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Conduct Risk: Old Wine in a New Bottle?

Meeting Regulatory Expectations for Conduct Risk in U.K. Financial Services Industry

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The Financial Conduct Authority (FCA) has defined conduct risk as a threat to its objectives. Insurance and other financial services businesses should build on their implementation efforts on treating customers fairly (TCF) to meet conduct risk regulatory expectations.

The FCA was founded in 2013 with the aim of ensuring that businesses across the U.K. financial services sector are conducted in a way that advances the interests of consumers. In this capacity, the FCA has defined "conduct risk" as a threat to its objectives and, as a result, the authority is challenging firms to demonstrate how they approach mitigating and managing that risk. However, for firms to be able to respond to the challenges presented by conduct risk, it is helpful to understand and take into account the wider changes in the supervisory powers of U.K. regulators, where there is increased emphasis on robust supervision, as summarised in Exhibit 1.

Exhibit 1: FCA Conduct Risk

Requirements	Supervision
	Demonstrate that customers are at the heart of business decision-making
TCF outcomes continue to apply	"Be tougher and bolder, following a strategy of credible deterrence, using new powers of intervention and enforcement."
Regulatory objective of consumer protection	"Intervene early to tackle potential risks to consumers before they take shape."

Source: FCA

This article summarises the changes in financial regulation that are relevant to conduct risk and identifies the steps businesses should consider to meet the challenges. Although the focus of this article is on the insurance business, the points made and actions suggested are equally relevant to banks.

Limited Changes in Regulatory Objectives and Policy

In "The FCA's Approach to Advancing Its Objectives" published in July 2013, the FCA set out how it intends to advance its three operational objectives, as shown in Exhibit 2. With respect to the consumer protection objective, there is a clear statement of intent in the guidance regarding how the FCA will work to secure the appropriate degree of consumer protection:

> The six retail outcomes set out in the FSA's Treating Customers Fairly (TCF) initiative remain central to our consumer protection objective and are part of our normal focus. They guide the general policy and principles by which we make rules, prepare and issue codes, and give general guidance. Getting a fair deal for consumers is at the heart of our approach.

Exhibit 2: FCA Supervisory Objectives

FCA's strategic objective:	"Ensure that the relevant markets function well"		
FCA's operational objectives:	**Consumer protection**	**Integrity**	**Competition**
	"Secure an appropriate degree of protection for consumers"	"Protect and enhance the integrity of the UK financial system"	"Promote effective competition in the interests of consumers"

Source: FCA

The relevance of the Financial Services Authority's (FSA) TCF outcomes to guide the FCA's delivery of its consumer protection objective, and hence its thinking on conduct risk, was described by the FSA in "Journey to the FSA" in October 2012.

Exhibit 3 provides some background on TCF.

In terms of the specific rules that apply, the FSA Handbook has been split between the FCA and the Prudential Regulation Authority (PRA). The FCA has identified the rules and guidance that apply with respect to its objectives, consisting mainly of those sections of the FSA Handbook which related to conduct of business. The FSA Handbook also includes high-level "principles for businesses" – rules in their own right. These principles apply to all firms under the FCA and PRA regime. Some of these principles are specifically relevant to TCF and require businesses to:

- "pay due regard to the interests of its customers and treat them fairly";
- "pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading"; and
- "take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement."

The FSA rolled out the TCF initiative in 2001. Motivated by concerns that detailed rules were unlikely to capture all of the circumstances and deliver the appropriate level of consumer protection, it was agreed that a more holistic approach was required.

Through various consultations, the FSA identified six different retail outcomes that cover the entire product cycle. Summarised in Exhibit 3, these have become the key reference points of TCF.

Exhibit 3: Treating Customers Fairly

1. Culture	2. Product design	3. Disclosures
"Consumers can be confident that they are dealing with firms where the fair treatment of consumers is central to the corporate culture."	"Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly."	"Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale."

4. Advice	5. Performance	6. Post-sale
"Where consumers receive advice, the advice is suitable and takes account of circumstances."	"Consumers are provided with products that perform as firms have led them to expect, and the associated service is on an acceptable standard and as they have been led to expect."	"Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint."

Source: FCA

Strengthened Supervisory Powers

The discussion here so far suggests that the requirements for conduct risk are not significantly different to the rules of the past. However, the FCA's supervisory oversight and intervention powers are stronger than those that were available to the FSA in the past. Accordingly, firms will need to do significantly more to demonstrate that they are meeting the conduct risk requirements.

The legislation includes product intervention powers, which allow the FCA to prohibit financial services businesses from, for example, using certain product features where the FCA considers they would present an unacceptable level of conduct risk.

More generally, the FCA's ongoing guidance about the use of its powers also makes it clear it intends to continue to apply more intense supervision. In "The FCA's Approach to Advancing Its Objectives," the FCA stated that it aims to "intervene early to tackle potential risks to consumers before they take shape" and "be tougher and bolder, following a strategy of credible deterrence, using new powers of intervention and enforcement."

The FCA guidance about the use of its regulatory powers includes an outline of the approach to supervision based on the sources of conduct risk. These are set out in Exhibit 4 and are grouped into the three pillars of the FCA's supervision framework.

The FCA continues to demonstrate a focus on conduct of business in a way that the FSA was not able to, given its wider responsibilities, and the industry continues to feel the effects. For example, the FCA is understood to have undertaken deep-dive conduct risk reviews of a number of financial services businesses.

This includes FCA representatives sitting as observers in the relevant committees, to enable a stock take of a firm's approach to managing conduct risk. Where the FCA identifies shortcomings in a firm's approach, it may require a skilled person report to be commissioned.

Exhibit 4: FCA Approach to Conduct Risk Supervision

Three Pillars of FCA Supervision Framework	Source of Conduct Risk	Comment
1 Firm systematic framework	Firm-specific	Day-to-day supervision of firms
2 Event supervision	Events	Supervisory interaction as a result of issues arising in the firm
3 Issues and product supervision	Sectoral issues	Thematic or cross-firm work we would expect to be driven by FCA risk outlook

Source: FCA

How Should the Business Respond to These Changes?

Financial services businesses have invested significant amounts of capital to implement TCF requirements. Given that the emphasis of conduct risk appears to be on supervision, and largely on how firms are complying with an existing suite of rules, a good starting point is for management to take stock of its TCF implementation so far and consider what additional capabilities may be needed.

Firms should consider a top-down assessment of conduct risk to help ensure that they can show evidence that customers' needs and interests are at heart of decision-making. The assessment should cover the natural life cycle of how decisions affecting customers are made:

- **The structure underpinning decision-making** – This includes an effective culture and governance arrangements.
- **Product design and sale** – This includes knowing customer needs and how the product is sold.
- **Post-sales management** – This includes getting the complaints process right and assessing that performance is in line with expectations and that products continue to meet customers' needs.

This exercise may identify some gaps – for example, in a firm's structure or the governance arrangements and wider risk framework. An organization's enterprise risk management framework, and in particular its risk appetite statements and metrics, may need to be extended to include conduct risk. Based on the FSA's field work about TCF, there might be gaps in terms of the extent to which root-cause analysis is used to extract lessons from unpredicted events and in terms of the extent to which there is appropriate follow-up on existing management information. There may also be gaps in specific areas, such as the relationship with distributors. These gaps would need to be prioritised and rectified within reasonable time periods.

Following past TCF reviews, in "Treating Customers Fairly – Culture," the FSA gave the feedback that in some firms 1) there was a failure to identify what TCF meant for their business, 2) senior management did not appropriately cascade their vision across the organisation, or 3) senior management did not effectively delegate implementation to the middle layers of management. Regardless of any specific gaps that may be identified in a conduct risk assessment, the FSA's feedback on TCF is also likely to be relevant.

Business Benefits of a Structured Approach to Conduct Risk

A top-down approach to conduct risk which builds on prior TCF investment is likely to yield significant business benefits.

A structured top-down approach provides senior management with a framework within which to gain a proactive understanding of their customers' needs. This could have tangible benefits for the business in terms of improved persistence and would contribute to underpinning sustainable profits and hence the business' ability to meet profitability targets.

An additional benefit of demonstrating compliance with FCA requirements for conduct risk is the cost of avoiding compensation and skilled person reviews, which are likely to be significant in monetary terms and in terms of the senior management time spent.

Other potential benefits include an enhanced reputation with external stakeholders. The FCA has reported finding evidence that the actions of some life insurance companies and advisors are "undermining the objectives" of the retail distribution review.

In Summary

- The FCA continues to further sharpen its focus on consumer protection, and this has been framed as "conduct risk."
- The firm-specific dimension of conduct risk appears to focus on reinforcing and building upon prior TCF developments.
- Financial services businesses should build on their TCF implementation work to deliver regulatory expectations related to conduct risk. They should focus on the natural life cycle of how decisions affecting customers are made and what gaps might exist and then devise a credible road map to remediate them.
- A proactive approach to conduct risk is likely to result in business benefits, including sustainable profitability and an enhanced reputation with external stakeholders.

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