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External in-house counsel

FCA's TR15-02 Thematic Review of Product Development and Governance

On 5 March 2015 the FCA published its Thematic Review 15/2: Structured Products: Thematic Review of Product Development and Governance (TR15/2). In TR15/2, the FCA sets out its findings from its latest review of the structured products market. The review is relevant to all firms involved in any stage of the design, manufacture, packaging and distribution of structured products.

In the review, the FCA identified that the development and governance of structured products has given rise to several risks that firms need to manage in order to treat customers fairly. Ensuring that the products which firms design have a reasonable prospect of delivering economic value to end customers and good product governance procedures in place is key to minimising related risks. The FCA has clear product governance guidance for structured products setting out expectations of firms operating in this market. Firms should:

- identify the target market and then design products that meet the needs of end customers in that target market;
- stress-test new products to ensure they are capable of delivering fair outcomes for the target market of end customers;
- ensure a robust product approval process for new products;
- provide appropriate information to distributors and end customers, and
- monitor the progress of a product through to the end of its life cycle.

However, in their review, the FCA found that some firms are falling below these expected standards in their approach to the designing, manufacturing, packaging and distributing structured products. The review was carried out in respect of two key categories – (i) Research with customers and (ii) Supervisory work with firms where the FCA identified the following issues within their findings:

- **Research with retail customers**: Retail customers need to have a clear understanding of structured products and should be making informed decision when buying them.

  The consumer research highlighted that retail customers struggle to understand the complex features common to many structured products. It also showed how consumers frequently overestimate the potential returns available from structured products, which has a negative impact on the quality of their decision-making. These findings reinforce the need for firms involved in developing structured products to ensure they take account of the objectives and financial sophistication of customers in the target market. This will help ensure products are designed to meet identified consumer needs, sold via appropriate distribution channels and communicated in a way that investors can understand.

- **Supervisory work with retail and wholesale firms**: Firms need to be designing products that customers need and understand. Firms also need to have good product development strategies, governance, distribution strategy and approaches to primary and secondary trading.

  The FCA observed that some firms failed in the following regards:

  - to define a clear target market of end customers at the product design stage and identify relevant needs which their product would serve;
  - to conduct sufficiently robust analysis and stress testing;
  - to properly asses whether products are likely to represent value for money for end customers; and
  - to monitor how the product was distributed to check that distributors had sufficient information about the product and its target market to fulfill their own obligations towards the end customer.

Six key findings were concluded as a result of the thematic review in this regard:

1. Retail consumers generally struggle to understand the relative merits of structured products and the factors driving potential returns. They find it difficult to compare alternatives and to make full use of analytical information. It is essential that firms take steps to bridge this gap.

2. Firms' senior management must do more to put customers at the forefront of their approach to product governance. This should begin with the identification of a clear target market during product design and then inform each subsequent part of the product development and distribution strategy.

3. Structured products should have a reasonable prospect of delivering economic value to customers in the target market. Firms must be able to determine and evidence this via robust stress testing as part of the product approval process. Products that fail this process should not be manufactured nor distributed.

4. Firms' need to provide customers with clear and balanced information on each product and any risks. This is particularly important for information explaining the likelihood of potential investment returns and any risk to the customer's capital.

5. Manufacturers need to strengthen the monitoring of their products. This includes ensuring distributors have enough information about the manufacturer's product to sell it appropriately and checking that each product is being distributed to its target market.

6. Firms need to do more to ensure fair treatment of customers (including best execution where relevant) throughout the lifecycle of a structured product.
[1]

The findings in the TR15-02 Review have focused the FCA's towards the approaches taken to product governance by some firms in this market and, in particular, that firms are not meeting expectations which is creating a risk that flawed product design could result in poor consumer outcomes.

Going forward, all of the firms that participated in the FCA's review will be asked to explain how they will ensure the fair treatment of customers for new structured products they bring to market. Moreover, regulated firms involved in the structured product market – whether manufacturing, packaging and/or distributing – should carefully consider this report, alongside the FCA's Principles, rules and guidance. Firms' senior management should satisfy themselves that they are meeting regulatory requirements and that their approaches support the delivery of good consumer outcomes.

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