FRTB: Better Get Your Skates On

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The New Product Intervention and Product Guidance Rules (PROD)

These UK FCA rules came into force on 3 Jan 2018 as the UK implemented MiFID 2, so essentially have a wider application than just the UK. Known as PROD they require that product manufacturers (referred to as product providers) and product distributors (referred to as product advisers) have systems and controls in place to design, approve, market and manage products throughout the product’s lifecycle to ensure that they meet the legal and regulatory requirements.

The UK financial industry has been saddled with a range of issues over recent years not the least of which has been the pensions mis-selling fiasco. This issue has severely impacted the financial results of many firms; accordingly, the introduction of regulation was both necessary and timely.

In terms of obligations at its most basic the onus is on the product manufacturer to outline which type of client their product is designed for, whereas the product distributor takes responsibility to whom the services are delivered.

Basically, this is all about due diligence and while there is not detailed guidance within the regulations, the objectives are clear cut. The analysis commences as follows:

Client Segmentation

The initial analysis commences with client segmentation. This is required for any business anyway to identify those clients that yield the greatest return or where the firm has a niche advantage to enable them to succeed.

This segmentation needs to focus on what meaningfully differentiates risk within the client population, taking account of the customers’ expectations, assets and needs. Clearly some of these factors will be qualitative whereas others are quantitative – but nobody said this was supposed to be easy. Only when you have this analysed can it be appropriate to move towards showing whether the population segment is likely to have a need for a specific product.
Target Market

Firms already have target market analysis identifying the types of clients that are most likely to be responsive to a particular product or service. Under PROD this is taken a bit further and will look to understand the nature of the suitable client. This will include an assessment being made of their financial knowledge and experience. It also needs to consider their ability to withstand losses or the customer’s risk appetite.

We all know clients tend to want the same thing, a high return at no risk. Many say they can suffer losses, yet when such losses occur there is an unwillingness to accept or a surprise element that is a concern. This needs to be properly assessed and documented. There also needs to be a clear understanding as to the customers for whom the product is unsuitable. Remember you cannot sell customers products that are not suitable for them. In many ways again you would not need regulation to make this clear. If you sell a customer an unsuitable product is would likely lead to a complaint anyway and the customer being compensated in some way – responsible and successful firms will not likely do this.

Product Governance

Product manufacturers are required to regularly review the products and services that they have developed to ensure that they remain fit for purpose. At the same time product distributors need to make sure that they fit the needs of their target market including its characteristics and goals. Of course, as this is conducted the distributors may well identify clients that are now in the wrong product and this will lead to them taking actions to prevent either complaints or rule breaches.

So, what should the product manufacturer actually do? Researching the market, looking at competitor strategies and stress testing both the markets and the customer segmentation analysis all seem to be required. Reports need to be generated highlighting that this has been successfully completed to be provided to the governance committees of the organisation to ensure that there is full senior management responsibility and that an audit trail is retained. This is going to need economic as well as market and business analysis, none of which is likely to be easy to obtain or complete.

In looking at the operation of the product and how it works in practice the firm will need to consider the return that the product achieves (or will achieve) as opposed to the risks that exist. This will include taking a view, where necessary on a range of external factors including market volatility. That these rules are coming in while the UK is under a Brexit trajectory uncertainty and a range of international elections all makes this even harder than would normally be the case. You would expect senior management to keep close monitoring of product performance to ensure that the results and the indicators or performance criteria remain aligned.

Financial History and Strength

Throughout the regulations that are being implemented, whether MiFID or Outsourcing, for example, the importance of financial strength is being emphasised. It is here within PROD where the financial strength of the manufacturer needs to be properly assessed. Other matters that need to be considered are the concentrations that might exist, the behavioural liquidity risks under stress and anticipated inflows and outflows that could undermine the product.

It needs to be recognised that this focus on financial strength is likely to be detrimental to new entrants and could form a barrier to competition leading to a flight to quality. If this is the unintended consequence that an amendment to the regulation will be likely to ensue.
Systems and Processes

The end point of sale issues which arise either at sale or subsequently need to be considered. This is not only the controls and processes that the product manufacturer applies at point of sale as we have discussed already, but also how complaints will be handled efficiently and effectively. These could also occur as the financial product reaches maturity, so some awareness of the continuing risks and controls needs to be considered.

As always, this discussion is limited to a few of the issues which are included within PROD. What is clear is that firms will need to take these rules seriously and look to ensure that there is adequate documentation ensuring compliance. Senior management need to be made aware of their responsibilities in this regard through Board meeting debriefs, training and presentations and these needs to be clearly documented within the information provided to them. Internal audit and the second line of defence need to align their scope and processes to ensure that such matters are addressed efficiently and effectively. There is a lot to this project and the new processes will be ongoing throughout and beyond the end the sales cycle of products until they are fully closed out. But the gains are clear for any firm – there should be less mis selling and never again a problem such as the PPIU crisis.

Debriefs for the Board and senior management plus training for product teams is available from Risk Reward Ltd. Please click here for a rapid response or contact Dennis Cox at DWC@riskrewardlimited.com.