Guidance consultation

NON EXECUTIVE DIRECTORS CONFERENCE; DELIVERING FAIR TREATMENT FOR CONSUMERS OF FINANCIAL SERVICES

December 2011

Contents

1 Introduction

1.1 The guidance below follows on from the Non-Executive Director (NED) Conference that we held on Tuesday 6 December 2011.

1.2 The purpose of the guidance is to set out to firms our expectations of NEDs in delivering the appropriate management of retail conduct risk within firms. By retail conduct risk, we mean the risk of a firm treating its retail customers unfairly and delivering inappropriate outcomes.

1.3 The guidance is to help NEDs understand better how to deliver against their regulatory responsibilities under the FSA Rules and Principles, from a retail conduct risk perspective, and what this looks like in practice. It is not a substitute for the rules and principles themselves, which NEDs should continue to ensure they are compliant with.

1.4 This guidance will be of relevance to firms that are directly involved with retail customers, along with firms whose actions have a significant impact on outcomes for retail customers. This may include firms that do not have a direct relationship with retail customers, but still play an important role in providing retail services or products (e.g. providing investment services, such as institutional funds used by retail pension schemes, derivatives used by retail firms in retail products).

2 Background

2.1 Through the TCF initiative and the publication of the Culture Framework in 2007, the FSA was increasingly challenging NEDs about their role in driving an appropriate culture within firms to support the delivery of fair outcomes to customers, both in speeches and in firm contact. With the creation of the CBU, and the move towards the FCA, it is an appropriate time to re-engage with NEDs on the important role they need to play in challenging their firms to deliver on their regulatory responsibilities to customers.

3 Expectations

3.1 Assessing customer outcomes remains a key part of our assessment of retail conduct risk.

3.2 NEDs, as part of the wider Board of Directors, have a pivotal role to play in the active governance of firms and driving an appropriate culture to meet the firms' regulatory responsibilities towards the fair treatment of retail customers.

3.4 To help firms manage their retail conduct risks, we expect NEDs to consider the following areas and challenge where appropriate to ensure that:

a) Business proposals are aligned with the firm's strategy and are within its stated retail conduct risk appetite. A NED should:

i. challenge whether the firm has an expressed risk tolerance/appetite statement for retail conduct risk;

ii. be comfortable with how the Board decides on its target customer base and how to segment it;

iii. encourage the Board to discuss customer expectations and how the firm deliver against them;

iv. challenge the Board to consider the products and services it delivers to customers and whether they are appropriate for the target market; and

v. be comfortable with the Board's involvement in new product development.

b) The firm's culture is such that it delivers good behaviours and outcomes, both prudentially and for customers. A NED should:

i. encourage the Board to embed and maintain a culture that supports an appropriate degree of protection for customers, taking into account factors such as the firm's business plan, risk appetite, remuneration mechanisms and identified internal and external risks;

ii. identify what prompts this particular discussion – e.g. change of management, change of strategy and crystallised risk;

iii. challenge the Board to provide continuing oversight of the firm's culture particularly in times of change;

iv. challenge the Board to lead the executive on culture and values; and

v. with the Board, monitor against the values that it has set.

c) The NEDs have the right information to enable them to make robust decisions and if they feel they do not, then they should ask for it. A NED should:

i. challenge the information the Board receives on retail conduct risk;

ii. ensure the information is sufficient to support decision making;

iii. encourage the Board to challenge the information it receives; and

iv. challenge the Board on how the information is used.

d) The firm has identified risks to customers. A NED should:

i. challenge the Board to proactively consider the retail conduct risks the firm might be giving rise to;

ii. be confident in how the Board identifies, mitigates and monitors its retail conduct risk; and

iii. be comfortable with the level of priority the firm gives to retail conduct risk.

e) Appropriate actions are in place to mitigate and monitor such risks. A NED should:

i. be comfortable that management information captures the key retail conduct risks within the firm;

ii. challenge that actions are put in place, where possible, to prevent the crystallisation of risk; and

iii. be confident there is clear accountability for mitigating identified risks.

f) The Board supports the identification and escalation of issues when they go wrong and ensures appropriate resolution. A NED should:

i. encourage the Board to create an open and collaborative working environment;

ii. challenge the Board to focus on seeking solutions rather than attributing blame;

iii. be comfortable that the Board ensures resolution is fair to all affected customers, i.e. not just those who have complained; and

iv. challenge the Board to monitor whether the recommended actions have led to the appropriate outcomes for customers.

g) The business learns from identified issues and draws out the wider implications. A NED should:

i. challenge the Board to identify the root causes of issues to help prevent them happening in the future; and

ii. where things go wrong, challenge the Board not to solely focus on the area where the issue originated, but give consideration to whether it may be apparent in other areas of the business.

4 Scenarios

4.1 To help illustrate some of these points, the following section sets out some case study scenarios and the types of actions we expect NEDs to take to fulfil their responsibilities under the key provisions in the FSA Handbook.

Scenario 1 – Strategy setting

- This is a mid-sized firm, typically offering 'vanilla' products on a non-advised basis mainly to the local area. To increase market share, it would like to introduce an in-house adviser population to enable it to branch into the sale of wider life, pensions and investment products.
- This recommendation is put to the Board – what questions should it ask before making a decision?

We expect NEDs to satisfy themselves of the following.

- The proposed strategy fits with the existing firm business model and is within the firm's retail conduct risk appetite.
- The risks to customers to which the proposed strategy might give rise, have been identified and actions to mitigate and monitor these are in place.
- The firm has the appropriate resources and systems to deliver the strategy, including the right quality and number of staff, policies and procedures to ensure the fair treatment of customers, e.g. how will the firm recruit, train and monitor the advisers. How will the firm ensure its support functions are also adequately competent, such as complaint handlers and compliance staff?
- The Board has sufficient knowledge and/or background in the proposed area to provide adequate challenge and oversight, e.g. who on the Board has experience of advised sales and the risks this model might give rise to? If no one has such knowledge or experience, how will the Board acquire it?

It became clear during the financial crisis that boards did not sufficiently understand their business models, strategies or products, and the risks they were running.

While we do not expect NEDs to know the answers to all of these questions in detail, it is important that they are comfortable that the business has considered these areas and the answers are adequate to satisfy them as a Board member to make a decision.

The driver of this scenario is the firm wanting to increase its market share. We recognise that this is important for firms and the positive effect it has on the bottom line. However, you can expect the FSA to question firms about proposed strategies – particularly contentious ones – and how your firm is managing the risks they present to customers.

One of the key roles that NEDs play is using their experience and expertise to identify, highlight and challenge developments that could pose a risk to the firm's strategy, profitability or reputation. This should also include risks to consumers. These risks could be external (e.g. driven by environmental, regulatory or competitor issues) or internal (e.g. strategic or product developments proposed by executive management).

Scenario 2 – Product development

- The New Product Development Committee proposes to the Board that the firm should launch a new Structured Deposit product. The reason for this is they have identified that many of the firm's competitors are running similar campaigns and are concerned about the competitiveness of their existing offerings.
- The basis of the offering appears quite complex and is in an area unfamiliar to you – what do you do?

We expect NEDs to do the following.

- Consider whether the information presented is adequate and clear enough to enable an informed decision to be made and challenge where not, e.g. do you understand the basic concepts of the way the product works and the risks it might present?
- Understand the benefits of the product for customers compared to the benefit of the offering to the firm and challenge where they are disproportionately in favour of the firm. What are the likely rates of return? What criteria have to be met for a customer to get this rate? Who do you think the product is really suitable for? How will the product be monitored after launch to evaluate actual outcomes for customers?
- Understand the risks the product poses to customers and satisfy themselves that the risks are within the firms tolerance and will be appropriately monitored and mitigated.
- Ensure the firm has appropriately considered aspects, such as the target market of the product, suitable distribution channels etc, e.g. does the firm's existing target market appear suitable for a structured deposit? Is the product to be sold through the advised route or will it be available non-advised? Is it appropriate to sell it non-advised?

We expect to see a Board engaged in ensuring products deliver the right outcomes for customers. It should ensure that the fair treatment of customers is built into its product oversight arrangements – with clearly allocated responsibilities and the effective inclusion of control functions such as Compliance. There should also be challenge around how the product will be monitored through time, to evaluate both actual and expected (or advertised) outcomes for customers.

We recognise it would not be reasonable to expect NEDs to possess as indepth a knowledge as the executive management, but they should have sufficient knowledge to carry out their role, i.e. to participate actively in the decision-making process of the board and to exercise appropriate oversight over the agreed strategy.

For example, we do not expect NEDs to have a detailed knowledge of the firm's entire product range, but they should understand the basic concepts and what they deliver for customers. If NEDs, as senior industry professionals, cannot understand the implications of their firm's products, then it is difficult to see how the 'average man or woman' on the street can be expected to.

NEDs have a role to play in challenging new products. Do they deliver genuine benefits to customers? Is there a genuine customer need? Or are they simply copying a competitor's offering? We expect firms to have a clear and coherent target market, plausible in size and shape – with a product appropriately matched to the needs of that market.

Scenario 3 – Post-sale amendments

- The capital position of the firm has been faltering over the past few months and we have increased our focus on the firm from a prudential risk perspective. In response to this, the heads of a number of business units have been asked to consider how additional capital can be raised.
- The Head of Mortgages presents their recommendation. In it, they note that the firm's mortgage book includes a group of customers whose circumstances no longer fit with the firm's lending criteria. These customers' contract terms include terms that allow the firm to demand immediate repayment of the mortgage if the customer's circumstances have changed or the customer has committed a breach of the terms and conditions of the mortgage. They recommend the firm look at how this particular term can be used with this group of customers.
- What do you think?

We expect NEDs to:

- consider how to fairly balance the needs of all stakeholders;
- understand how such terms will be used and in what circumstances;
- understand what the impact will be on affected customers; and
- challenge such proposals for how they meet the firm's treating customers fairly obligations.

While firms may have prudential reasons for taking these actions, and may wish to balance the interests of savers and borrowers, they need to handle the whole process carefully to not breach FSA Rules and Principles (including Principle 6, to treat customers fairly) or the law.

The examples we saw included firms relying on these terms in instances where the customer has only a minor change in circumstances or committed only a minor breach of the terms and conditions. In these instances, it would appear that such terms could give firms wide discretion to demand repayment of the mortgage, to the detriment of customers. As a result, we have published undertakings under the Unfair Terms in Consumer Contracts Regulations 1999 from firms agreeing not to apply such terms unfairly.

This scenario is based on a real example included in the Retail Conduct Risk Outlook of March 2011.

Scenario 4 – Crystallised issue

- The firm distributes a range of its own products through in-house call centres. At the latest Board meeting, Compliance escalates an issue relating to a recent monitoring review of one of the call centres.

- The review identified high-risk issues relating to the non-advised sale of level term assurance, in particular numerous instances of the call handlers providing ‘advice’ to customers.

Compliance recommends immediate cessation of sales until further training and controls are in place to stop this happening further. What are your thoughts?

We expect NEDs to challenge whether the following has happened.

- The firm has identified the actual root causes of these issues and the proposed action tackles these, i.e. has the firm considered what is driving this behaviour, is it that the firm has insufficient policies, is it poor training or could it be reward incentivising such behaviour?

- Consideration has been given to the wider implications of these findings i.e. whether similar failings are occurring in the other call centres for other products.

- Remedial action will be taken for those customers affected and whether such plans are adequate, e.g. has the firm taken the approach only to remediate those customers who have complained, or will there be a wider customer contact exercise?

- Appropriate communication is in place to manage potential issues arising from this, e.g. how have other areas of the business been informed, such as the Complaints and Claims areas?

We recognise issues will still occur. Where this happens, we want to see the firm acknowledge the problem and seek to put it right. It is important that the Board be seen to be open to hearing about things going wrong from a customer perspective. We have seen, in some instances, Boards not wanting to hear about issues unless the business has solutions to put them right – this has obviously led to important items not being escalated. That is not to say that the Board should know about everything, but it needs to be sure that, if there is something they should know about, the business feels comfortable in raising such things, i.e. the culture supports an open, collaborative working environment.

5 Assessing effective conduct risk governance

5.1 Now that we have explained how NEDs could deliver against their responsibilities in helping firms manage its conduct risk, we want to set out the type of things NEDs and indeed the wider Board of directors can expect from a retail conduct risk governance assessment.

5.2 The next section briefly sets out what we see as some of the key areas in effective retail conduct risk management within a firm. Please note that the list is not exhaustive and indeed, specific questions will depend on the business model of the firm and the specific area of focus of the assessment.

Board and Board committees/management and management committees

- Is there sufficient evidence that the Board/management committee structures and compositions, plans and policies are effective in identifying and managing the firm's retail conduct risk?
- Is there sufficient evidence that the Board and management's leadership and decision making support the delivery of fair outcomes to customers?

Organisational structure and relationships

- What retail conduct risks might the organisational/group structure present and how are these being effectively managed?
- What are the dynamics of stakeholder relationships and how are any conflicts of interest managed to ensure effective retail conduct risk management?

Setting strategy

- Does the firm have an effective process for setting, implementing and monitoring strategy to ensure the robust management of any associated retail conduct risks?
- Does it work in practice and is there evidence of effective challenge on strategic proposals?

Management information

- Does the management information provided to the Board/management committees enable proactive, timely decision-making?
- Is it outcomes focused and a true reflection of the retail conduct risks within the firm?
- Is there evidence of the information being used to effect positive change in the way customers are treated?

Control functions

- Are the firms' control functions, e.g. compliance, internal audit and risk, effective in identifying, assessing and mitigating retail conduct risk?
- Is there evidence of them being effective in influencing business behaviour to change the way customers are treated?

Performance and pay/recruitment training and competence

- Are policies designed to support the fair treatment of customers?
- Where they give rise to retail conduct risk is this adequately controlled?
- Is there evidence that these are monitored for their effectiveness and changed where appropriate?

Culture

In his October 2010 Mansion House Speech, Hector Sants addressed the question of whether culture can be regulated. It was clear that the regulator has a key role in assessing what an unacceptable culture looks like and what outcomes that drives. 'It is neither feasible nor desirable for the regulator to specify the type of culture a firm has, nor the measures and metrics by which this should be assessed. What should matter to the regulator are the outcomes that the culture delivers and that the firm can demonstrate it has a framework for assessing and maintaining it. To be completely clear, a box-ticking approach to regulating culture will not work. The regulator must focus on the actions a firm takes and whether the board has a compelling story to tell about how it ensures it has the right culture that rings true and is consistent with what the firm does.'

Through our retail conduct risk governance assessments, we will be using the evidence we gather, along with all other intelligence we hold on the firm, to form a judgement on the culture of the firm and whether we believe it facilitates good behaviors that lead to judgements that deliver fair outcomes for customers.