

Conduct Risk

Old wine in a new bottle?



The Financial Conduct Authority (FCA) was founded in 2013 with the aim of ensuring that businesses across the 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, continuous to challenge firms to demonstrate how they deal with ‘conduct risk’. However, in order 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 supervisory powers, where there is increased emphasis on robust supervision, as summarised in figure 1.

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

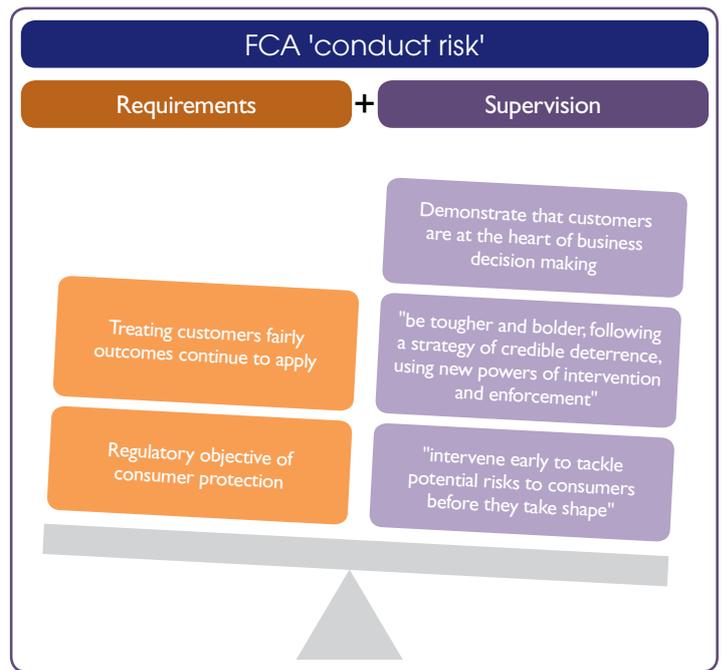


Figure 1: 'Conduct risk'

Limited changes in regulatory objectives and policy

The FCA has previously published guidance setting out how it intends to advance its three operational objectives¹ as shown in figure 2. In respect of 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 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.”

¹ FCA, The FCA’s approach to advancing its objectives, July 2013.

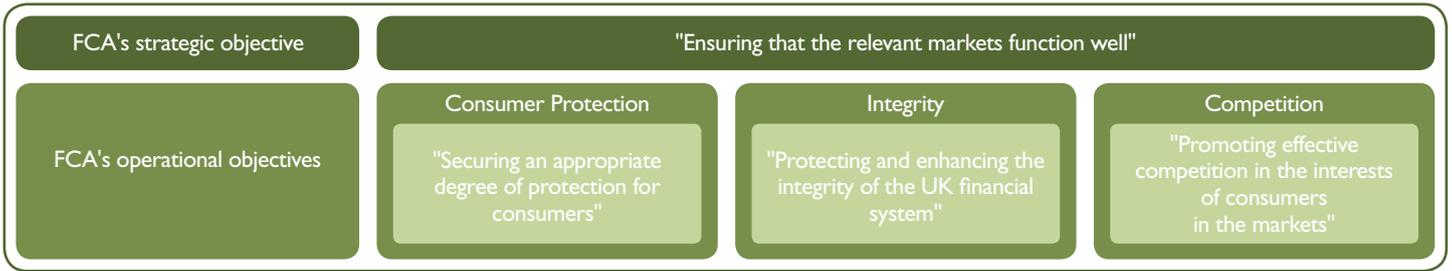


Figure 2: FCA supervisory objectives

The relevance of the FSA's 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 October 2012.²

Figure 3 provides some background on treating customers fairly (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 in respect of 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 judgment".



Figure 3: Treating Customers Fairly

Strengthened supervisory powers

The discussion 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 strengthened compared to those that were available to the FSA. 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 this would prevent an unacceptable level of conduct risk³.

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. The FCA has 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 figure 4 and are grouped into the three pillars of the FCA's supervision framework⁴.

² See page 27 of FSA, Journey to the FCA, October 2012.

³ Article 24 of the Financial Services Act 2012.

⁴ The FCA's approach to advancing its objectives, July 2013.

The FCA continues to demonstrate a focus on conduct of business in a way that the FSA was not able, given the wider responsibilities that the FSA had, 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.

Three pillars FCA supervision framework	Source of conduct risk	Comment
Pillar 1 – firm systematic framework	Firm-specific	Day to day supervision of firms
Pillar 2 – event supervision	Events	Supervisory interaction as a result of issues arising in the firm
Pillar 3 – issues and product supervision	Sectoral issues	Thematic or cross-firm work which we would expect to be driven by FCA risk outlook

Figure 4: FCA approach to conduct risk supervision

How should the business respond to these changes?

Financial services businesses have invested significant amounts 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 would be for management to take stock of its TCF implementation and consider what additional capabilities may be needed.

Firms should consider a top-down assessment of conduct risk to ensure that they can evidence that customers’ needs and interests are at heart of decision making. The assessment should cover the natural lifecycle 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 what the customer needs are and how the product is sold;
- post-sales management; this includes getting the complaints process right, 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 terms of the structure, i.e. the governance arrangements and wider risk framework. The Enterprise Risk Management Framework, and in particular the 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 MI. There may also be gaps in specific areas, e.g. relationship with distributors. These gaps would need to be prioritised and rectified within reasonable timescales.

Following their TCF reviews in the past, the FSA gave feedback that some firms failed to identify what TCF meant for their business and that senior management did not appropriately cascade their vision across the organisation or 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 likely also to be relevant.⁵

Business benefits of a structured approach to conduct risk

There should be significant business benefits from a top-down approach to conduct risk which builds on prior TCF investment.

A structured top-down approach would provide senior management with a framework within which to ensure a proactive understanding of their customers’ needs. This could have tangible benefits for the business in terms of improved persistency and would contribute to underpinning sustainable profits and hence the business’s 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 that it consumes.

There would also be potential benefits in terms of enhanced reputation with external stakeholders. The FCA has reported that they have found evidence that the actions of some life insurance and advisors are “undermining the objectives” of the retail distribution review.

⁵ FSA, Treating customers fairly – culture, July 2007.

In summary:

- The FCA continuous to bring an even sharper focus on consumer protection, this has been framed as ‘conduct risk’.
- In respect of the firm-specific dimension of conduct risk, this 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 around conduct risk. They should focus on the natural life cycle of how decisions affecting customers are made, what gaps might exist and then devise a credible road-map to remediate them.
- A proactive approach to conduct risk will result in business benefits, including sustainable profitability and enhanced reputation with external stakeholders.

BaxterBruce & Conduct risk

- ▶ BaxterBruce has extensive experience working with companies to ensure compliance with regulatory requirements whilst maintaining a focus on delivering business benefits. This work has encompassed carrying out gap analysis as well as integrating conduct risk within existing risk frameworks, extending risk appetite to include conduct risk and enhancing internal governance arrangements. We also offer online training courses on conduct risk to ensure that appropriate understanding of conduct risk, and the importance of putting customers at the heart of decision making, is cascaded throughout the business.

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