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Conduct Risk: tackling the burning platform

A regulatory priority is now a reputational and industry-wide risk, which presents an opportunity to develop competitive advantage for firms who want to rise to the challenge – retail and wholesale alike.

First, Treating Customers Fairly; now, managing Conduct Risk. The management of conduct which might disadvantage customers is a clear regulatory priority for retail financial services firms. Drawing on lessons from Payment Protection Insurance, the FSA has demanded that firms deal with the risks much earlier in the product process.

As the Financial Conduct Authority (FCA) evolves out of the Financial Services Authority (FSA), this priority was expected to increase, with greater regulatory assertiveness and intrusion. But US and UK regulatory enforcement actions on major banks in relation to the fixing of LIBOR now puts banking and general financial services conduct under further public and regulatory scrutiny of practices and ethics. It also creates a challenge for firms who want to separate themselves from the negative impact of industry-wide reputational damage.

For some firms, faced with competing priorities of remediating known problems such as PPI and dealing with other regulatory priorities, the challenge is how to deal with Conduct Risk on an ongoing basis.

Rising to this challenge means tackling governance, risk management and strategic direction up front. This needs an integrated, strategic approach with:

- rigorous management of process
- intelligent use of data and information
- governance, product design and process assurance
- alignment of board, corporate and staff commitment and behaviours

...all as part of a strongly managed programme, which we outline here.

The focus on Conduct Risk has stepped up

Treating Customers Fairly (TCF) requirements have now evolved into the obligation to manage Conduct Risk. While TCF should stay on the business agenda, conduct is a much broader concept. Anyone not grasping that will be at risk.

TCF started out looking principally at what happens between the firm and the customer at, and after, the point of sale. The approach to Conduct Risk goes much further. It requires the identification of customer detriment earlier, when products are being developed, and associated business models devised. It goes beyond retail products into wholesale business. This carries the potential for regulatory intervention earlier in relation to unsuitable and mis-sold products, while maintaining the focus on redress, complaints handling, disclosure and fair contracts.

Firms are therefore expected to revisit their governance and business models in order to embed Conduct Risk prevention into their organisations.

An emphasis on governance in a firm will build regulators' confidence that the board and senior executive are actively engaged in the conduct agenda. This shows they understand and manage the business and its Conduct Risks, product by product, and in line with the business model and corporate direction.

"We will now seek to proactively intervene earlier in the product chain to anticipate consumer detriment and choke it off before it occurs"

Hector Sants, outgoing CEO, FSA, March 12, 2010

"The crisis exposed significant shortcomings in the governance and risk management of firms and the culture and ethics which underpin them. This is not principally a structural issue. It is a failure in behaviour, attitude and in some cases, competence"

Hector Sants, outgoing CEO, FSA, April 24, 2012

An integrated, strategic approach is required

Martin Wheatley, CEO designate of the FCA, has already warned firms that the creation of the Prudential Regulation Authority (PRA) and the FCA will result in two sets of supervisors, both expecting equal priority on financial institutions' agendas. While the FCA specialises in Conduct Risk, recent events mean that the PRA and the Bank of England are likely to take a keen interest too. This is especially when crystallised Conduct Risk produces the sort of reputational damage to key players that has been seen in the recent LIBOR scandal.

Those tackling Conduct Risk are finding that the risks and issues criss-cross traditional risk and organisational structures in a way that makes them difficult to deal with. This difficulty is compounded by the tougher stance of regulators and their growing interest in the capability and commitment of the senior executive and board, including in matters of product design and excessive profitability that may signal crystallised Conduct Risk.

Dealing with these complex needs therefore requires an integrated, strategic approach to Conduct Risk management, with rigorous management of process, and intelligent use of data and information. Crucially, the approach must address governance, product design, process assurance, and the alignment of board, corporate and staff commitment and behaviours. All of this must form part of a strongly managed programme.

"We will each expect you to address actions from prudential and conduct reviews with equal focus"

Martin Wheatley, CEO designate, FCA, BSA Annual Conference, May 9, 2012

Managing Conduct Risk is good for your business and your compliance

This kind of approach brings practical business benefits, greater regulatory assurance and a more compliant profile in relation to regulatory rules.

Conduct Risk is estimated by the FSA to be costing the industry £10bn in relation to Payment Protection Insurance alone. The reputational and remedial impacts are clear in an environment of greater regulatory rigour, decreasing public patience with the sector, and greater social and media transparency.

Given a competitive market, high customer expectations and the speed with which reputational damage spreads across traditional and social media, it is evident that managing Conduct Risk is also a crucial aspect of customer management and brand and firm protection that can be turned to competitive advantage.

"...firms will also need to change the way they think about regulation... dragging their feet in complying with requests .... is not a behaviour which should survive in the new world."

Hector Sants,
outgoing CEO, FSA.
FSA Business Plan 2012/13

A four-step approach to Conduct Risk management

We recommend a managed approach based on four steps.

Step 1: start by understanding what Conduct Risk means for your firm
According to the FSA's definition, "Conduct Risk" means a risk to the FSA's statutory objective of consumer protection, including wholesale customers. This is different from a firm's own view of customer risk, which is more about risk of customer cancellation of a product, default or false identity.

The individual firm's risk appetite should be the starting point for understanding Conduct Risk. The concept of Conduct Risk needs to be integrated into the firm's risk framework and language to drive the right management information (MI) and governance. That will make it possible to understand Conduct Risk in the context of compliance, regulatory relationships and customer loss.

Diagnosis of the level of risk must now go beyond known consumer problems and emerging issues. Key Risk Indicators should be put in place to alert board and management to future Conduct Risk.

This requires insight and strategic thinking. Indicators should include not only classic lagging indicators such as complaints statistics, but also leading indicators that can reveal the signs and causes of Conduct Risk. In contrast with the traditional classification of issues and risks, the question should not be "what data can I use from my current data set?" but "what data could tell me I have a problem, and where do I find that data?"

Step 2: engage senior management
Boards should be asking themselves what known and emerging Conduct Risk they are responsible for. Quality MI allows senior management to monitor the firm's Conduct Risk exposure and its performance in tackling known issues. It should also enable them to ask challenging questions, and ensure that business strategy and overall risk management take full account of Conduct Risk.

When senior management gets involved with Conduct Risk management, their interest should not be purely on financial

performance. They also need to look at the quality and integrity of the people in the firm's key controlled functions, and to drive the Conduct Risk agenda in the firm through strategic challenge.

The FSA expects[1] boards and senior management to have a strategic approach to Conduct Risk, and to be engaged in the firm's Conduct Risk agenda. The FCA will continue the FSA's assertive approach to approving and challenging candidates as Approved Persons for control functions, and so firms must integrate their Conduct Risk focus with their executive recruitment. They must ensure that anyone who is performing, or is a candidate for, an executive or non-executive director role understands Conduct Risk, and can actively contribute to controlling it.

"...boards should ... ask searching questions about ... the good interest of consumers..... good business conduct is partially driven by rules, but it is also driven by norms of behaviour and values."

Lord Turner,
Chairman, FSA,
Treasury Select Committee,
March 14, 2012

Step 3: integrate Conduct Risk management into the way you work

The FSA has made it clear, via its Product Intervention Strategy[2] that it wants firms to prevent Conduct Risk, not just clear up after it. The FSA will look at product development governance, in which it expects boards to be engaged as part of their involvement with Conduct Risk.

Tackling Conduct Risk to the expected standard requires a firm to bring together many elements: compliance, policy, control framework, product and process development, risk identification and regulatory relationship management, self-challenging governance, insightful management information. Its reward systems and HR need to be informed with respect to Conduct Risk.

Setting an appropriate tone from the top, along with norms of behaviour and values, will help to bring about the required behavioural change, but Conduct Risk awareness also needs to be hard-coded into the way the firm works. Traditional, technical, views of risk have to be supplemented with more strategic and outward-looking capabilities for risk and customer management. Approaches to personnel management, recruitment, performance measurement and reward also need to be aligned to this new reality.

"Now is the time that we can really get to grips with what has been causing problems for consumers.... the FCA's focus on conduct issues will give us far more freedom to really deal with them once and for all."

Martin Wheatley,
CEO designate, FCA,
BSA Annual Conference, May 9, 2012

Step 4: integrate Conduct Risk management into digital and organisational transformation

Many organisations are transforming themselves using digital tools. This is a response to pressure on business models and efficiency, the need to maximise value from data and the desire to reach out to customers in a more flexible, competitive and accessible way.

However, along with the opportunity to become quicker and smarter, digital also brings the danger of making old mistakes faster.

Therefore, any digital transformation requires careful diagnosis, planning and execution in order to minimise the potential for digital to affect behaviours for the worse. Managed the right way, though, a digital transformation creates the opportunity to reduce Conduct Risk exposure in new and strategic ways.

[1] See FSA Business Plan for 2012/13
[2] http://www.fsa.gov.uk/pubs/discussion/fs11_03.pdf

Meeting the challenges of Conduct Risk through a coherent, managed approach

All this is taking firms into new territory. It is important to ensure that traditional, vertical organisational structures and functional skill sets do not constrain or derail the change.

Firms need clear, targeted commitments to tackling the causes and the symptoms of Conduct Risk. They also need a joined-up, strategic corporate approach which realises benefits, assimilates lessons and delivers customer, shareholder and regulatory assurance. This whole approach needs to be integrated into the firm's business model.

A strongly managed programme of activity is imperative to Conduct Risk management. It must be supported by an operational delivery approach that:

- Streamlines, and where possible digitises, management of complaints and current risks.
- Identifies emerging risks.
- Strengthens governance, risk management and process to reduce future risk.

Recommended priorities for an effective Conduct Risk programme

- Strong senior executive and board support with clear lines of accountability.
- Definition of risk appetite within a risk management framework that focuses on process, people, governance and culture.
- Information and reporting to enable active challenge and oversight.
- Strategic and tactical diagnosis of Conduct Risk, spanning review of complaints, back book, governance, decision making and MI.
- Mapping of key risk vulnerabilities across the value chain.
- Early insight for cost avoidance, fines, reputational risk, and non-compliance with FSA rules.
- Critical planning of remediation for identified risks, and improvements to the risk management process.
- Reviewing and improving data collection, insight extraction, "dashboarding" and Key Risk Indicators.
- Development of intelligent leading, as well as lagging, indicators of Conduct Risk to inform, challenge, alert and assure.
- Control remediation observations and checklists for product areas and associated governance.
- Review and development of performance management, remuneration and people management structures to integrate customer outcome commitment and Conduct Risk minimisation.
- Organisational transformation review and integration with a Conduct Risk minimisation strategy.
- Training, Conduct Risk and customer outcome awareness packages – for internal communications and staff development and onboarding.

Conclusion

We have argued that effective Conduct Risk management requires a coherent strategic approach coupled with strong operational delivery of all aspects of Conduct Risk, all within a planned organisation-wide programme that recognises the multiple drivers and controls.

The FSA and FCA expect firms to treat Conduct Risk and customer outcomes as a business priority. But in challenging markets for business, with competing public and regulatory expectations, we believe that firms are searching for the path to build customer, investor and regulatory confidence.

With the right approach, doing so can help build competitive advantage.

> "Conduct Risk is now our single biggest issue"
>
> COO, major retail bank

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