MiFID II: The Need to Improve Suitability Assessments

Your Partner For What's Next

The Central Bank of Ireland ("CBI") has recently published a "Dear CEO" letter which noted that MiFID II firms are failing in their approach to implementing risk-based and client-centric suitability assessments. The findings of the review on investment firms' compliance with suitability requirements outline a number of areas which need improvement.

Background to the "Dear CEO" Letter

In February 2020, the European Securities and Markets Authority ("ESMA) announced the launch of a Common Supervisory Action ("CSA") on the application of MiFID II suitability rules, with the aim of assessing how firms comply with suitability requirements.

Since the publication of the CSA, the CBI has engaged with all authorised firms to determine if they are taking all reasonable steps to ensure that a client's investments align to their investment objectives and personal circumstances. This engagement was carried out via desktop review and virtual inspections with selected firms, to determine whether suitability steps were in place to ensure investments do not exposure clients to the risk of purchasing products that do not align to their needs.

The "Dear CEO" Letter, published on 1 December 2021, details the outcome of their inspection and firms are now required to conduct an in-depth review of their sales practices and suitability programmes with reference to the letter, while also taking mitigating action on any formal findings issued to them as part of the CSA. This review must consider ESMA's public statement on the results of the CSA and requires **documentation and board approved action plans by the end of Q1 2022.**

"Investing in an unsuitable investment product can lead to unexpected losses, which can have devastating consequences for individual investors and their families. Regulated firms play a key role in protecting consumers against this risk."

Colm Kincaid,
CBI Director of Consumer Protection:
December 2021

Key Findings

Four key findings emerged from the CBI review, which are accompanied by examples of positive and weak practices in an Appendix to the letter. Firms are required to review these findings and consider how they apply to their specific suitability arrangements. Some considerations in respect of these findings are summarised below:

1. Firms need to adopt a client-focused approach:

- The CBI is concerned that a risk-based and client-centric approach is not in place. There is **a lack of focus on good customer outcomes** and current suitability frameworks do not reflect firms' business models and their client base;

- Some firms are not considering all aspects of a client's situation, instead collecting information required to execute standalone transactions. Firms need to take a comprehensive approach to suitability that focusses on a broad and complete understanding of their client;

- Digital channels are being utilised to carry out suitability assessments at speed, which realises costs and convenience benefits for firms and clients. Ease and efficiency cannot ignore the requirement to conduct a comprehensive suitability assessment through all delivery channels; and

- **Deficiencies are appearing in the identification of vulnerable customers,** which is particularly apparent in the lack of policies and procedures in this area. Without embedded proactive, detective and reactive steps to guide staff interaction with vulnerable customers, there is a risk that the suitability assessment process will be inherently flawed when assisting such customers. Financial services firms should have a good understanding of their customer population and embedding an end-to-end vulnerable customer framework that is periodically reviewed.

2. Firms must improve their assessment of clients' knowledge and experience, financial situation and investment objectives:

- **Too much reliance is being placed on clients' self-assessment** of their financial situation and capacity to bear losses. Firms are relying on clients' attitude to risk without counterbalancing this with more objective criteria. Firms must collect all necessary information and consider all clients' circumstances in order to make a recommendation to a client and this includes more extensive inputs, such as the information generated from the firm's own calculation of the capacity of the client to make a loss; and

- Shortcomings in record keeping were noted and updates to client information need to fully align to a client's risk profile. For firms to demonstrate that they perform holistic suitability assessments, they need a robust process to capture and update client information to build a reliable, accurate and consistent picture of a client's needs and objectives. It is important that the risk of only emphasising the positive aspects of a product is mitigated, so that the client's best interests are protected.

3. Suitability Reports need to be sufficiently detailed and personalised:

- Generic templates and standardised wording within suitability statements significantly reduce the ability of clients to make informed decisions. Disclosures should be transparent and tailored to a client's unique circumstances, so that they can understand how and why an investment product meets their needs; and

- While automatic generation of suitability statements provides a degree of consistency, there is a risk that the approach to suitability can be reduced to a "tick-box" exercise. **Firms need to balance standardisation with individualisation,** so that a product (including the recommendation not to sell, buy or hold) matches the client's investment objectives, including their risk tolerance, financial circumstances and knowledge / experience.

4. Controls on 'Exception' Processes need to be stricter:

- Firms are failing to enforce oversight and control of exception processes, particularly in instances where a client decides to deviate from suitability advice provided to them. Where clients are accepting this risk, **firms must ensure that disclaimers signed by the client to document their decision cannot limit or remove the obligation of the firm to conduct a full suitability assessment.** Where exceptions are processed, senior management oversight and control is critical; and

- Gaps in training and oversight procedures were noted, whereby firms are over-relying on the staff experience and longevity to act as a substitute for regular, formal suitability training. A comprehensive training programme can help mitigate the risk that staff are unaware of their regulatory obligations to clients and reinforce the client-centric approach required.

How Can KPMG Help?

KPMG's Consulting experts in the conduct, regulatory and financial services sectors have unparalleled experience assisting financial institutions with conduct risk reviews and regulatory implementations. KPMG provide regulatory advice, proposition design and programme support services across the financial services sector. We have competencies across a number of areas that will assist you in addressing the weak practices identified by the CBI in suitability requirements.

Examples of where our team of experts can assist throughout the end-to-journey are as follows:

Suitability Assessment Review & Assurance

- Infrequent minimum update of information; and
- No risk-based approach to updating information.

How KPMG Can Help

√ Developing policies and procedures to assist with embedding a risk-based approach to updating suitability information; and

√ Assisting you with updating your internal control mechanisms to strengthen your suitability assessment framework.

Training

- Material is not tailored to Firm's business model, sales strategy or product offering; and
- Failure to ensure all relevant staff involved in suitability (including administrative staff) receive formal suitability training.

How KPMG Can Help

√ Supporting you in delivering training to your people that is client-focussed and proportionate to the nature, scale and complexity of your business and client base.

Disclosures & Transparency

- Unclear disclosures within Terms & Conditions, limiting Firms' responsibility regarding the assessment of suitability.

How KPMG Can Help

√ Assisting you with a gap analysis, assessing any updates against regulatory requirements and benchmarking against industry best practice.

Vulnerable Customers

- Vague or non-existent policies for defining vulnerabilities; and
- No evidence of formal additional checks / monitoring.

How KPMG Can Help

√ Developing a customer treatment strategy for all categories of vulnerability to embed an end-to-end Vulnerable Customer framework; and

√ Designing a reporting framework with quantitative and qualitative MI, to demonstrate trends as well as the characteristics of vulnerability and potential vulnerability.

Understanding Investment Products

- Lack of formal policies and procedures to ensure Firms understand the investment products selected for their clients, including the complexity and risk of the product. Instead, reliance placed on basic templates containing limited information.

How KPMG Can Help

√ Supporting you with implementation and post-implementation assessment of changes to your policies and procedures, ensuring they meet regulatory expectations and can be understood by staff in practice.

System

- Operational resilience and recovery of systems continue to be an area of focus as cyber vulnerabilities become increasingly evident and disruptive.

How KPMG Can Help

√ Developing customised strategies to protect your assets and systems as threats appear.

Complaints

- There should be entreprise-wide responsibility for complaints, recognising it's important as a valuable source of MI and a leading indicator of conduct risk issues.

How KPMG Can Help

√ Benchmark how prepared organisations are to manage complaints in a highly competitive and rapidly evolving market; and

√ Provide valuable trends and insights on varied aspects of international complaints management practice including reporting and governance, linking root cause analysis with organisational strategy, and automation and technology solutions.

Monitoring & Oversight

- Absence of a risk-based monitoring programme that applies additional monitoring or controls to higher-risk practices.

How KPMG Can Help

√ Supporting you in establishing a programme to control the activities of higher-risk areas or where additional monitoring is required; and

√ Designing and implementing a bespoke product assurance approach to control your product set and align with the evolving and expanding Product Governance and client protection expectations.

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