

Challenger banks prepare for the FCA's Consumer Duty

May 2022



The Consumer Duty marks a fundamental shift in how the Financial Conduct Authority expects firms to treat retail customers.

The FCA has not yet finalised its rules but has warned firms not to wait to begin preparing. Starting this work early will be particularly important for challenger banks with significant retail business.



What is the Consumer Duty?

The FCA's proposals in a nutshell



Pinning down scope

Identifying the relevant areas of your business



Meeting outcomes

Potential issues for challenger banks when implementing the FCA's four outcomes



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Talk to us about the impact of these proposals for your business or your ongoing change programmes



What's changing?

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Background

The FCA is not satisfied with the customer outcomes it is seeing in practice. In response, its proposals for the Consumer Duty introduce a new Consumer Principle. This Consumer Principle is supplemented by cross-cutting rules which develop and amplify its expectations. Sitting under those rules is a suite of rules and guidance organised by four outcomes that the FCA wants to see.

Timeline

The FCA published its second consultation paper on the Consumer Duty in December 2021. The paper contained the FCA's proposed draft rules and guidance which will form the package of Consumer Duty requirements.

The FCA is set to finalise the rules in July 2022 and our expectation is that the draft rules and guidance in the second consultation paper will remain largely unchanged.

The FCA considers that firms should have until 30 April 2023 to implement the Consumer Duty.



Pinning down scope

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The first challenge is to identify which areas of your business are impacted by the Consumer Duty. The Consumer Duty will apply where a firm:

- > is conducting “retail market business”, which essentially covers regulated and ancillary activities (including for these purposes activities relating to payment services and issuing electronic money) in connection with a product which has been or will be distributed to retail consumers;
- > contracts with a retail consumer, or is in a position through its business to have a material influence over the design or operation of retail products or services; and
- > is not able to avail itself of an exemption.

Many challenger banks will undertake regulated activities in connection with a product that is distributed to retail customers. For example, the provision of a credit card to a retail customer involves the provision of regulated consumer credit and the regulated payment service of issuing a payment instrument. The analysis for other products may not be so clear-cut, such as dealing in unregulated cryptoassets.

Challenger banks also need to be alive to the fact that the new Consumer Duty will not be limited to dealings with UK retail customers.

Activities with non-UK customers will be caught if other rules regulating that activity have a broader territorial scope. For example, many challenger banks will already be required to adhere to the FCA’s conduct of business rules in its COBS sourcebook. Where COBS applies to a firm’s interactions with a non-UK retail client, the Consumer Duty will also apply.

The Consumer Duty will not apply retrospectively to past business. Even so, challenger banks will need to review any products or services that they plan to continue offering once the Consumer Duty comes into force to make sure that they comply with the relevant requirements. In relation to existing business, the FCA does not expect firms to give up any contractual rights they had a firm expectation of being able to enjoy. However, where product terms pre-date the introduction of the Consumer Duty and might not meet the new standards, firms should consider other ways to prevent harm for existing customers.

Once specific touchpoints within the bank’s business have been identified, attention turns to ensuring that governance frameworks and reporting chains for management information are designed to accommodate the additional obligations under the Consumer Duty.





Meeting the products and services outcome

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The Consumer Duty applies to manufacturers and distributors of retail products – and challenger banks may play both roles. For example:

- > *Bank accounts.* Challenger banks will act as manufacturers when they provide bank accounts and carry out payment services associated with operating those accounts. If the bank then offers the bank account to customers directly, it will also be deemed to be a distributor.
- > *Credit cards.* The issuance of a credit card and provision of a credit line involves a challenger bank operating as a manufacturer. If the challenger bank then offers the credit card to customers directly, it will also be deemed to be a distributor.

Challenger banks acting as a manufacturer will need to, for example:

- > develop an **approval process** for products or services;
- > identify a **target market** of consumers for whose needs, characteristics and objectives the product or service is compatible;
- > consider if there are any consumers with characteristics of **vulnerability** in the target market and take account of any additional or different needs of those consumers; and
- > select **distribution channels** that are appropriate for the target market and provide adequate

information to distributors to enable them to understand the product or service and the target market.

Distributors are firms which offer, sell, recommend, advise on, propose or provide a product or service. Where a challenger bank offers intermediated access to products from third parties the challenger bank will need to make sure it obtains enough information from the third parties to understand the product, target market and intended distribution strategy.

For example, some challenger banks allow customers to take out insurance products from third parties through online marketplaces that are accessed through the customer's mobile banking app. In this situation the challenger bank will be distributing the third party insurance products to its customers and must meet the product distribution aspects of the Consumer Duty.

It is helpful that, under the FCA's proposals, complying with PROD 3, 4 or 7 will tend to show compliance with the rules relating to the retail customer outcome on products and services. The Consumer Duty goes further than PROD, however. For example, it covers services as well as products and imposes specific obligations regarding vulnerable customers. Even so, challenger banks which are fully compliant with PROD will have a head start over firms not currently subject to that regime.



Meeting the consumer understanding outcome

The consumer understanding outcome goes beyond current legislative and regulatory disclosure requirements. The overall approach to communicating information should equip retail customers to make timely and well-informed decisions.

For example:

- > *Communication channels.* Challenger banks will need to review their current customer communications to evaluate whether customers can readily understand them. This could include reviewing customer communications to determine whether they are achieving this. For example:
 - When issuing fraud prevention warnings, challenger banks will need to consider whether they can explain what it is about a particular transaction that raises a concern. Such warnings may need to be tested so that challenger banks have the data to evidence that they are being understood, both generally and by vulnerable customers.
 - A particular challenge for some digital challenger banks will be determining whether there are groups of customers for which internet-based channels and apps are not appropriate.

- > *Level of information to be provided.* Challenger banks will need to assess the appropriate level and format of information to provide to customers to ensure that they are properly informed. For example, when a customer takes out a credit card, firms must comply with the prescriptive disclosure requirements imposed by the FCA's CONC rules. These may be difficult for some customers to understand. To reduce the risk of customer confusion or misunderstanding, challenger banks may choose to explain industry jargon or highlight key information upfront and signpost to where further detail can be found, while ensuring that statutory disclosures are still given.

- > *Testing.* There is a need to evidence that communications are understood which may require testing of content. Possible questions to consider are: has content been written to be viewed on screen or in an app? Are there mechanisms in place to ensure a degree of 'positive friction' to ensure that customers cannot skip through relevant information?

The ultimate aim is to address potential imbalances where retail customers may lack experience or expertise in financial products or may not have the information they require to make informed decisions.

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Meeting the consumer support outcome

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The Consumer Duty aims to set an appropriate standard of support for firms provide. Consumers should be able to use the products and services they buy as anticipated and act in their interests without unreasonable barriers. The FCA considers unreasonable barriers to be those which frustrate the customer's use of the product or service (or ending its use) without reasonable explanation.

As they review their products or services which are in the scope of the Consumer Duty, challenger banks will need to assess whether there are unreasonable barriers to retail customers wanting to:

- > make general enquiries or requests to the bank;
- > amend or switch product;
- > transfer to a new product provider;
- > submit a claim;
- > make a complaint; or
- > cancel the contract, agreement or arrangement, or otherwise terminate their relationship with the bank.

As part of that review, challenger banks should take care to make sure that retail customers are not required to take steps which would be considered unreasonably onerous, time consuming, complex or difficult to understand.

For example, imagine a challenger bank which offers an online automated web chat function for handling customer issues. Given that chatbots typically have limited functionality and are usually used for handling simple tasks, the bank may want to ensure that more complicated issues customers may face are routed elsewhere, such as to call centre staff or alternative written correspondence.



Meeting the price and value outcome

This outcome pushes firms to make sure that the price of their products and services are proportionate to their value. As noted above, many challenger banks manufacture financial products. This means they must assess fair value at the product or service design stage and must regularly review the assessment throughout the life of the product.

The consideration of fair value must take into account:

- > the nature of the product or service, including the benefits that will be provided or that consumers may reasonably expect, and their quality;
- > any limitations that are part of the product/service;
- > the expected total price customers will pay;
- > any characteristics of vulnerability in the target market for the product or service; and
- > non-financial benefits and costs such as customer providing personal data (but the FCA has so far not explained how firms should quantify the value of these).

The fair value outcome presents a number of challenges for banks operating in an innovative and fast-growing space where prices might be more volatile or products may be more innovative such that there is no market standard price. Challenger banks will need to be extra vigilant when assessing whether their products provide fair value, including when the customer renews. This obligation also applies where the challenger bank is acting as a distributor of third-party products.

Challenger banks would need to continue monitoring retail consumer outcomes on an ongoing basis. Monitoring whether products or services are meeting Consumer Duty outcomes should, where appropriate, feed into management information to ensure that senior management have good visibility of the bank's performance against Consumer Duty outcomes. Robust monitoring at product team level will also keep banks ensure that any issues are identified and rectified promptly.

Finally, the concept of vulnerable customers is a core theme throughout the Consumer Duty. Challenger banks will need to ensure that their products and/or the products they distribute on behalf of third parties are able to accommodate vulnerable customers, otherwise procedures will need to be put in place so that products that are unsuitable for vulnerable groups are not offered to such groups.

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