Regulation

TREATING CUSTOMERS FAIRLY

The latest FSA initiative means the writing is on the wall for opaque sales processes and other Spanish customs. But Malcolm Small argues that TCF is also a source of market advantage for the strong and the brave.

I don't suppose that too many financial services marketing people wake up in the morning and ask themselves what they can do to comprehensively maltreat their customers when they get to work.

However, if you were one of the unhappy band of customers on the receiving end of such (admittedly, retrospective) triumphs in the *Opaque Product of the Year* award category – characterized by, for example, precipice bonds and split-capital investment trusts – you might reasonably conclude that such thoughts do occur.

And, of course, there are mortgage endowments, with-profit bonds, Equitable Life and a host of other background sour tastes to choose from. It sometimes astonishes me that the industry so frequently continues to see itself as a victim in its relationship with the regulator, when all this is set in the context of customer perception.

Of course, no financial product can ever be entirely risk-free, and there are companies around who have gone to great lengths to ensure that their products are presented in a way that customers stand a better than even chance of comprehending. We'll revisit this topic later, but first, what is *Treating Customers Fairly* about?

Letters you'll be hearing more of

The requirement, in a regulatory sense, to treat customers fairly, has been around since the dawn of UK financial services regulation in the late 1980s. In the operating principles laid down by the Financial Services Authority (FSA), Principle 6 states that "a firm must pay due regard to the interests of its customers, and treat them fairly".

From the point of view of the financial services marketer, this one must surely be a no-brainer. Unfair treatment of customers will virtually ensure that you are never in a position to harvest that Holy Grail of lifetime customer value. So why does it even need to be expressed as a principle, never mind become the centre-piece for a major regulatory initiative?

From the point of view of regulatory policy, part of the answer is outlined above. The government perceived that complex, opaque products were sold on behalf of their constructors by poorly-informed, small, undercapitalized sales businesses, nominally independent, who carried the regulatory risk of advice at arm's length. Yet when called upon for restitution, some of them could not take the strain and melted away like hailstones on a hot summer day. The results have been sharply-increased compensation scheme levies and the splits "deal".

The Treating Customers Fairly (TCF) initiative is part of the regulatory response to this situation. It has featured in virtually every major FSA speech this year. It is serious, and here to stay.

Background thematic work on TCF with a handful of companies, mostly bancassurers, had been in train for some time before the first significant paper on the topic hit the FSA website in July 2004. Perhaps because of the summer holidays, perhaps because it was not clearly labelled as "something you **must** read", or perhaps because there was so much other regulatory tinnitus, many in the industry missed reading this slim, twenty-two page volume. As a result, its content only oozed slowly into the collective financial services consciousness during the autumn of last year.

And it still seems to have some way to ooze yet, if a recent media survey indicating that 50% of independent financial advisers (IFAs) have never heard of it is to be believed.

So what is TCF all about?

One thing is for sure, this is no "tick-box" initiative, although there will, naturally, be boxes to tick. The responsibility for ensuring that the fair treatment of customers is embedded at all levels of **all** regulated firms, however large or small, rests with senior management – for which read the board, and especially the CEO. Firms will have to provide evidence that they have done this, with management information to back it up. The FSA expects to see nothing less than culture change in regulated firms, where required, as a result of this initiative, and it says this in no uncertain terms. Failure to live up to the TCF principle will mean that it will "consider the use of its enforcement tools". Everyone involved in financial services marketing should read the July 2004 paper thoroughly – not a difficult or time-consuming task.

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Certain areas are highlighted for "critical review" by firms:

- Corporate strategy and culture.
- Product design and governance.
- Financial promotions.
- Sales and advice processes.
- Information and service after the point of sale.
- Complaint handling procedures.

A recent Watson Wyatt debate on this topic that I attended[1] included a straw poll at the end. Worryingly, this indicated that only about a third of organizations present had a board member (though not necessarily the CEO) carrying responsibility for TCF implementation. Another third had it on the compliance manager's plate, and the last lot were not sure, but thought that it might be marketing.

For the avoidance of doubt, the last two are the *wrong* answers. Compliance and, especially, marketing have a great deal to input to the project, but if you are the marketing person in your organization and you are carrying the overall responsibility, delegate it upwards promptly – unless you are already on the main board.

In addition to the areas for critical review indicated above, four of which fall squarely into the marketing folder, it is considered likely that firms will have to address the following issues:

- Developing and marketing products for specific target markets, based on a clear (and suitably evidenced) understanding of the likely needs and financial capability of each group of customers.
- Providing clear, fair and not misleading communications during promotions, advice, sales and after-sales activities.
- Making charges *transparent*.
- Balancing the commercial objective of increasing sales with the requirement to ensure the fair treatment of customers.

There are others, but to maintain focus I've just noted the ones immediately relevant to the marketing function.

The first thing to realize is that these requirements do not cease to apply to provider firms when they sell through another independent regulated entity – although they apply to that entity as well.

The second point is that this is all linked to perceived product risk; the more complex the product, the more the regulator will expect you to do to ensure that such products are marketed effectively and safely, throughout their lifetime.

The third point is that any uncertainty that all the operational risks associated with any potential inadequacies in the TCF régime (which increase with product complexity) are effectively mitigated will need to be reflected in the level of the individual capital assessment (ICA) for the firm.

This is all very scary stuff. Some boards are squaring up to the responsibility seriously, but there are others who take the view that "we'll do something about it when we get more specific guidance from the FSA". These boards are the ones likely to get caught out. There will be some more examples of good and bad practice in further work to be published in June, but the FSA expects serious work to be underway **now**, with firms deciding individually what it means for them and their businesses.

And the examples will be just that; the FSA will not publish detailed guidance in this age of principle-based regulation, so the laggard boards will be waiting a long time.

Let's take a look at a couple of the specific topics highlighted above and consider the relevant questions you, as a financial services marketer, will need to satisfy yourself about, in order to help your board and your colleagues to ensure that no regulatory solids adhere to your firm, or to them individually.

Making charges transparent

I think it's time to "fess up" in the marketing community about this one, don't you? Can we really claim that a typical IFA market charging structure for, say, an income drawdown product is "transparent"? I've seen some pretty amazing structures, with varying allocations dependent on age at entry, early-transfer penalties, obfuscated commission and strange, concealed, kick-backs from fund managers. Ask yourself:

- Where did we explicitly consider this requirement in the product development process? (You do have a written process, don't you, and it is up-to-date, isn't it?)
- Has the board signed it off?

- Did the board minutes clearly indicate that it had considered its TCF compliance systematically?
- If you have a complex charging structure, how do you ensure that the intermediary is taking the end client through it thoroughly as part of the sales process, so that the client fully understands it?
- Is the cost of advice clear?
- Are the charges for on-going service clear?
- How do you comply with this without disabling yourself in the market?

There are more, of course, but you get the picture.

Clear, fair and not misleading …

There can be a big gulf between the communication material you produce and what the end client *actually receives* (or not) from the distributor. Many intermediaries currently produce their own marketing material, including on-line material, all of which currently falls within the financial promotions régime. Now, I don't know about you, but I've seen some distributor material in my time in financial services marketing that would make your hair stand on end.

Ah, you say, it's the distributor's responsibility to get this signed off by his own compliance function from the financial promotions point of view. Not now so. Under TCF, **everyone** in the supply chain is accountable for ensuring that the client actually receives and understands material by, for example, clearly identifying the target market (and, by implication, the client profiles for whom the product is not likely to be suitable).

- How can you be sure that the client receives, and is guided through, the clear, fair, not misleading and plain English material you send to the distributor for onward transmission to or use with him or her?
- Have you seen and approved any distributor promotional material relating to your products, including web material?
- How do you know how, and where, material is used in the distributor's sales process?
- Have you audited this to validate it?

Once again, there's more. There are also lots of interesting questions on the sales side, such as how to ensure that remuneration structures reward compliant, risk-mitigating behaviours such as fully-completed proposals and pre-sale documentation, low complaint levels and high scores in client satisfaction surveys. Commission-only remuneration, anyone?

Some conclusions

I cannot do more here than take a very high-level look at some of the issues raised by this initiative. To its credit, the FSA has been very proactive and open in talking to trade bodies such as the ABI and the Investment and Life Assurance Group (ILAG) about TCF. It has also listened to the concerns raised and modified its approach in parts.

However, those of you still awake at this point will be getting the distinct impression of a much greater involvement in, and responsibility for, IFA and multi-tied business on the part of the provider community. You would be dead right, in my view. The interesting question is what the economic effect of this will be on the providers' business models, where arm's-length distribution of complex products is involved.

Of course, this initiative really points up some issues that were raised by Sandler[2] – for example, design of products for distributors rather than end customers – as well as more fundamental issues about what clients really want from retail financial services products in themselves.

The more complex the product, the more the regulator will expect you to do to ensure that such products are marketed effectively and safely, throughout their lifetime.

Even if just this issue is finally tackled by the industry, it will bring fundamental change in its wake, and there are many many more questions raised in the TCF agenda than can be covered here. It is quite clear to me from interactions with policy-makers and regulators that there is a collective determination to force change upon an industry that they view as craven, weak and poorly managed, and which all too frequently winds up foisting potentially toxic products on its customers. TCF is just one of a number of drivers to change.

Yet nothing of what is raised in this initiative should be anything other than welcome to professional marketers. For the strong and the brave in the financial services marketing community, there is market advantage to be gained from an intelligent and thorough engagement with these requirements.

Whether that advantage can be gained will depend upon the appetite of the board, and in particular the CEO, to read the writing on the proverbial wall. Fundamental cultural change will be required in many cases if firms are to comply and, indeed, to survive. □

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[1] 12 April 2005

[2] See *Argent 1.5*, November 2002 for a detailed discussion of the Sandler Report and its likely effects. Ed