Right first time
Staying ahead of the conduct agenda

Using the conduct risk agenda to build trust.
The real issue is not the new conduct risk agenda ushered in by the arrival of the Financial Conduct Authority (FCA) but how to overcome the breakdown in public trust that lies behind it. And to re-engage with consumers in the ‘Amazon age’ you’ll also have to meet their demands for more responsive products and an intuitive customer experience.

We all know that the FCA expects your board to put the customer at the heart of its strategy. But if your business simply looks to comply on a basic ‘tick the box’ level, then sooner or later you’ll come unstuck.

From reviewing new product or services launches through to responding to claims of miss-selling, individual board members will need to show that they ‘walk the walk’ as well as ‘talk the talk’ when it comes to the conduct agenda. Setting the right tone at the top and embedding a culture of doing the right thing by customers, clients and counterparties is the only way to get this right.

Under the scrutiny of the media, customers and the regulators, boards can no longer rely upon formal annual reviews to flush out inappropriate behaviours or practices. Instead, boards need to apply the same level of rigour to reviewing customer outcomes as they do to monitoring the financial performance of the business.

And as we conclude in this paper, by embracing the new regulatory agenda and by using it to help you collaborate more closely with customers and clients to get to know what they really want, you will ultimately stay ahead of your competition.
The FCA is only just getting going, but it’s already clear that it intends to reach into new areas not touched by the Financial Services Authority (FSA). As the FCA’s 2013 Business Plan and Risk Outlook outline, it will continue to focus on retrospective market misconduct issues such as The London Interbank Offered Rate (LIBOR), payment protection insurance (PPI) and interest rate swaps (what the risk grid in Figure 1 describes as the ‘known-knowns’). But its focus is beginning to reach out into new areas of concern including payday lending and interest-only mortgages (‘known-unknowns’).

Soon enough, the FCA is going to be taking a view on potential lapses (‘unknown-knowns’), forcing businesses to look through their books to identify products and sales practices that could come under the spotlight in the future. Its investigations will go beyond how the product was sold to whether it meets the customer’s needs through the life of the product, starting with product design and ending with post-sale service (which the FCA refers to as managing conduct risk throughout the product lifecycle). This approach opens the way for much more retrospective action. And having learned the ropes in its review and actions against banks, the FCA is able to quickly move in on any perceived lapses in insurers and asset managers.

However, it isn’t just the retail side of the industry that is under the FCA spotlight. As Martin Wheatley, now CEO of the FCA, highlighted during his speech at the British Bankers Association (BBA) Annual Banking Conference in October 2012, the FCA will have also have a renewed focus on conduct in wholesale markets. “This is because we realise there is a connection between what happens in retail and wholesale markets – and the risks caused by poor wholesale conduct can be passed between them,” he said. You only have to look at the impact that the LIBOR scandal has had on the reputation of the entire banking industry to see that the conduct agenda extends far beyond simply ensuring that banks are transparent around the products that they sell.

### Figure 1: Managing susceptibility to conduct risk

<table>
<thead>
<tr>
<th>Known-knowns</th>
<th>Unknown-knowns</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risks:</strong> Known lapses such as PPI, rate setting, or product suitability</td>
<td><strong>Risks:</strong> Products or services that you might have identified as concerns, but aren’t yet on the supervisory radar</td>
</tr>
<tr>
<td><strong>Action:</strong> Assess scale of exposure and compensation</td>
<td><strong>Action:</strong> Assess risk and judge whether to re-design or withdraw</td>
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<table>
<thead>
<tr>
<th>Known-unknowns</th>
<th>Unknown-unknowns</th>
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<tbody>
<tr>
<td><strong>Risks:</strong> Risk from products and practices that are coming onto the regulatory radar such as interest-only mortgages and forbearance in the mortgage market, product design and oversight in the asset management sector, or cross selling in full service/investment banking groups</td>
<td><strong>Risks:</strong> Unidentified or future risks</td>
</tr>
<tr>
<td><strong>Action:</strong> Assess risk and judge whether to re-design or withdraw</td>
<td><strong>Action:</strong> Risk-based assessment of the portfolio and scenario analysis, before adapting future product/service design and customer engagement strategies, and taking action in relation to issues that arise</td>
</tr>
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Source: PwC

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1 ‘The incentivisation of sales staff – are consumers getting a fair deal?, speech by Martin Wheatley, CEO designate of the FCA, 05.09.12
Underpinning the FCA’s agenda is the focus on ‘good profits’². This concept has not been explicitly defined as the FCA wants businesses to take responsibility for doing the right thing rather than relying on it to set prescriptive rules. We believe that ‘good profits’ come from making sure that products and services are suitable for the people they’re being sold to, they understand what they’re buying and they’re getting appropriate value for money. In many cases, you’ll be required to make sure that the product or service remains suitable as your client’s needs and expectations change. The generation of ‘good profits’ will help you to avoid FCA sanction and deliver sustainable returns.

The response from your business won’t just need to meet the FCA’s expectations, it should also consider how to repair the breakdown in customer trust that has brought the new body into being – more than half of the FS industry leaders polled in our latest annual CEO survey see a lack of trust in their sector as a significant threat to growth³.

And if we assume that it’s only a matter of time before the FCA uncovers the next big scandal, then the only way to rebuild trust is to make sure your business is ahead of the game by proactively seeking out and planning for future threats (‘unknown-unknowns’). Ultimately, customer engagement is a competitive opportunity rather than just an exercise in compliance. The sector is facing a shake-up that has raised questions over what different customers value, how they want to buy Financial Services (FS) products and what features they’re prepared to pay for. This could be a disruptive challenge for some – half of industry leaders see the shift in customer spending and behaviour as a threat to growth⁴. But it also provides valuable openings for businesses that can use their understanding of customers to tailor and target products and services more effectively.

² The FCA: the future of conduct regulation, speech by Martin Wheatley, CEO designate of the FCA, 17.10.12
³ PwC. ‘16th Annual Global CEO Survey: Dealing with disruption - Adapting to survive and thrive.’ 2013. www.pwc.co.uk/ceo-survey
⁴ Ibid.
Ahead of the curve

Businesses that take a narrow compliance approach will struggle to provide the evidence now required by the FCA. They also leave themselves at risk from undetected future risks and damaging retrospective action if they don’t look at the underlying issues of customer and market trust and understanding.

Many companies may move towards simpler products, but this safety first approach could impede innovation, product differentiation and speed to market and thus fail to meet customers’ more exacting expectations.

Smarter businesses are going to put customer engagement at the heart of their strategy, culture and operating model and underpin this with an appropriate conduct risk appetite, management framework and key controls. The big difference from the past is the greater focus on collaborative relationships with customers, which brings them into the heart of the product design process. Not only will this approach help product innovation and differentiation, it will also provide a sustainable and demonstrable platform for compliance. And given that the FCA expects the industry to lead the conduct debate, they will no doubt be more sympathetic to firms who can demonstrate they have considered the wider impact of their business on customers and society and have been actively trying to do the right thing.

This will, however, call for a re-think of the conventional three lines of defence model (frontline first, risk management second and internal audit third) towards an even closer partnership approach in areas such as product design and marketing. While products might only have been vetted by risk and compliance teams once they were already developed, the ‘second line’ will now need to be actively involved from the beginning. There will also need to be more extensive executive and board level review of new product and service initiatives, which constitute either changes in strategy or are at the very edge of your conduct risk appetite. The FCA is expecting firms to be able to demonstrate ownership of conduct by the business. It is no longer an area that compliance can own though of course they are still a key enabler. Senior management will also be expected to discuss with the FCA how their business models and strategies meet their conduct agenda.

A further challenge is the potential for conflict between conduct and other risks. For example, the ways used to modify a guaranteed savings product to make it less capital intensive under new prudential regulations might make it harder to meet the conduct risk customer value test. It’s noticeable that certain passages of the new FCA and PRA handbooks are identical, but are starting to be interpreted by the two regulators in potentially contradictory ways.

It’s also going to be necessary to carry out a rolling review of past and present product portfolios, identify what products may need to be modified or withdrawn and what issues may need to be remediated. However, developing effective lead as well as lagging indicators of potential conduct risk will be vital in preventing new issues from springing up, as once complaints about the sales process begin to flood in it is already too late to resolve the problem.

In the wholesale markets, smarter businesses will also be looking to demonstrate that they operate with market integrity. For many this will include reviewing not only their product design process and distribution channels but, more importantly, will require them to manage their risks in a way that will not adversely impact the stability and resilience of the entire financial market.

Understanding their role in the wholesale and retail markets, and planning their response in a way that reflects their relative sophistication against other market participants is a key first step. Particularly when it comes to pricing, transaction structures, their dependence on technology and their ongoing management of conflicts of interest. They also need to understand the extent to which existing risk management frameworks (such as compliance and operational risk) effectively capture these risks.

Whilst we’re already seeing many retail and investment banks undertaking reviews of their approach to managing conduct risk. Many insurers and asset management firms are behind the curve.

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Are you ready?

The conduct agenda will have fundamental implications for how you run your business and go to market. If you’re slow to respond you not only risk regulatory sanction and reputational damage, but it could also prove more difficult to rebuild the trust and engagement needed to sustain profitability and market share.

Drawing on our work with FS firms and regular discussions with the FCA, we believe that there a number of considerations your business needs to address, for example:

• Do you understand the conduct risk inherent in your business model and future strategy, and can you explain how you manage it?

• Can you demonstrate that you make ‘good’ rather than ‘unsustainable’ profits?

• Do you know if there are products in your portfolio that were compliant when sold but could be the focus of retrospective supervisory investigation under the new conduct agenda?

• How will you bring customers into the product design process to make sure you understand their needs and can deliver a fair deal?

• How do you determine whether your customers understand what they’re being sold and it meets their real needs on an ongoing basis?
How the FCA is going to operate

With more than 30,000 businesses to oversee and a broad new remit that covers protecting consumers, strengthening competition and promoting integrity, the FCA is facing an extremely tough task.

To make supervision more manageable, it has divided the market into four risk categories. At one end are bigger companies with a large and complex array of products. These firms will have their own dedicated supervisors. At the other end are lower impact firms, which will be subject to remote monitoring and thematics. The middle two categories will typically include medium sized insurers, asset managers and building societies as well as larger Independent Financial Advisors (IFAs). Wholesale businesses will also come under review as the FCA believes that what they do will have a knock-on impact on the retail market.

The set piece examination of the ARROW visit will give way to an ongoing assessment of your company’s business model and strategies. Rather than simply setting standards and looking back at what your business has done, the assessment will delve into the attitudes and behaviour that shape how you operate, treat customers and make money. This begins with the tone and objectives set by the board before filtering down to the frontline teams who directly engage with customers.

‘Mystery shopping’ is likely to be stepped up as supervisors look to see how products are being sold and whether customer expectations are being met. The ‘follow the money’ investigative focus will include targeting products deemed to be delivering excessive profits.

Ultimately, the FCA knows that it can only do so much to oversee the market and it’s putting the onus on companies themselves to set their conduct risk appetite, build conduct risk into their wider framework and demonstrate how customers are being appropriately protected.
Giving you the edge

We’re helping a range of banks, insurers, intermediaries and asset managers to get to grips with the new customer and conduct agenda. Our work includes:

• Helping firms redefine their strategy to meet the heightened expectations of customers, the FCA and other stakeholders.
• Working with the board to ensure that conduct risk is embedded into their governance arrangements.
• Helping firms define and embed cultural change to support the implementation of their new strategy.
• Helping firms design, implement and embed conduct risk management frameworks.
• Helping firms articulate the different conduct risks presented by their business model and how they are managing these risks.
• Assessing the effectiveness of firms’ processes, policies and procedures at all stages of the product lifecycle.
• Assistance with the design and delivery of remediation programmes.

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