s rapidly expanding competition team, and the FCA was at the forefront of applying behavioural economics principles to UK economic regulation – both in the diagnosis of competition issues to address and in the design of (typically) behavioural remedies for the problems identified. The logic chain clearly ran from diagnosis to inputs to outcomes.

Of course, the strands of these earlier approaches remain in place today to varying degrees: for example, the Consumer Duty consultation paper talks about behavioural economic concepts such as “sludge” practices, while the new rules and guidance around the Consumer Duty are proposed as additions to the existing handbooks, albeit possibly with scope to streamline them in due course. One of the criticisms of the earlier approaches was that the detailed input rules and supervisory processes had not been effective

enough in avoiding harms overall, particularly in a small number of high-profile cases (e.g. payment protection insurance, PPI). Critics also charged that market investigations and behavioural remedies were taking too long and were not shifting market outcomes sufficiently to resolve the harms that had been identified.

But looking back over the last five years, the FCA has been acting for some time now with greater urgency to narrow its focus on outcomes of concern and to intervene more directly to address these concerns. Market investigations have been more closely targeted at outcomes for a number of years, with the FCA increasingly willing to go further than simple behavioural remedies. Examples include remedies to support customers in persistent credit card debt, pricing intervention in overdrafts and, most recently and most forcefully, through intervention in general insurance pricing.

This is consistent with a wider UK regulatory trend in recent years towards emphasising consumer outcomes, as illustrated by the loyalty pricing super-complaint brought to the Competition and Markets Authority (CMA) by Citizen's Advice, CMA and FCA work on customer vulnerability, and, lately, the FCA's fairness framework. At a high level, the FCA had also been increasingly trying to influence outcomes via conduct and culture through changes to the senior managers regime and debates around a duty of care.

Seen in this context, the changes proposed under the Consumer Duty are a continuation of the direction of travel the FCA has been on for some time. By knitting together many separate strands of the FCA's existing work, the changes also appear consistent with recent structural shifts within the agency aimed at bringing competition and supervisory functions into closer internal alignment. But while the FCA may be continuing in an existing direction of travel, there are differing views about quite how much of a step change this will represent in terms of the execution of the proposals, and ultimately, the impact for consumers.

## **COLLECTIVE EXPLORATION WILL BE NEEDED TO UNDERSTAND IMPACTS**

The consultation paper sets out in some detail the types of impacts that could follow as a result of the proposals. At this stage, we believe it is too early to predict with certainty the likely impact of the new Consumer Duty (or indeed the potential new private right of action) on consumers or regulated firms. Market outcomes in regulated markets are determined by a combination of:

- the regulatory "rules" - including in this case the wording of the new Consumer Principle, and the associated underpinning rules;
- the implementation of policies that determine how the rules are applied and operate in practice (e.g. where the regulator focuses, how it engages with regulated firms, how transparent it is, etc);
- the penalties (financial, reputational etc.) and availability of compensation/redress that applies if the rules are broken (scale, likelihood, ease of process, etc.);
- the scale of regulatory efforts (and regulatory effectiveness) to monitor and enforce the rules;
- the effort and focus of associated parties to uphold or otherwise monitor compliance with the rules (e.g. policymakers, ombudsman, etc.);
- the effort and focus of other external challengers (e.g. consumer organisations, private litigants); and
- the strength, speed and effectiveness of feedback mechanisms and learning within the market, particularly where the market is competitive.

The combination of these various regulatory forces, and the interactions between them, determine the outcomes observed in a market. The proposed FCA changes are limited to one or two of these forces (elements of the “rules” and the possibility of increased penalties), with details about the others either unknown or to be provided later. For this reason, the precise drafting of the detailed rules and how the changes ultimately flow through to new established regulatory standards and legal precedent may have greater repercussions than the changes formally within the scope of the current consultation.

In describing how it believes firms would behave once the new Consumer Duty is in place, the FCA invites firms and individuals to ask themselves a version of a kitchen table test: ‘Would I be happy to be treated in the way my firm treats its customers?’, or ‘Would I recommend my firm’s products and services to my friends and family?’. This seems intuitively simple and hard to argue against as a laudable objective.

But in practice the realistic answer to the question may be, in many cases, “it depends”. Perhaps in most cases. Suitability depends to a significant extent on the needs of customers and their circumstances as well as their actual behaviour once they start to use the product. This can be hard to predict in advance – including, as behavioural economics tells us, for individual customers themselves – meaning the relevant information may be revealed only at some point in the distant future. The new proposals seek to resolve this issue by requiring firms to engage in “active ongoing monitoring”.

The test may provide a helpful steer in the most egregious cases. But the FCA’s ambition is higher than this: it is to raise standards overall. If the genuine answer to the kitchen table test is “it depends”, this level of uncertainty is unlikely to be sustainable (or helpful) for the purposes of regulating markets and changing behaviours. More clarity will be needed in order to operationalise the new Consumer Duty.

In the forthcoming consultations, in drafting the rules and over time as the Consumer Duty starts to be implemented, the FCA and the industry will need to work together to reach a collective understanding over what is acceptable for the answer to the kitchen table test to depend on. This dialogue has started. It will continue into the next FCA consultation and beyond.

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## **WANT TO KNOW MORE?**

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