Financial Services Authority

Treating Customers Fairly – what it means for small firms

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We have been working on our Treating Customer Fairly (TCF) initiative for some time. Initially we focussed our work on major groups and over the last year have been looking increasingly at what TCF means for small – medium sized firms.

The aim of the initiative is for firms to put customers at the heart of their business, to help build consumer confidence in the financial services industry. The principle of TCF applies to all firms, no matter how large or small they are. It also applies to all firms regardless of whether they produce, distribute or advise on retail products.

We have produced a range of materials, available on our website (www.fsa.gov.uk/tcf), to help firms assess what the principle of TCF means for their business. The material does not provide specific guidance but identifies examples of good, and in some cases not so good, practice to help with those assessments. In this way TCF can be applied in a more flexible way to reflect business size and purpose. There is no standard way for TCF to be applied as no two firms are the same.

This booklet is intended for smaller firms and contains the points of TCF that are most relevant to you. Discussions have taken place with representatives of smaller firms to ensure that it is easy to digest and put into practice, containing information on practical considerations such as:

- financial promotions;
- advice and sales processes;
- training;
- information issued by product providers;
- accurate and timely record keeping;
- disputes and complaint handling;
- flow of information; and
- risk assessment.

We will continue to develop the principle of TCF and how it applies to smaller firms and will work closely with trade bodies and industry representatives. In this way we hope to communicate clearly through good practice what TCF means for smaller organisations.

Stephen Bland
Acting Director, Small Firms Division

TCF and smaller firms

Customers are entitled to the same degree of protection no matter what size of firm they do business with. The principle of TCF therefore applies to all firms regardless of size, and we expect smaller firms to comply with it.

How firms translate the principle of TCF into practice, and the amount of resource required, will vary. Smaller firms may have significantly less management resource to devote to governance arrangements and less financial resource to devote to systems and controls.

The objective of our programme is to bring about a change to the retail marketplace that will benefit consumers – we have never intended that TCF should become an exercise in form filling or an unwelcome distraction for management. Proportionality is key.

There is no standard way in which TCF should be applied – smaller retail firms' business models and the range of their activities are too diverse for there to be a single approach. But we recognise that it is important for us to help the management of smaller firms work out how the principle of TCF applies to their business, and our discussions with trade associations representing smaller firms have been very helpful.

Ways in which smaller firms may differ

We recognise that there are differences between large and small firms. Some of these differences include:

- Small firms typically have fewer layers of management. In theory, this can make it easier for management to ensure that their staff adhere to the principle of TCF. For this reason, some of the wider corporate governance issues, and our concerns relating to the adequacy of high-level systems and controls and management information, may seem less relevant. That said, small firms still need to have adequate controls over their staff and, where relevant, Appointed Representatives. Furthermore, there are areas where having fewer staff may pose greater challenges for management who do not have separately resourced internal control functions.

- The majority of small firms are not product providers, so the management of many of those firms may feel that the material about the product design process may not be directly relevant. But for those small firms that are product providers, control over the product design process is essential. And even those firms providing services to clients may want to consider some of the product design issues as they bring new services to market.
- A frequently-observed feature of small firms is a long-standing client base and a high level of knowledge about individual clients and their needs. But our investigations show that having a small client base does not always mean client needs are better understood, or TCF better addressed.

Therefore, while there are some differences in the way small firms operate and how they go about meeting their TCF obligations, two key requirements remain:

- Management should be fully involved in considering what TCF means for their business, and establish an appropriate culture for their firm.
- For firms involved in providing products and/or services to consumers, the principle of TCF needs to be upheld throughout the process – from designing services or products, marketing and promotions, and giving advice to selling and providing help after the sale, such as handling complaints.

Practical considerations for smaller firms

The Handbook outlines rules and guidance covering many aspects of how we expect firms to behave and supporting our objective that firms should treat their customers fairly.

However, TCF is not only about compliance with the detailed requirements set out in our rules. It is also about firms acting to observe the spirit of what our rules aim to achieve. Management should consider whether compliance with specific rules is always sufficient to deliver TCF. Rules cannot cover every possible situation.

Smaller firms should therefore consider and be able to explain how the principle of TCF applies to their business. Section 4 of *Treating Customers Fairly – building on progress* gives a model that some firms find helpful. Essentially, it describes how a firm can step back and look at its operations, identify areas of potential risk to its customers, and consider how to remove or mitigate these.

While Section 4 of *Treating Customers Fairly – building on progress* describes processes, we do not necessarily expect smaller firms to undertake an elaborate review involving consultants. But given the problems across the financial sector in recent years, we think it is reasonable to expect firms to take an objective look at the way they do business, to help identify areas where operating standards need to be strengthened.

Smaller firms may find it helpful to use the framework in Section 4 to structure management discussions of TCF.

Where applicable we recognise that smaller firms may not have a documented strategy or detailed files evidencing how they deliver on TCF. But management should be able to describe their strategy and how TCF fits with it. Where applicable, management should also ensure that the principle of TCF is understood by relevant members of staff and that their behaviour takes account of the needs, risk appetite, level of understanding and rights of their customers.

Issues for consideration

Our rules already set out to some degree how regulated firms should conduct themselves. Many smaller firms are advisers, so various practical aspects of their operations will already be shaped by the requirements of our conduct of business sourcebooks for investment, insurance and mortgages. But sourcebooks do not cover every aspect of a firm's operations. Even where firms are subject to those rules, we would still encourage management to consider if TCF is properly reflected in their businesses.

All smaller firms should at least review whether the structure of the firm positively supports the principle of TCF as well as compliance with detailed rules. A good example might be whether the remuneration structure encourages the right kinds of behaviour. Other areas that firms might like to think about are outlined below.

Financial promotions: During any marketing or sales activity, financial promotions of any sort, including bespoke material such as suitability letters, must be clear, fair and not misleading.

Advice and sales process: Management should ensure that advice is appropriate and timely for the particular sale, that due account has been taken of the profile of the customer, and that the customer's needs, knowledge and attitude to risk have been adequately assessed and taken into account. Firms must also disclose information to their customers in ways that comply with our rules and requirements.

Practices clearly resulting in a bad deal for consumers include firms failing to demonstrate responsible advice. We have seen customers being sold sub-prime mortgage products when prime products were available to them.

Our priority in relation to mortgage and general insurance firms is focusing on the standard of disclosures to consumers. While the Key Facts requirements have only been in place for a few months, standards of disclosure by mortgage intermediaries are not high and we will be working intensively over coming months to raise standards.

But we also see firms taking steps, beyond the requirements of our detailed conduct of business rules, to make sure they treat their customers fairly. We have seen a general insurance intermediary that uses a warning notice to draw attention to exclusions in policies, rather than embedding them in small print. This is embracing the spirit of TCF and placing the welfare of the customer at the forefront.

Another firm changed its practices when alerted to the fact that customers might have been disadvantaged. A sole trader had been recommending his clients to invest in a bond where he thought capital was guaranteed. On discovering that this was not the case, he contacted each client affected, explained the situation and arranged for them to take appropriate action. He paid compensation where appropriate, and continued to have very good relationships with his clients.

Training: The ability of staff to offer customers the appropriate standard of service obviously depends on how well they are trained. Few smaller firms have dedicated training functions, so it is important for management to be satisfied that staff have the necessary skills and competence. This applies to all staff who may have an impact on whether customers receive fair treatment, including those involved in sales, marketing, complaints handling and compliance. Management should also be realistic about the potential limitations of training offered by product providers.

Information issued by product providers: It is for product providers to provide clear and relevant information about their products to distributors. But it is important for distributors to consider the information they are given. By this we do not mean that financial advisers have to second guess the actuarial assumptions underlying the design of a product, but they should be able to form a judgement about, for example, whether the material is suitable for use by their clients.

Management and staff involved in marketing or selling should understand the features and risks associated with the products they handle. If they do not, they should not be selling the products. This is essential if products are to be explained adequately to customers and advisers are to be certain of their suitability. Advisers should also be able to make an informed judgement on whether they agree with opinions expressed in providers' literature.

Accurate and timely record keeping: This is an area that can suffer at firms with few staff, especially at one-person operations. It is nevertheless important that firms maintain adequate records of customer profiles and instructions, and on each stage of the sales process. This is essential for management to be able to respond fairly when disputes arise, and will help if they have to provide evidence to the Financial Ombudsman Service (FOS).

Disputes and complaint handling: Smaller firms need to attach the same importance to the fair and effective resolution of complaints as larger firms, which may have dedicated complaint-handling functions. Smaller firms are often closer to their customers and may be better placed to resolve any complaints; but they need to be aware of the potential risks when the person handling the complaint could also be responsible for the advice.

A client complained to his financial adviser that he had been charged a surrender penalty when he cashed in his life policy. He complained that the adviser had not told him, when he bought the policy, that a penalty could be charged. After investigating the complaint, the firm accepted that it had given poor advice.

The investigation also revealed that the policy was probably unsuitable for the client and that he had suffered a much greater loss than the penalty he had first complained about. But suspecting that the client was unaware of the wider problems, the firm only offered to reimburse him for the cost of the surrender penalty. It did not tell him that the original advice had been unsuitable and that the potential loss to him may have been far greater than the amount they had offered.

The client was therefore unable to take an informed decision when deciding whether to accept the offer.

Flow of information between a firm and its clients: A particular feature of many smaller firms is that they have close and long-standing relationships with their clients. This may give the customers many benefits, but it can also result in the flow of information between firm and client becoming less formal, both at the point of advice or sale and afterwards. It is important that customers remain clear about the nature of the services being offered by the firm.

Management may want to consider how to keep customers properly informed during the course of an ongoing relationship. Firms need to ensure that they always act with integrity in their dealings with customers, regardless of the length of the relationship.

Risk assessment: Although the practical implementation of TCF may be less formal, the management of smaller firms should still review all aspects of their business and organisational structures to identify risks that might have an impact on their ability to treat customers fairly. Management should then act to mitigate any such risks.

A risk that already concerns us is the poor level of control exercised by general insurance intermediaries over Appointed Representatives. Our supervision work is targeting the potentially serious consequences for customers.

We also see evidence that some firms are putting themselves into administration to avoid their liabilities, only to re-incorporate as a separate legal entity (a 'phoenix firm') and carry on trading. We have devised an approach to deal with these situations, so that any claims arising are dealt with appropriately and customers are treated fairly.

TCF objectives and management information (MI)

We expect the management of smaller firms to determine what TCF means for their business and decide what they need to do to deliver that. This need not be complex. For example, a financial adviser might aim to:

- sell products that are suitable to the needs, wishes and financial sophistication of its clients;
- ensure clients receive all necessary information about the service offered by the adviser and on any products recommended by the adviser, and that this is explained in a way that is understandable to clients; and

- handle complaints fairly.

Having set their objectives, management should decide how the firm will achieve them and how this will be monitored.

Our focus on MI and performance measurement is because we consider it important that management should be able to access MI to assess whether the firm is successfully meeting its TCF objectives.

The MI that firms gather need not be complex or require expensive systems, but should be proportionate and sufficient to inform management whether the business is delivering TCF in the way they have defined it. So, for an advisory firm, relatively simple data about sales, persistency and complaints (which the firm already has) could provide many of the answers.

Having the appropriate MI will help management know if they are delivering their strategies and help them identify gaps where further work is needed.

Assisting smaller firms in meeting their obligation to TCF

We do not have day-to-day contact with smaller firms and we may not visit them on a regular basis. Instead, we will generally contact them:

- to give them information which we think they might find useful, about good and bad practices we have seen in the industry, or other relevant FSA developments;
- when we need to follow up any information we have received about them; and
- to ask them to participate in our thematic work.

However, there are other ways in which we communicate with smaller firms and we have initiatives to make us easier for smaller firms to do business with. These include our Firm Contact Centre and Firms Online, a system that allows firms to submit returns, make applications and change their details electronically.

We have also begun a series of visits, roadshows and surgeries around the country at which firms can ask questions. We are running a series of industry training events and there is a great deal of useful information on our website, including dedicated pages for mortgage and general insurance business and a tailored version of the Handbook.

All these channels of communication will help smaller firms to have a good understanding of their TCF responsibilities and the issues they may wish to consider in meeting them.

Next steps

We will continue to develop our thinking about how TCF applies to smaller firms, and in this we wish to work closely with the relevant trade bodies and industry representatives. In addition to our work on TCF for smaller firms, we will continue to consider TCF issues relevant to specific industry sectors, some of which – particularly in the advisory sector – are closely linked to smaller firms.

We will communicate the results of our supervisory work on smaller firms, most of which relates to ensuring that their customers receive a fair deal. In this way, we intend to provide clear statements to help smaller firms consider what TCF might mean for them.

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