

Protecting customers

The FSA has been trying to improve the way financial firms market their products, so that they do not mislead customers. Is it making any difference? Neil Hodge reports

➤ PRODUCT mis-selling had seriously damaged public trust in the financial sector well before the credit crunch came along. From endowment mortgages to payment protection insurance, there have been seemingly endless examples of firms selling their customers products that they do not need and that are largely unsuitable for them.

To try and cut down the number of mis-selling cases, the Financial Services Authority (FSA) has created a framework of rules and principles that all firms have to follow when marketing their products. The only problem is, not many firms have done much to resolve the issues that the FSA wants addressed.

As part of its mandate, the FSA is meant to uphold consumer confidence and protection by ensuring that financial services providers market, sell, and administer their products according to its principles. But recent mis-selling scandals, combined with a worsening recession caused by the global banking crisis, have led the

regulator to revise and update some of its guidelines to restore confidence, particularly with regard to how banks and insurers conduct their business.

The current conduct of business sourcebook (COBS), which provides guidelines on the way financial services firms should market their products, replaced the previous version on 1 November 2007. As well as reflecting the implementation of the Markets in Financial Instruments Directive (MiFID), which requires financial firms to obtain enough information from their clients to decide whether certain products are suitable and appropriate for them, COBS is meant to introduce a more principles-based approach, giving firms greater flexibility around how they meet the regulatory standards according to their own circumstances and needs.

But it seems that many financial firms are sceptical about the benefits of the COBS regime, given the amount of other FSA-related compliance work that they have to move towards. "This is just one of a number of different



compliance regimes that we have to follow for the FSA that largely focus on the same issue – protecting consumers. The regulator has not really issued a lot of guidance on this, and what little there is is not particularly helpful," said a head of internal audit who wanted to remain off the record.

Concerns

The FSA has been reviewing what firms have done to implement



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the new COBS. It published its interim findings in December.

Nearly all the firms the FSA contacted had reviewed their procedures in some way to identify where changes might be required, though the regulator found that they had not necessarily changed their procedures as a result. However, the FSA says that it is “concerned” at how many smaller firms described their knowledge of COBS as only “basic” several months after

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it came into effect. “By now, we will expect this to have improved,” it says.

The FSA reports that while awareness in larger organisations is better than in smaller organisations, the level of preparedness in some is not markedly different. For example, the FSA found that many retail market firms have acknowledged that COBS allows them greater discretion to review their approaches to compliance, but for many this has not been prioritised during the first year of it being in place, except in a few specific areas. The regulator found that some firms have deferred much of their more advanced COBS compliance work while they focussed on embedding Treating Customers Fairly, a central tenet in the FSA’s push to move towards more effective principles-based regulation while putting the needs of the consumer above all else.

However, the FSA is impressed that where broader change has been required (notably for larger investment firms), some firms appear to have taken the opportunity to carry out more fundamental reviews of their internal processes, one example being the approach to client profiling. But the regulator has also noted a degree of caution among firms in how to respond to a more outcomes-focussed regulatory framework because they remain »

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» unclear about the FSA's expectations in this regard. "We have seen management information from certain firms that helps indicate the scale of some potential positive consumer impacts from COBS but this data is early and limited. We expect the realisation of measurable benefits to become more apparent over time as COBS awareness improves with the continued implementation of changes," it says.

Initial review findings indicate that while standards have been maintained under COBS, firms are not yet taking full advantage of the flexibility provided in the regime. However, many of the firms that issue financial promotions surveyed so far reported changes in the way in which they prepare them. For example, there has been earlier engagement between marketing and compliance, increased senior management involvement, and increased management information. Some firms also indicated that they had changed, or planned to change, the wording and/or presentation of risk warnings, which COBS now allows, to reflect the nature of the product better and to make risk warnings more meaningful and relevant to their target market.

However, the FSA's review suggests there has been little take-up by firms in using the greater flexibility regarding when and how information is provided in direct offer financial promotions and in how past performance information is presented.

But the FSA maintains that COBS is providing greater protection to consumers through better disclosure of relevant risks and making information regarding the product more readily available. It says that "we have already found some evidence of potential benefits to vulnerable consumers, especially in terms of helping to promote client awareness of risks associated with products that are more complex".

Risk warnings

Lawyers believe that the COBS regime can only be effective if financial services firms provide their internal

The good, the bad and the ugly

Since November 2007, the FSA has identified examples of good and poor practice through its review of firms' implementation of COBS 4, as well as through related Treating Customers Fairly (TCF) work. Its main findings are as follows:

Examples of good practice

- Compliance and marketing departments are both involved in the product development process and understand the target market from the outset
- Marketing staff undertake sufficient training to understand the key requirements of financial promotion compliance and TCF outcomes, such as the requirement to consider the needs of the target audience during the marketing process
- Compliance and marketing departments consider the information needs of both the target market and the actual market (the likely recipients), if these differ
- Marketing staff are involved in the financial promotion sign-off process and these sign-offs are monitored on a risk basis by risk or compliance staff
- Use plain English and avoid jargon in promotional material
- Understanding by the firm of what constitutes a "direct offer" financial promotion, meaning that it is not restricted to direct mail or promotions with a tear-off slip

Examples of bad practice

- Firms use a mechanical, tick-box procedure for the preparation and sign-off of financial promotions which may lead to non-compliant financial promotions
- Firms use wording that diminishes or dilutes the message in an important risk warning. For example: "Markets and currency movements vary, so you may get back less than you pay in. But as one of the UK's largest investment trust managers, we know a thing or two about discovering good investment opportunities".
- Firms use generic risk warnings that are inserted automatically or as an afterthought. These can be unnecessary and can sometimes mislead customers by detracting from the relevant risks. Inappropriate warnings can also confuse customers and prevent a clear understanding of the nature of the investment.
- Firms use of out-of-date risk warnings that duplicate warnings used in earlier promotions without the firm having reassessed current risks and market conditions.
- Financial promotions that form part of a series of direct offer financial promotions are not assessed individually as "standalone compliant". Each promotion should give a balanced indication of the potential benefits and relevant risks.

audit and compliance functions with the right level of support to ensure that the FSA's aims are properly embedded throughout the organisation and especially its marketing operations.

Christopher Jones, head of law firm Mishcon de Reya's investment funds group, says that "many of the risk warnings and disclosures required by the conduct of business sourcebook are quite specific, although some allow

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the firm concerned to use their own form of words. Either way, if firms are not using the correct form of words or are choosing to diminish the impact of the warnings and disclosures given, it can only be because they do not have a proper understanding of what is required. This could be because their compliance function is below par or is not being taken seriously and/or they are not being given the right advice.”

“Firms may not be presently taking regulatory compliance as seriously as they should because they may view the risk of investigation and consequent penalties as relatively low. There have only been a few mis-selling cases announced by the FSA over the last few years, and there is an impression that the FSA is more concerned about other issues, such as market abuse, but

given recent events, this may change.”

Tony Watts, a consultant lawyer in the commercial team at solicitors Keystone Law, says that while the FSA has highlighted many improvements, poor practice remains for a number of reasons. For example, he says, commercial pressures are intense, and some firms are still finding it difficult to adapt to a more “principles-based” environment with fewer detailed rules as to what a firm can or cannot do. Other possible reasons include the fact that some firms do not fully understand the importance of the FSA’s general principle of treating customers fairly, and that their management structures are not always geared to getting the best results. “It’s doubtful whether firms calculate that increased business volumes outweigh the risk – it’s more likely that they don’t have the right systems and controls, underestimate the likelihood and effect of regulatory action or succumb to commercial pressures,” he says.

But Watts adds that, despite these pressures, firms must make sure that they comply wholeheartedly with COBS – or face the consequences. “The FSA has powers to impose unlimited fines and it can take action against individuals registered with them

(approved persons), including directors and those responsible for compliance, who are personally responsible for failures – fining them or prohibiting them from occupying similar roles in financial services organisations again. Furthermore, there is still serious reputational damage associated with FSA enforcement action,” he says.

Audit role

Both Jones and Watts believe that internal audit has a role to play in ensuring that the firm follows the FSA’s guidance properly, and that the organisation itself realises the value that appropriate compliance can achieve.

Watts says that “in terms of practical advice, I know there’s a lot of material, but make sure someone is monitoring what the FSA is saying about Treating Customers Fairly and good and bad practice. Make sure non-compliance staff know about these things.” But he adds that it is important to ensure that the compliance department and functions like internal audit retain their independence from management to ensure that commercial considerations do not overshadow the FSA’s very real concerns about mis-selling and poor market practice. “Look at where your compliance staff are positioned – are they going to be put under too much pressure to be commercial?” says Watts. “Culturally, will senior management support them if they give unpopular advice? These are issues that all firms need to consider.”

Jones says that financial services providers need to take compliance seriously and that the FSA’s findings that firms have not moved quickly enough yet should be a first warning. “Hire a good compliance officer and get some proper advice,” he says. “Quite apart from the FSA requirements, if products have been mis-sold without adequate disclosure, and investors lose money, the firm can be liable. This can potentially be as serious or more serious for a firm than an FSA investigation and penalties.” ●

