Getting the right outcome
Internal Audit and retail conduct risk

An Internal Audit viewpoint

Introduction

Recently, the Financial Conduct Authority (FCA) and the financial services industry have focused on embedding greater awareness and integration of conduct risk within a firm's risk framework and appetite. The FCA expects firms to be able to demonstrate that conduct-focused behaviour and customer outcomes are truly embedded to play an integral part in all strategic and operational decisions. As significant time and effort have been spent in business and risk functions enhancing their risk management capabilities, including conduct risk, we are seeing an increased focus from the regulator on the internal audit function and how they are exercising their responsibilities in assessing how the internal control environment supports the delivery of fair customer outcomes.

Conduct risk – Current focus

Key areas of focus from the FCA for the coming year include: technology; poor culture and controls; large back-books leading firms to act against existing customers' best interests; pensions, retirement income products and distribution methods (all of which are described as being of "significant interest"); and the risks from unaffordable debt; and unfair contract terms.[1] Firms will need to ensure that their business plans demonstrate clearly which strategies they will use to counter mid-to-long term risks as well as those risks which the FCA considers to have already crystallised. The culture within firms needs to be conducive to customers achieving fair outcomes and as such it is crucial for firms to have a strategic vision which endorses and recognises this, embedding it within the firm's business model and day to day operations.

Strategy

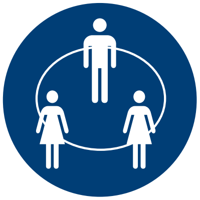
Firms should leverage the conduct agenda to evidence and demonstrate that their strategic decisions are in the best interests of their customers. Conduct should not be seen as a burden but more as that which can generate long term value for any firm. Creating a business structure, go to market approach and products which are designed to serve a defined target market can ensure a healthy bottom line via customer satisfaction and loyalty, whilst minimising the risk of regulatory intervention and remediation programmes. Fair outcomes are positive measures that firms should seek to understand and maintain as a measure for success in the market. The key will be to understand the customer outcomes that firms wish to achieve, and work back to design products and interactions in accordance with these. Positive reinforcement around these values can be just as effective in motivating and retaining staff as sales-based incentives have been, which can help sustain conduct-based culture and values. It is an approach that has worked for firms such as John Lewis for 150 years and is already present within financial services. Many within the mutual sector had long operated such an approach and recent growth in this sector suggests that there are considerable pay offs of such an approach. The building society sector increased its mortgage lending share in 2014 by over 7%, attributed to an "individual approach to underwriting"[2].

The FCA expect to see firms assessing their business model and strategy, reviewing the controls that they already have in place and assessing how conduct considerations will feed into top-level decision making. It is essential for senior management to ensure that the information provided is sufficient and relevant to allow them to make informed decisions, whilst ensuring all lines of defence verify that the underlying data is accurate.

1 http://www.fca.org.uk/news/our-business-plan-2015-16

2 http://www.bsa.org.uk/media-centre/press-releases/building-societies-continue-to-perform-in-highly-c/

Culture



Culture is key to ensuring that firms, at all levels, act in a customer centric way, especially when monitoring cannot provide 100% coverage (internally and externally). A firm cannot rely solely on its risk framework to drive customer outcomes as it can never compensate for poor judgement in relation to customer outcomes. In fact, culture is vital to act as a conscience within the business to flag where the current framework or processes, whilst executed compliantly, do not achieve fair outcomes. Many firms still talk about TCF and Conduct as though they are the same thing – whilst there is significant overlap, the conduct agenda is much broader. It is this widening of scope where the FCA expects to see firms demonstrate and embed understanding. Where firms are still equating conduct to TCF, this will raise concerns.

The key to embedding and sustaining a customer centric culture within a firm is the staff. We have observed clear differences in the level of conduct understanding, attitude and ultimately implementation with firms. The tone at the top is often good, and firms have embraced the principles of conduct and can be seen to be driving strategy. At the coal-face, staff have often always operated with the customer's best interest in mind. Where once the desire to do the right thing has been constrained by process and/or system inflexibility ("computer says no" effect), there is now a desire for staff to air such instances and make the necessary changes to achieve a good outcome.

Where conduct culture still seems to struggle is in the middle-management function of firms. These are the staff who seem to be having the most difficulty in managing the balance that they perceive needs to be struck between conduct considerations and day-to-day operational and commercial priorities.

Frameworks

The FCA note in their outlook that “firms should ensure that all of their processes support and reinforce the culture they want to promote”. In short, relying on the culture of individuals as a key pervasive context to deliver fair outcomes may not be enough, and should be underpinned by processes that would ensure such behaviour can be sustained. We see that for most participants in the industry, the approach has been to build ‘bolt-on’ frameworks to their existing risk frameworks, often a repackaging and rebranding of what was historically a TCF framework. With this approach however comes inflexibility and a sense of artificiality, as it does not truly embed within the firm, and instead is viewed as another risk to manage. Such an approach is now unlikely to satisfy the FCA. There is an expectation on firms to have flexible arrangements whereby they can monitor, control and respond to risks which arise during any stage of the product lifecycle and adopt a more centralised conduct and customer centric approach which is consistent across the business.

Product lifecycle

Conduct risk is present throughout the product lifecycle and there are few activities undertaken by firms which do not impact on the customer and threaten fair customer outcomes. As such, a more holistic view of conduct risk is now required.

The regulatory landscape has changed, and firms need to adapt if they are to meet the regulators’ expectations. Historically, compliance with regulatory expectations was viewed by firms as a “tick-box” exercise. However, as the regulatory supervision has shifted to a judgment-based approach, views on compliance will be formed based on the impact that processes and decisions have on the customers as well as activity prescribed by rules. This is not to say firms should discount pure compliance, but a balance should be struck between commercial viability, meeting the rules, and achieving a fair outcome. As mentioned above, management may struggle to hit this balance where a decision must be made between meeting regulatory requirements, which are mandatory, commercial/operational viability and achieving a fair outcome. In regards to the latter, the extent to which a firm wishes to comply with regulatory expectations is largely driven by their appetite which will allow for some discretion by management. Clear market segmentation, understanding of customer journey and product lifecycle, and the evolution of a customer’s needs can provide firms with the confidence it need to take those decisions.

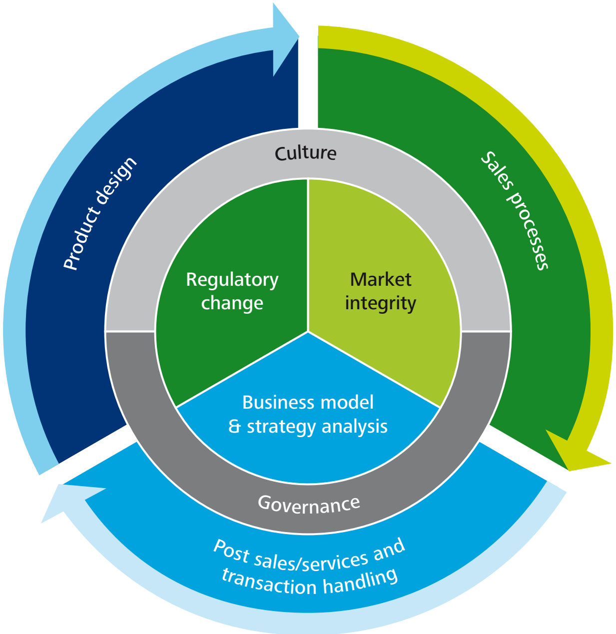
Approach to conduct risk in internal audit

As the focus of the FCA shifts from standalone frameworks to embedded and customer-centric processes, the approach adopted by internal audit should evolve accordingly to reflect this. Conduct risk is not static, nor is it limited to a defined part of the business. It is present in almost every part of the business in different ways, driven by firm strategy, product set and customer journeys adopted by each firm. Consequently, conduct risk will be managed differently within each firm and there is no standard or "off the shelf" approach that internal audit can utilise. Below, we explore four of the drivers which may influence how conduct risk is audited.

1. Standalone framework reviews

Where internal audit has yet to approach conduct risk, there is still value in internal audit conducting an assessment to understand the appropriate policy and control landscape and responsibilities across the first and second line in place to manage conduct risk, whether this is specifically articulated as a framework or not. Ultimately, this provides assurance to the Board that there is an appropriate risk framework in place to effectively manage conduct risk, and achieve fair outcomes.

Conduct risk key framework elements



Such a review should comprise key framework elements such as: Governance, Management Information, Supporting Tools/Policies/Procedures, Culture and Outcome Testing.

Consideration should be given to the points above in order to determine how flexible the current conduct management is to avoid FCA concerns of rigidity and artificiality. Such reviews are beneficial where substantial changes to strategy, organisational design or risk management frameworks occur to understand the impact on conduct management and the approach adopted to inform further assurance activity. This should not be or become the default approach to assessing conduct risk management.

2. Integration into existing activity

As internal audit gains awareness of the form and operation of conduct risk management within the firm, it will allow internal audit to move away from the framework reviews outlined previously, and begin to introduce an integrated audit approach to add depth to the value audit can provide in relation to conduct. As a function's understanding of conduct risk grows, staff should be able to identify conduct risk as it manifests in various parts of a control framework or process, in the same way they would spot other risk types. This will allow the function to add value by providing real challenge and assessment around the controls in place on a continual basis.

For example, the ability to identify where process effectiveness does not necessarily equate to fair outcomes.

This benefits internal audit in three ways:

✓ It allows internal audit to be flexible in their approach to the assessment of conduct risk;

✓ It helps demonstrate early on – to the FCA and other interested parties – that the firm does not a have rigid and inflexible framework to conduct risk, and it is properly embedded in all activities; and

✓ It adds additional value to a firm by showing that the embedding of conduct risk is not limited to the first and second lines.

As the FCA believes putting consumers first and market integrity should be at the heart of the way firms do business,[3] it would appear sensible to consider conduct within all reviews carried out, by integrating conduct assessments within planned audit activity. On this basis, the following may be considered:

- Identify whether or not conduct has been identified as applicable to a business area;
- Understand and challenge the activity management has completed to identify conduct impact across the customer journey and the product lifecycle; and
- Identify how conduct risk is managed in line with business expectations/strategy for conduct risk, providing commentary as to how the components under review may impede a firm's ability to manage conduct risk.

This approach provides consistency coverage throughout the audit plan, and can provide a view as to how well conduct is embedded and managed within the firm.

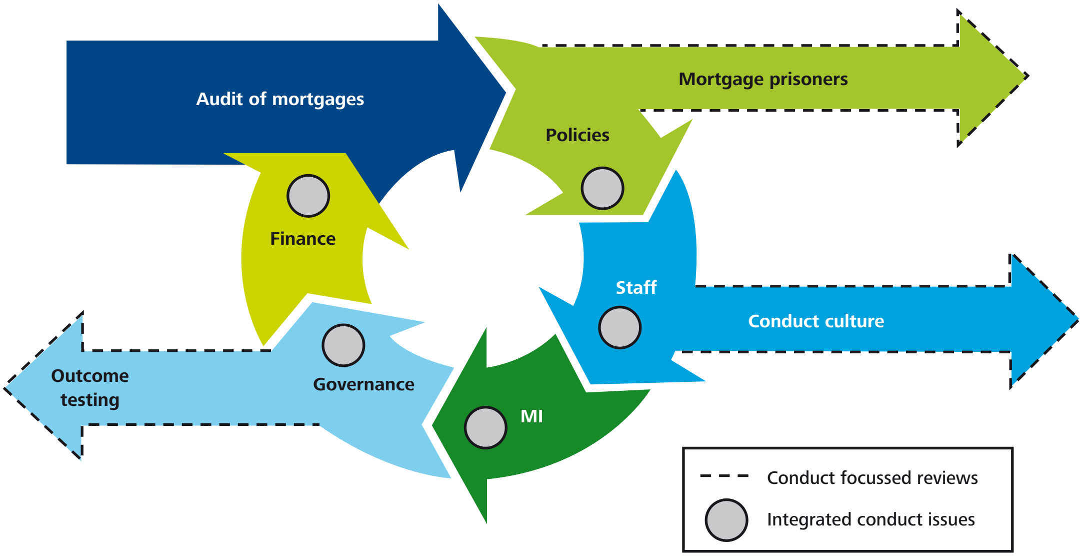
3 http://www.fca.org.uk/static/channel-page/business-plan/business-plan-2015-16.html

3. Conduct focussed reviews

Following an assessment of the conduct framework, followed by integration of conduct risk into existing audits, internal audit should have a much more informed view of the key conduct risks present within the business; including any themes or systemic issues. This then allows internal audit to structure more focused reviews around conduct-related areas. A key example of this would be an end-to-end review of a particular product across its entire lifecycle. The objective of such a review would be to ensure that in both design and day-to-day operation of functions, the firm's conduct strategy and impact on customers is always considered. Strategy should not be driven by commercial achievability and customer satisfaction alone, as we still see the industry mistaking a positive customer journey as a fair outcome. Internal audit should assess whether the relevant control framework can separate the two.

If this approach is adopted, internal audit may consider areas such as Product Development, Sales and Distribution, and Customer Servicing. This can be product specific or transcend all products if the business model and operational approach allow.

Focused vs. Integrated approaches



Ultimately, to ensure efficient and effective coverage of conduct risk, internal audit should be utilising a combination of all the approaches listed previously. Through an integrated approach, it can help support a continual opinion on the business's ability to understand and manage conduct risk, whilst the deep dive focus can provide valuable assurance on key conduct areas where risk appetite is low or where the audit committee has raised concerns. In respect of the former, this should be used as a pulse-check on the business to ensure customer centric behaviours and activity are being sustained especially if external scrutiny has been low.

As more fundamental changes to the risk management framework or operational structure occur, it would be prudent to conduct framework reviews to ensure all key components remain in place and fit for purpose following any change and also to inform the day-to-day plan in relation to conduct throughout the integrated and deep dive approaches.

4. Competency

Internal audit should consider whether or not the firm has the right capability and skill set within the function's staff to understand and recognise and assess conduct risk within a business. We are seeing a number of internal audit functions utilising conduct or product specialists to support or lead internal audit work in order for them to properly understand and make judgements around specific conduct matters.

Whilst internal audit can fill resourcing gaps for initial conduct specific reviews (either through internal SME secondments or external providers), firms should consider their long term needs in relation to resource and structure for conduct risk. We notice that some are firms looking to build conduct identification tools to help their teams understand when and if there is a conduct element to their review to allow continual assessment. Given the continued attention around conduct risk, and the increasing scrutiny on internal audit in regards to this, internal audit function should consider whether or not they should invest in conduct risk as a key priority.

Key retail conduct considerations for internal audit

Technology

The speed at which technology is moving and the impact that it is having on the industry raises numerous conduct concerns. Primarily, the increased use of digital channels makes firms susceptible to infrastructure disruption and financial crimes. This has an immediate impact on customers where they cannot access funds due to either system attacks, or more simply, theft.

For many firms, a lack of investment in infrastructure has resulted in shifts to outsourced providers in a bid to maintain pace and scale. The FCA has raised concerns around firms' ability to respond to critical failures, where processes are not under direct control. Internal audit should seek to provide assurance that the internal infrastructure is robust enough to deal with such situations, and close attention should be paid to the contractual arrangements and governance around outsourced relationships to ensure issues and conduct can be managed as effectively as if they were in-house.

A further concern from the regulator is around digital banking and the associated customers. Whilst manageable, there are naturally risks attached to the customer journey with regards to ensuring appropriate disclosure around products and features, and the ability of firms to appropriately capture and use the data within this process to measure and monitor customer outcomes. In addition, with the rapid increase in the use of Smart Phones and Tablets firms face further challenges in displaying all key product features and information on devices which are significantly smaller in size.

Internal audit should be looking to understand where shifts in strategy are occurring from traditional distribution to digital platforms, assessing whether appropriate governance and controls are in place to ensure that conduct risks are appropriately identified at an early stage. These risks should be factored into all relevant processes and monitoring approaches. Attention should be paid to the firm's ability to understand where the conduct risk profile of a process changes from low to high, and the impact on customer expectations where process is not fully straight through with and changes from digital routes to existing manual processes. Internal audit should also consider where a conduct risk can be lowered through digital platforms and automation due to the removal of manual, inherently higher risk, processes.

Some of the issues highlighted previously were identified as key concerns in the FCA Mobile Banking Thematic review,[4] which reported in September 2014. Conduct risk features in the report along with recommendations that internal audit teams across Financial Services (FS) start to plan Mobile Banking audits into the annual reporting cycle.

This shift in strategy and operating model can be advantageous to internal audit. Automated and digital processes can be assessed more efficiently through the use of analytical tools. For example, voice recognition, and digital journey tracking can be used to assess customer understanding and behaviour which may add real value to an audit. Internal audit should consider whether or not they have the correct blend of technical, analytical and conduct expertise in order to identify the risk and assess the control appropriately and effectively. This will ensure that internal audit teams in FS firms are providing genuine challenge and oversight of the digital propositions in their organisations.

Consumer credit

As the regulation of consumer credit has transitioned from the Office of Fair Trading (OFT) to the FCA, requirements from the Consumer Credit Act have been moved into a specific sourcebook (CONC). Whilst firms may be comfortable they have historically been compliant, there may have been some complacency within the industry due to the comparatively low level of scrutiny by the OFT.

Internal audit should be undertaking assurance to ensure that firms have appropriately reflected the change in their control environment, as well as seeking to understand what changes have been implemented to ensure a firm remains compliant with consumer credit and conduct expectations in an FCA regulated environment. Where firms also offer mortgage products, internal audit may want to consider the read across between mortgage arrears expectations, which a firm should be more familiar with, to the equivalent activity they currently conduct for consumer credit products. Whilst the rules differ, the conduct expectations are largely aligned.

4 TR14/15 Mobile banking and payments

Disclosure and unfair terms

From a compliance and a conduct perspective, disclosure and unfair contract terms remain key risks to all firms. The FCA has articulated concerns around this in a number of ways. First, through the recent pension reforms there is a concern that customers will not have appropriate access to information. There is a need to offer high-quality financial advice and guidance, through all distribution channels. This is particularly difficult through an online journey, where firms still continue to face many challenges. The regulator is pushing for innovation in this space to drive good value in the market and improve consumer confidence.

More broadly, due to legislative changes[5] there will be an increased focus on unfair contract terms. Whilst not exclusively aimed at financial services, this may provide some much needed clarity to the industry around fairness expectations. In the short term, firms should continue to consider the level of clarity provided to customers around key terms and conditions, particularly around terms which customers may not consider at the purchase of a product (for example, exit fees) where their focus is around the immediate benefit rather than long term implications.

Mortgages

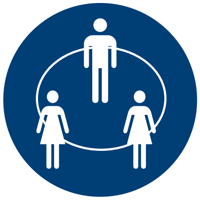
Since the implementation of the Mortgage Market Review requirements in 2014, internal audit should be scrutinising the new processes to understand whether the required outcomes of the review have been fulfilled. Focus from an audit perspective is to understand what changes have been made to first and second line oversight approaches to ensure processes and products are achieving the appropriate outcomes, and are compliant with the new rules. Attention should also be paid to assessing the governance and relevant project plans used to make the changes, to understand if all key risks were addressed, and to form a view of a firm's ability to manage change. This will assist with ongoing regulatory change programmes as the conduct agenda is progressed within the industry, for example, under the Mortgage Credit Directive.

Mortgages more generally will continue to receive a lot of scrutiny, not only through continued thematic work, but also as part of the FCA's broader concerns around customer inertia. Firms will be expected to support consumers where they are expecting better value in existing product sets. Internal audit should look to understand how the firm is identifying customer needs, not only in new propositions, but how legacy products continue to satisfy the needs of existing customers.

5 Consumer Rights Act 2015

Culture

Internal audit cannot ignore the strong emphasis the FCA is placing on risk culture of a firm in regards to driving customer focussed results. As we have discussed, firms place a lot of emphasis and faith in the culture of their business driving fair outcomes for their customers. Internal audit needs to be able to assess and monitor their firm's culture alongside more tangible conduct controls.



Nowadays there is no need to postpone culture audits because a firm's leadership team has not agreed its desired or target culture for the firm. A culture assessment framework to audit against can be developed by considering a proxy culture baseline for a firm from its existing culture related drivers, influencers and indicators; such as existing board approved business and risk strategies, goals, objectives, minimum requirements, key principles, values and ethics. These can be enhanced with other key influencers and indicators typically found in good organisational cultures within the firm's industry.

For example, in supporting internal audit functions to develop 'Culture Assessment Frameworks', Deloitte LLP UK uses the following four generic influencers of a good organisational culture; specifically:

- **Business competence:** the collective business competence of the organisation.
- **Motivation:** the reasons why people do the things the way that they do; in particular when no one else is watching.
- **Organisation:** how the organisational environment is structured and what is valued.
- **Relationship:** how people in the organisation interact with others.

Following this, internal audit should then consider what it would seek to identify as tangible evidence of culture performance against the culture assessment framework, for example, data analytics, survey, stakeholder interviews and workshops.

Is internal audit getting the right outcome?

1. **Can you identify the firm's conduct vision, strategic customer outcomes and key conduct risks?**
   If internal audit themselves cannot articulate the firm's strategy and objectives in regards to conduct risk management, it may point to a deficiency in the firm's embedding of customer centric behaviour in line with FCA's expectations.

2. **Is your firm saying conduct, or doing conduct?**
   Internal audit are often misled by dialogue within the business around conduct as an indicator, assuming it is embedded, when in reality it is dialogue about how to implement. Look not for "conduct" branded activity, but rather for evidence that customer focus is prevalent in all activities and where decisions are being made there is a healthy challenge to commercial proposition.

   If your firm is heavily reliant on a conduct culture to drive fair outcomes, is there sufficient infrastructure to ensure culture does not dwindle or dissolve? How does your firm protect and maintain the culture it has created?

3. **What does conduct say about the wider implementation of your three lines of defence?**
   If internal audit is identifying significant conduct issues, it suggests not only that conduct risk management is not operating effectively, but there may be wider issues in relation to the extent that assurance is applied and integrated across the three lines of defence.

4. **Can your internal audit team keep pace with the evolving and expanding conduct agenda?**
   As business strategies and models are evolving with speed, internal audit should ensure they have the right skills and knowledge to assess the controls and risks surrounding customers. Internal audit should consider their current recruitment approach and skill sets to reflect the evolving risk profiles of business, and the larger expectations of an internal audit function. It may be more effective to teach a conduct specialist to audit, rather that make an auditor an expert on conduct. Providing an opinion on conduct issues is often highly judgement-based, and as such internal audit may face more challenge and scrutiny when justifying findings. If a firm has not clearly articulated its appetite with regard to conduct, this will be even more challenging.

5. **Does your plan cover the breadth and depth of customer outcomes expected by the FCA?**
   Internal audit should be able to point to key conduct risks, and their relation to a firm's overall conduct strategy and appetite in all parts of the business. There should also be sufficient flexibility to perform deeper dives, and conduct focussed reviews where appropriate.

Key contacts

UK Financial Services Internal Audit Leadership Team

Paul Day
Partner, Banking and Capital Markets
+44 (0) 20 7007 5064
pauday@deloitte.co.uk

Russell Davis
Partner, Banking and Capital Markets
+44 (0) 20 7007 6755
rdavis@deloitte.co.uk

Matt Cox
Director, Insurance
+44 (0) 20 7303 2239
macox@deloitte.co.uk

Terri Fielding
Partner, Investment Management and Private Equity
+44 (0) 20 7303 8403
tfielding@deloitte.co.uk

Mike Sobers
Partner, Technology
+44 (0) 20 7007 0483
msobers@deloitte.co.uk

Kevin Doherty
Partner, Scotland
+44 (0) 141 304 5711
kedoherty@deloitte.co.uk

Dougie McAndrew
Partner, Scotland
+44 (0) 131 535 7331
dmcandrew@deloitte.co.uk

Jamie Young
Partner, Regions
+44 (0) 113 292 1256
jayoung@deloitte.co.uk

UK Risk and Regulation

Cindy Chan
Partner, Retail Conduct Lead
+44 (0) 20 7303 5836
cichan@deloitte.co.uk

Stephen Lucas
Partner, Risk Culture
+44 (0) 20 7303 5088
stelucas@deloitte.co.uk

Dave Clements
Director, Regional Conduct Lead
+44 (0) 117 984 1199
daclements@deloitte.co.uk

Lynsey Fallon
Director, Risk and Conduct Regions
+44 (0) 161 455 6084
lfallon@deloitte.co.uk

Alastair McGeorge
Manager, Risk and Conduct Regions
+44 (0) 131 535 7822
amcgeorge@deloitte.co.uk

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