SLAUGHTER AND MAY/

NEWSLETTER

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INSURANCE

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A new Consumer Duty

Overview

In May the FCA published a consultation paper on a proposed new Consumer Duty in retail financial services (CP21/13). This has been a long-running project – the original discussion paper was published in June 2018 and a number of associated strands have been developed in the intervening period. More recently, the Financial Services Act 2021 was enacted with a provision requiring the FCA to carry out a public consultation about whether it should make general rules providing that authorised persons owe a duty of care to consumers. The Act provides that the consultation must be carried out and an analysis of the responses published before 1 January 2022, with a view to any new rules coming into force by 1 August 2022.

The May consultation focuses on a new Consumer Principle and outlines the scope and structure of the new rules which the FCA proposes introducing to support that new Principle. Further detail will follow in a second consultation to take place later in the year which will cover: detailed drafting of the new rules; specific proposals on the interaction between existing Principles and the new requirements; and the possible private right of action for consumers, which is discussed in high level terms in the initial consultation.

The Consumer Duty consultation should be read alongside the FCA's related work in this area, in particular its work on general insurance pricing practices and its guidance on the treatment of vulnerable customers.

Timeline

14 May 2021 – consultation paper published

31 July 2021 – deadline for responses to the consultation paper

By 31 December 2021 – FCA to publish second consultation with detailed rules

31 July 2022 – deadline for any new rules to be made

For further information on any Insurance related matter, please contact the Insurance Group or your usual Slaughter and May contact.

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The key proposals

The FCA proposes introducing a new "Consumer Duty", which would apply to products and services sold to retail clients. The duty would comprise:

- a new **Consumer Principle**, forming part of the FCA's Principles for Businesses, which would provide an overarching standard of conduct
- **"Cross-cutting rules"** to support the Consumer Principle
- **Four Outcomes** setting more detailed expectations for how firms can comply with the Consumer Principle.

The FCA is consulting on two alternative versions of the Consumer Principle:

> *"A firm must act to deliver good outcomes for retail clients"*
>
> or
>
> *"A firm must act in the best interests of retail clients"*

At this stage the FCA is not consulting on the detail of the Cross-cutting rules but the consultation paper states that these will require firms to: (i) take all reasonable steps to avoid causing foreseeable harm to customers; (ii) take all reasonable steps to enable customers to pursue their financial objectives; and (iii) act in good faith.

The Four Outcomes

The Four Outcomes relate to **Communications**, **Products and Services**, **Customer Service**, and **Price and Fair Value**.

The outcomes the FCA is seeking are:

- Communications equip consumers to make effective, timely and properly informed decisions about financial products and services
- Products and services are specifically designed to meet the needs of consumers, and sold to those whose needs they meet
- Customer service meets the needs of consumers, enabling them to realise the benefits of products and services and act in their interests without due hindrance
- The price of products and services represents fair value for consumers.

A particular area of concern for the FCA is so-called "sludge practices", which are practices which make it harder for consumers to take decisions in their interests, such as difficult processes for cancelling products. The FCA is concerned that firms are taking advantage of behavioural bias, such as consumer loyalty or inertia, an issue highlighted in the FCA's work on general insurance pricing practices.

From a practical perspective, the need to ensure that products are sold to the intended market will mean different firms in the manufacture and distribution chain will need to be clear about their respective responsibilities, although similar requirements are already set out in the Product Intervention and Product Governance Sourcebook in respect of many types of product and in the FCA's guide on The Responsibilities of Providers and Distributors for the Fair Treatment of Customers.

Possible private right of action

In the feedback statement to its discussion paper (April 2019) the FCA discussed the possibility of creating a private right of action for breaches of the Principles. This option is discussed again in the consultation paper but the FCA is seeking further feedback on the advantages and disadvantages of introducing such a right of action, either in respect of all of its Principles or just the Consumer Principle.

Comment

The FCA's stated objective in introducing a new Consumer Duty is to require all firms to ensure that their products and services are fit for purpose and offer fair value and that their communications and customer service enable consumers to make and act on well-informed decisions. This is clearly a laudable aim but the consultation does give rise to a number of issues which we anticipate may be raised in feedback from stakeholders.

The FCA's view is that, for the time being at least, the new Consumer Principle should sit along existing principles. There is, however, a degree of overlap which may give rise to some confusion over, for example, what the new principle requires over and above existing requirements to treat customers fairly. The FCA states that firms will need to take responsibility for judging whether their conduct serves consumers' interests and delivers good outcomes, although clearly the FCA will ultimately have views on this. It also acknowledges that neither the concept of a "good outcome" for consumers nor acting in consumers "best interests" is clearly legally defined.

The FCA refers in a number of places to reasonable steps being taken and to the reasonable expectations of consumers regarding the products and services provided to them. Firms may want some additional certainty regarding how reasonableness will be judged, either in the more detailed rules or guidance from the FCA. There is also reference to a requirement for firms to act in good faith but it is not clear how this standard will be judged and whether existing legal concepts of good faith will be applied.

Clarity in respect of all aspects of the Consumer Duty is likely to be particularly important if a private right of action is introduced.

The consultation closes on 31 July.

Operational resilience

In March, the Bank of England, PRA and FCA published a suite of final documents setting out the new approach of the regulators to operational resilience. The policy has been some time in the making, with consultations originally published in December 2019 but final rules delayed due to the pandemic.

The PRA requirements will sit in new Operational Resilience Parts of the rulebook for CRR firms and Solvency II firms, supported by a Statement of Policy and a supervisory statement (SS1/21). The FCA rules will be applied through amendments to SYSC.

Operational resilience is the ability of firms and the financial sector as a whole to prevent, adapt, respond to, recover from, and learn from operational disruptions. The new framework, which must be implemented from 31 March 2022 and fully complied with by 31 March 2025, requires firms to consider which their important business services are, the impact tolerances for those services and how they can ensure they remain within impact tolerance. An impact tolerance is the maximum level of disruption which can be tolerated for the business service. As part of the process, firms should map the resources (including people, processes and technology) required for delivery of each of the relevant business services.

> By 31 March 2025 *"firms should have sound, effective and comprehensive strategies, processes, and systems that enable them to address risks to their ability to remain within their impact tolerance for each important business service in the event of a severe but plausible disruption"*

Important business services are services which are provided to end users, rather than important internal services such as treasury services or HR. Internal services may, however, need to be taken into account in considering possible disruptions where they are necessary for the delivery of the external facing service.

The identification of an important business service is subject to different considerations for PRA regulated and FCA regulated firms. Dual regulated firms such as insurers will need to consider both concepts. An important business service is one provided by a firm, or by another person on behalf of the firm:

- to another person which, if disrupted, could pose a risk to: (i) where the firm is a relevant Solvency II firm, the stability of the UK financial system; (ii) the firm's safety and soundness; or (iii) an appropriate degree of protection for those who are or may become the firm's policyholders (PRA definition)
- to one or more clients of the firm which, if disrupted, could: (i) cause intolerable levels of harm to any one or more of the firm's clients; or (ii) pose a risk to the soundness, stability or resilience of the

- UK financial system or the orderly operation of the financial markets (FCA definition).

A crucial part of the approach to operational resilience is that firms should assume that disruptions will occur and plan for how they can meet their impact tolerances in "severe but plausible" scenarios. The probability of those scenarios occurring is not relevant.

Operational resilience overlaps with other regulatory requirements and considerations such as the management of and setting of capital requirements for operational risk and the critical services which firms may need to consider as part of resolution planning. The fundamental approach to operational resilience is different, however, from other requirements - for example the outward facing nature of the concept of important business services and the assumption that disruptions will occur. The regulators acknowledge that it is likely to take time for firms to comply fully with the new regime and that good practice in areas such as scenario testing are likely to emerge over time.

Alongside the publication of the new operational resilience rules, the PRA has at the same time published related guidance in a new supervisory statement on outsourcing and third party arrangements, which we discuss in our briefing note here.

Amendments to the insolvency arrangements for insurers

In May HM Treasury published a consultation on amendments to the current insolvency regime for insurers. In the consultation document it stresses that this is not intended as a substitute for the introduction of a resolution regime for insurers, proposals for which are currently being developed by Treasury jointly with the Bank of England.

The proposals focus on the power under section 377 of FSMA for the court to write down the value of an insolvent insurer's contracts. This power has never been used and there is uncertainty around some aspects of its application. HM Treasury's proposals would clarify these uncertainties and also broaden the scope of the provision to allow it to be used at an earlier stage. It is hoped that this will improve the position of policyholders, in particular by facilitating continuity of cover.

The consultation makes five specific proposals:

- amendments to section 377 to, among other things, clarify the parties who may apply to the court for a write-down (i.e. the directors or shareholders of the insurer, the PRA, or a singular or group of the insurer's policyholders or creditors); widen the scope of the provision, to allow the court to exercise the power if the insurer is *likely to become* unable to pay its debts; and clarify that liabilities can be written back up
- the creation of a new "write-down manager" position, to lead the design of the write-down proposal and ensure it works as intended to stabilise the insurer
- introduction of a statutory moratorium on certain termination rights while an insurer is undergoing a write-down or administration (subject to conditions and exceptions)
- a stay on policyholder surrender rights for life insurance policies while an insurer is undergoing a write-down or administration (also subject to conditions and exceptions)
- changes to the protection provided by the FSCS in the event of a write-down, to allow compensation to be calculated by reference to the pre-write-down value of a claim - although it notes that it is for the PRA to introduce any such changes to its rulebook.

The consultation closes on 13 August.

Climate change developments

Disclosure requirements

For premium listed UK insurers (and other premium listed companies), a requirement was introduced in December 2020 to make climate-related disclosures in their annual reports for financial periods starting on or after 1 January 2021, based on the framework established by the Task Force on Climate-related Financial Disclosures (TCFD). Although disclosures are not mandatory, if a company does not include a disclosure it will need to explain why.

There are, however, further ongoing developments which will impact on the need for insurance companies to make climate-related disclosures. In March the UK government published a consultation on mandating climate-related financial disclosures by publicly quoted companies, large private companies and LLPs and "relevant public interest entities", which includes insurance companies. Separately, the FCA has said that it intends to consult in June 2021 on proposals to require climate-related disclosures by asset managers, life insurers, and FCA regulated pension providers, aligned with the recommendations of the TCFD. It is not entirely clear at the moment how these various initiatives will be weaved together, although hopefully they will overlap sufficiently that compliance with the most onerous set of requirements will satisfy the others.

Sustainability issues and Solvency II

At a European level, changes are being made to the Solvency II regime to integrate sustainability issues. In April the European Commission published a final version of proposed amendments to the Level 2 Delegated Regulation which will:

- require insurers to reflect sustainability risks in their risk management
- require an insurer's actuarial function to take into account sustainability risks in relation to the calculation of technical provisions
- require an insurer's remuneration policy to include information on its consistency with the integration of sustainability risks
- require that sustainability risks are taken into account in the implementation of the prudent person principle.

Although these changes will not directly affect UK corporates they indicate a broader direction of travel which may be followed in the UK.

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