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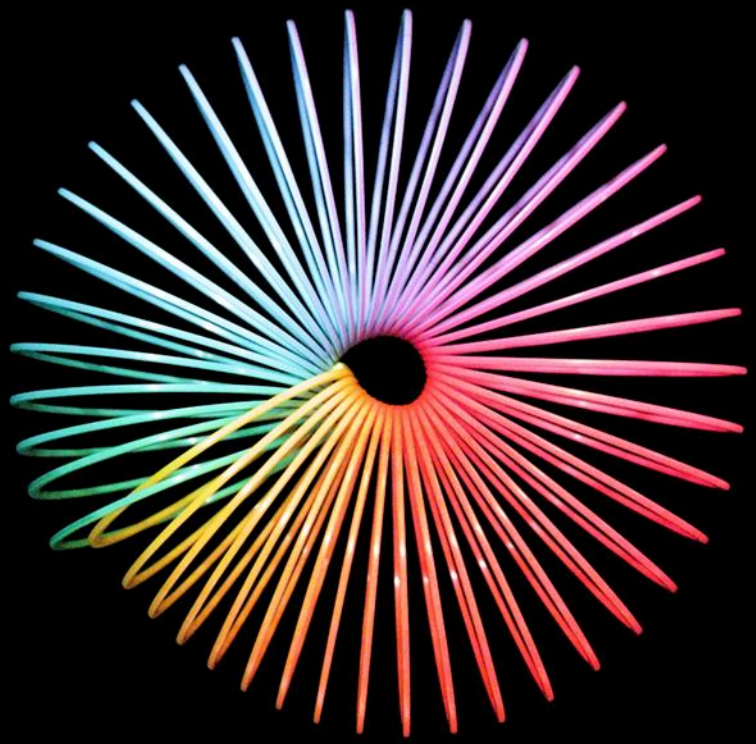


Conduct risk – a UK perspective

Nicola Vincent

Where did conduct risk emerge from?

The UK's journey

FSA

FINANCIAL CONDUCT AUTHORITY

2001

Financial Services Authority (FSA) established as principal UK financial regulator.

Responsibility for prudential and conduct regulation.

2006

Treating Customers Fairly published.

2008

Northern Rock nationalised due to collapse.

(Minimal regulatory focus on conduct risk.)

2010

PPI mis-selling scandal emerges.

2013

FSA becomes 'Financial Conduct Authority' (FCA).

FSA's main prudential responsibilities transferred to newly-created 'Prudential Regulation Authority'.

Conduct-focussed language introduced into FCA documents e.g. Business Plan and Risk Outlook..

2014

2015

Significant enforcement action against firms for misconduct.

Santander UK fined £12.4m in 2014 for providing unsuitable advice to customers.

Barclays fined £72m in 2015 for financial crime failings.

Lloyds fined £117m in 2015 for failing to treat customers fairly when handling complaints.

2016

2017

Risks to customer outcomes incorporated into wider rules and policy.

Fair and Effective Markets Review 2015.

Remuneration Code 2015.

Senior Managers Regime 2016.

An evolving approach
From TCF to conduct risk

From its creation in 2013, the FCA has taken a far broader approach to managing risks to customers.

TCF

- Focus on the symptoms of unfair outcomes, not the causes.
- Approach was retrospective, not forward looking. E.g. MI only provided insight into current performance.
- Outcomes placed emphasis on business processes.
- Narrow in focus and geared more towards firms in the retail finance sector.
- Some firms struggled to embed TCF into their business models. E.g the non-advised investment space.
- Responsibility remained with customers for assessing the quality and suitability of the products they were choosing (Caveat Emptor).

Conduct risk

- Broader than TCF – focus on issues that impact their consumer protection objective beyond the six stated TCF outcomes
- Includes whole value chain, not just point of sale. E.g. product governance, conflicts of interest, distribution channels, etc. As such, seeks to address both symptoms and causes of unfair outcomes.
- Focus on wholesale markets as well as retail market, as misconduct in wholesale markets also impacts on consumer outcomes.
- Conduct risk MI provides both a historical and forward looking view.
- Less reliance on Caveat Emptor.

Conduct risk and conduct risk frameworks – how it started

In its 2014 Conduct Risk Outlook, the FCA set out what it considered to be the drivers of conduct risk. Conduct risks can arise at various points throughout the customer journey. The impact/severity of the conduct risks and the appropriate approach to mitigating may differ depending on:

1) the nature of the relationship with the client (e.g. retail or private banking client)
2) the types of products and services offered (e.g. current accounts, savings, lending, mortgages, investments, retirement planning, inheritance tax planning)
3) customer profile (including financial circumstances, knowledge and experience, objectives)

In order to manage these risks effectively, the FCA expected firms to include conduct risks within their risk management frameworks.

Effective conduct risk frameworks consider product design, sales and post-sales, and culture and governance, as these all contribute to the ultimate outcomes experienced by customers.

Conduct risk across the sectors

The boxes below illustrate the range of conduct risks across different financial services sectors and FCA focus areas

Cross Sector

- EU withdrawal
- Firms culture and governance
- Financial Crime
- Data security and resilience
- Innovation and technology
- Treatment of existing customers

Banking

- Remuneration
- Operational resilience
- Risk governance
- Cost-cutting initiatives
- Advice
- Risk Appetite
- Complaints handling
- Responsible lending
- Payments
- Financial Crime

Capital Markets

- Best execution
- Data
- Investor Protection
- Conflicts of Interest
- Competition
- Information Controls
- Market integrity
- Benchmarks
- Operational resilience
- Dealing Commission

Insurance

- Pensions and Retirement Income
- Complex terms and conditions
- Insurance add-ons
- Claim handling
- IDD
- Product Governance
- Distribution
- Treatment of back-book customers
- Sales of premium finance
- Complaints handling

Investment Management

- Market Conduct
- Financial Crime
- Governance of fund charges
- Use of in-house funds
- PRIIPS
- Best Execution
- Use of dealing commission / advisor charging
- Protection of client money
- Market abuse controls

Challenges for firms managing conduct risk in the UK

1

Ownership and engaging business stakeholders

Many firms have struggled to embrace the holistic nature of conduct risk. Conduct risk frameworks often remained the responsibility of Compliance teams, with no business ownership. In some firms, this led to risks not being properly mapped and measured. E.g. the impact of product design (owned by business managers) or culture (owned by senior leaders) on customer outcomes was not properly explored or understood.

2

Managing conduct risk within existing risk management frameworks

Firms have struggled to incorporate conduct risk into their risk management frameworks without a risk-reward ratio. There are no set metrics for measuring conduct risk, there may be universal indicators but the metrics required for good conduct risk management will vary.

3

Judgement and uncertainty

While principles-based regulation has been a feature of the UK approach for some time (e.g. TCF outcomes), some firms can find it difficult to adapt to the need to exercise judgement rather than following hard rules. The extension of the regulatory focus beyond narrowly defined TCF outcomes to any risk impacting customer outcomes increased this challenge.

4

Retrospective application

Firms have been particularly challenged where the FCA has applied current standards and expectations to historic activity.

The consequences of conduct risk failings in the UK

Failing to meet these challenges and manage conduct risk effectively can lead to significant consequences for firms:

LBG - mortgages | £283m redress

- Lloyds acknowledged that when customers fell into arrears, they did not always do enough to understand customers' circumstances to be confident that their arrears payment plans were affordable and sustainable.
- As a result, Lloyds has committed to refund all fees charged to customers for arrears management and broken payment arrangements from 1 January 2009 to January 2016.
- Lloyds estimates that approximately 590,000 customers will receive redress payments, totalling around £283 million.

July 2017

HSBC – Debt collection | £4 million redress

- Between 2003 and 2009, customers of HFC and JLFS who fell into arrears were referred to the firms' nominated solicitors. On referral, HFC and JLFS levied a charge to the account representing 16.4% of the balance as a "debt collection charge". The flat rate charge was identified as unreasonable by the Office of Fair Trading in 2010, as it did not reflect the actual and necessary costs of collecting the debt.
- It is estimated that approximately £4 million will be paid by HSBC in redress to affected customers

January 2017

Capita | £66m redress and public censure

- Capita was publicly censured and will pay up to £66 million to investors who suffered loss as a result of investing in the Connaught Income Fund, Series 1.
- The FCA found Capita failed to undertake adequate due diligence of the unregulated collective investment scheme, of which it was operator until 2009, and that it failed to communicate with investors in a way which was clear, fair and not misleading.

November 2017

BrightHouse | £14.8m redress

- BrightHouse is a rent-to-own firm which provides household goods to customers on hire purchase agreements.
- Following engagement with the FCA, BrightHouse has committed to pay over £14.8 million to 249,000 customers in respect of 384,000 agreements for lending which may not have been affordable and payments which should have been refunded.

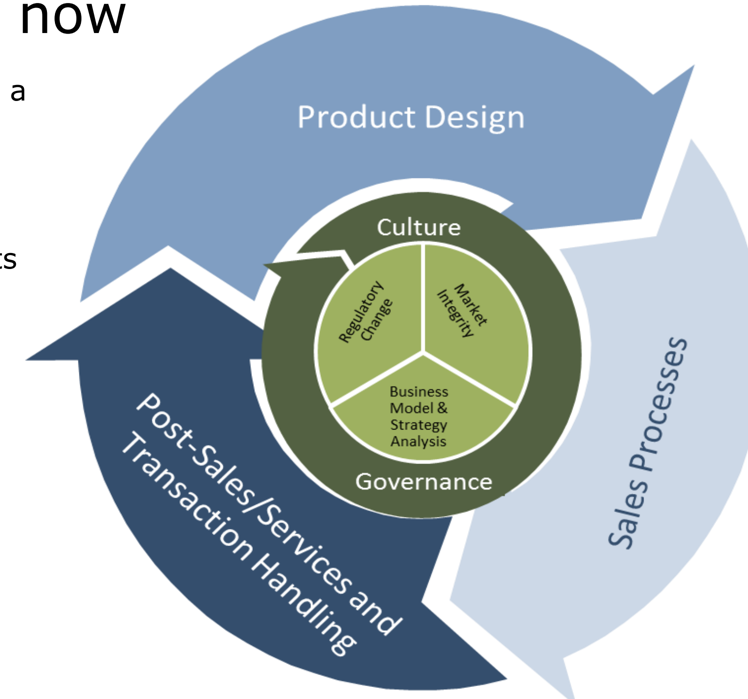
"During the time in question, BrightHouse was not a responsible lender and failed to meet our expectations of firms in this sector." FCA

October 2017

Beyond conduct risk frameworks: Holistic risk mapping where we are now

To effectively understand, and therefore manage, its conduct risks, a firm needs to consider both the customer journey and elements beyond this which – directly or indirectly – impact on customer outcomes. This includes product design, culture and governance.

The firm needs to map the risks that exist in each of these elements and collect relevant management information which will allow it measure these risks.



Firms need to pay close attention to the design and implementation of controls targeted at addressing conduct risks across the three lines of defence ("LOD").

Tight collaboration between customer-facing businesses and control functions such as Compliance, Operational Risk, Human Resources, Operations and Technology, as well as Legal and Internal Audit is key to the effective implementation of conduct risk management.

Further developments and expectations - Outcome testing

The FCA expects firms to measure and demonstrate fair outcomes for customers. Doing this proactively, and not just in response to a complaint, is a key part of effective conduct risk management.

Traditionally, many firms' quality assurance activities focused on whether staff had followed policies and processes correctly. But a focus on adherence to procedure can give false comfort about whether customers are receiving fair outcomes.

Several key aspects need to be considered when planning outcome testing. These should be based on clearly thought-through inputs and outputs and supported by processes to drive continuous improvement.

Clear Approach	Sample Methodology	Insightful MI / Robust Governance	Customer Remediation	Feedback Process
• A clear outcome testing and rating methodology which covers 1st line quality checking and independent 2nd line teams.	• A statistically valid sampling methodology which ensures a minimum sample of complaints/ transactions are reviewed each week/month across the business with a defined segmented approach.	• Clear and consistent outcome testing MI along with clear governance and oversight.	• A customer remediation approach to deal consistently with cases where unfair outcomes have been identified.	• Feedback process in place to ensure key themes/ messages are highlighted, escalated and also communicated to appropriate business areas.

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