

Governance over mortgage lending strategies

March 2015



Contents

1	Overview	2
	Who should read this paper?	2
	Why should firms read this paper?	2
	What is the issue?	2
	Why we carried out this work	3
	Culture, governance and conduct risk	3
	Our approach	4
2	Key findings	5
	What should firms do?	6
3	Next steps	9

1. Overview

Who should read this paper?

This paper will primarily be of interest to regulated mortgage lenders but, as the focus is on forward strategy, it could be of interest to all firms.

Why should firms read this paper?

This paper highlights the key findings of the thematic work which assessed the quality of firms' governance from a conduct perspective, when setting or amending mortgage-lending strategies. We provide a list of questions which may help firms to consider good customer outcomes at each stage of the mortgage lending strategy process.

What is the issue?

In response to changes in the mortgage market following the financial crisis, many lenders are looking to find ways to increase and develop their mortgage lending business. Increased competition and innovation can improve access and product choice for customers. However, it is important that, alongside efforts to achieve an increased market share, firms fully assess the risks of poor outcomes for their customers.

- **Effective governance ensures that strategic decision making is challenged from a customer perspective**, and helps firms to balance commercial objectives with good customer outcomes. A formal governance structure or framework with clear responsibility, accountability and monitoring supports this, and can help firms to apply a consistent approach.
- **Conversely, ineffective governance can lead to mortgage lending strategies where the risks of poor customer outcomes are not fully considered or mitigated.** This could lead to firms providing products and/or services that do not adequately meet the needs and circumstances of customers, increasing the likelihood of customers suffering detriment.

Why we carried out this work

Since we became the FCA, we have seen executive management and Boards becoming more explicit in the way they engage with the concepts of conduct and customer focus. Through our thematic work, we wanted to understand how this translates into the development of new lending strategies at a time when many lenders are innovating and adapting in the face of market pressures and changes to regulation.

If firms are fully taking account of the potential customer outcomes as they develop, approve, implement and review their strategies, we can be reassured that they are considering conduct risks in a preventative and forward-looking way. However where there are areas that could be improved, by publishing this report, we expect that firms can take on board these recommendations and make changes before risks crystallise into poor outcomes.

There are a wide range of governance structures and practices within firms when setting mortgage-lending strategies. We believe it is right that firms should tailor their approach in an appropriate way for their business. However, within the variety of approaches adopted by firms, our focus is to assess whether they are considering the risks to customer outcomes in their decision-making processes.

In particular, we want firms to recognise that effective governance means **considering the customer throughout all stages** of strategy formulation and delivery.

Culture, governance and conduct risk

Throughout this report, we refer to culture, governance and conduct risk. Here, we set out our expectations for culture, governance and conduct risk.

Culture

We expect firms to have a culture that places customers, market integrity and competition at the heart of their business. Culture is evidenced through the way firms conduct their business, what they expect of their staff and their attitude towards customers. Firms must evidence such culture exists and is applied from the top and throughout all layers of the firm.

Governance

The governance of firms is the process of decision-making and the process by which decisions are implemented by senior management and Boards. We expect Boards to be able to clearly explain the conduct risks within their own strategies, understand their own management information and how it influences good customer outcomes.

Conduct risk

We see conduct risk as the risk that firm behaviour will result in poor outcomes for customers. A firm's conduct risk profile will be unique to it; and there is no one-size-fits-all framework that can assess it. We expect firms to be looking at their own business models and strategic plans to see if they are identifying, mitigating and monitoring the consumer risks arising from them. They need to be considering customer outcomes equally alongside commercial objectives.

Our approach

Scope of the thematic review

The thematic project assessed the quality of firms' governance from a conduct perspective, when setting or amending lending strategies. The review included ten regulated firms, varying in types and sizes, including banks, building societies and smaller niche lenders.

The analysis of each firm focused on the governance related to a specific strategic change. We did not make a judgement on the quality of the strategy itself. For example, where we reviewed the launch of a new product or a change in distribution model we assessed how customers were considered throughout the process; we did not comment on whether the particular strategic change was appropriate for that firm. We did this because we did not wish to discourage firms from being innovative and considering new ways in which they can meet their customers' needs. We wanted to remain focused on strategy development, assessing how the customer is considered during four distinct stages of strategy formulation: **development, approval, implementation and assurance**.

Methodology

Our thematic review was carried out in two stages.

- **Market analysis** to identify firms looking to grow their mortgage-lending business by changing their lending criteria or distribution model. We used the results of the market analysis to select a sample of ten firms to be included in the next phase of the review.
- **Assess governance** - we worked with these ten firms between August and October 2014 to assess the quality of firms' governance from a conduct perspective, when setting or amending lending strategies.

We conducted in-depth assessments on a sample of regulated banks, building societies and specialist lenders. These included desk-based reviews of the development, approval, implementation and assurance of a specific strategic change, for example, a change in distribution strategy or product launch, followed by a visit to the firm.

We held discussions with a cross-section of staff in each firm, from senior management to those implementing and reviewing the effectiveness of the strategies. This informed our view of how firms consider good customer outcomes at each stage of the process.

We considered both the governance structure (what framework the firm has in place) and the effectiveness of the structure (what is happening in practice).

2. Key findings

This section provides further detail that explains how firms consider the customer when setting mortgage-lending strategies. It includes examples of practices seen to illustrate our findings.

Conduct is not culturally embedded

Conduct is on the agenda of all firms we reviewed. However, there is an inconsistency in the way firms are considering the impact of their actions on customer outcomes throughout the whole strategy-setting process. For example, we saw less focus on customer outcomes at the implementation and assurance stages when compared with the initial development and approval stages. There is also evidence that conduct risk is not adequately cascaded and understood throughout the business. This leads to some areas being able to articulate the conduct risks associated with the strategies more clearly than others despite clear conduct remit and accountability.

We expect the potential customer outcomes to be fully considered and mitigated at all stages of the strategy setting process; from development through to assurance.

Appropriate structure and process facilitates governance but customer focus makes it effective

We saw a range of approaches to strategy formulation and this evidence showed that while structure and process is important, it is not everything. Whether the governance structure is highly engineered or a more informal network, it is the firm's focus on customer outcomes and experience that makes the difference to the effectiveness of governance.

However, it is important for all firms to evidence the key decisions when formulating new strategies. This enables the firm to have an audit trail which can be particularly useful if key individuals move firm.

Over reliance on key 'conduct risk' individuals

We found that some firms are overly reliant on a small number of key individuals to act as conduct champions and there is a lack of succession planning for retaining conduct knowledge.

This poses a risk to customer outcomes because, unless these conduct champions are involved in every step of the strategy formulation, there will be times when the firm will fail to challenge effectively on behalf of the customer. Key person risk exists in some firms due to those understanding conduct being in the minority. If they fail to fulfil their duty or leave the firm, the risk is heightened considerably.

We believe more needs to be done by firms to ensure that conduct champions' focus on good customer outcomes is not diluted or lost as strategies are implemented.

Firms need to ensure that conduct and focus on customer outcomes are understood by all business levels and operational business areas, and they are owned by everyone in the business. We expect firms to be able to evidence this, including any challenge, through management information, for example Board/committee papers.

Customer research and engagement

We saw a number of firms making use of customer research and engagement focusing on the customer journey and potential risks, both during the development and assurance phases (whether through direct contact or an outside agency). Firms are recognising the importance and value these insights can bring and are using the information to better understand the customer experience and improve outcomes.

Best interests of customers

When setting or amending lending strategies, firms should consider if the decision is in the best interests of their customers. This includes ensuring that they understand the impact on the actual customer experience and how the decision will affect the customer. Firms should constantly challenge themselves as to the possible impact on customer outcomes throughout the life of those strategies. This means keeping lending strategies under review from a customer outcome, as well as commercial, perspective.

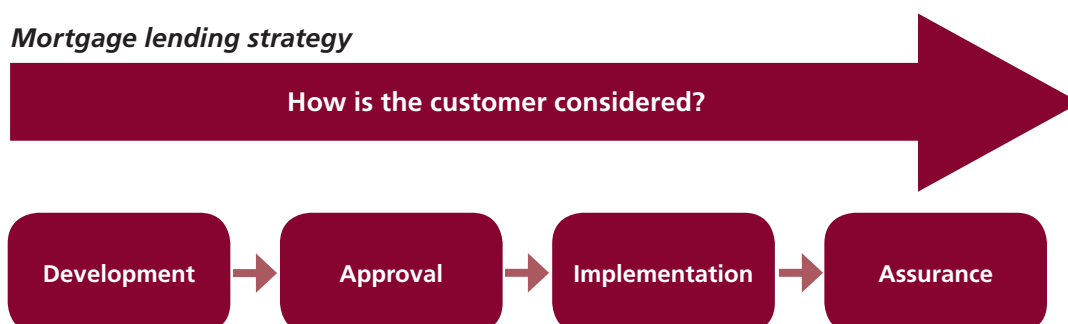
The firms in the review adopted different approaches and in the best examples these were appropriate to the experience and knowledge of the firm in that area of the market. For example, some firms moving into relatively new areas ran a pilot which could be reviewed from a conduct-risk perspective before a full launch. Similarly, other firms had thorough post-implementation reviews with both qualitative and quantitative measures to assess the impact of a significant lending-strategy proposal.

However, in some cases, the measures put in place to provide assurance on the strategy did not always read across to the potential risks that had been considered during approval and development. This meant that, for those particular risks, the firm would not be able to identify through its assurance measures whether the mitigations it had put in place were being effective.

What should firms do?

By publishing our findings from the thematic review, we aim to encourage firms to be preventative in their approach by considering the customer at all stages of the mortgage-lending strategy process.

Mortgage lending strategy



It is not our intention to prescribe a specific conduct-governance process to the industry. Our review covered a broad range of firms and a variety of changes to mortgage-lending strategies. We found that effective conduct governance can be achieved in different ways and through various structures, according to the nature of the issues and the firm's business models. However, we do want to encourage firms to consider the areas identified within this report, how they might apply to their business and how they can fully consider customer outcomes and experience at all stages of the strategy formulation.

We have provided a list of questions below which, while not exhaustive, may help firms to consider good customer outcomes at each stage of the strategy process. In addition we also found that it was often helpful if firms asked themselves certain questions before embarking on the initial development of the strategy which we have included under the heading Pre strategy considerations.

Pre strategy considerations

- Who has individual accountability for each stage of developing, approving, implementing and providing assurance for the lending strategy and how is their performance measured?
- How do you ensure you have the necessary experience and capability to deliver the proposed strategic change?
- If consultants/advisers are brought in at any stage of the process, how does your firm assess their competency and how are the changes recommended embedded?
- How do you ensure that conduct-risk knowledge is retained when key individuals leave the firm? Do you have a succession plan in place?

Development

- What are the drivers for developing the strategy, and how do these take account of the potential outcomes for customers?
- How do you ensure that the right individuals/committees provide challenge from the customer perspective and are involved in the initiation and development of the lending strategy?
- How will the potential risks to customers of the proposed lending strategy be considered and how will you keep a record of this?
- If risks are identified, how does your firm decide how to mitigate and/or monitor these risks?
- How do the risks identified fit in with your risk appetite?
- How are conduct considerations captured in the proposal taken for decision or approval?

Approval

- How do you ensure that the right individuals/committees are in place for the approval of the lending strategy?
- How do you ensure the right people/processes are in place to consider the conduct risk of that strategy?
- How do you ensure the body/individual responsible for approving the strategy is provided with sufficient information to appreciate any potential conduct risks?
- How do you ensure there is evidence of adequate challenge from a conduct perspective?
- How do you ensure there is evidence of consideration of conduct risks at this stage?
- How does your firm manage any conflicts of interest?
- If risks are identified, how does your firm mitigate and/or monitor these risks?

- How does your firm evidence that the potential impacts on customers have been considered when approving a mortgage lending strategy?
- What measures are there to assess whether the lending strategy is within tolerance from a conduct-risk perspective?

Implementation

- How do you ensure the right individuals/committees are in place for the implementation of the mortgage-lending strategy?
- How do you ensure that you have the right people/processes to manage conduct risk during the implementation phase?
- How is the approved strategy cascaded to the business?
- Does the implementation of the strategy effectively address the conduct risks identified during the development and approval phases?
- How do you ensure that implementation of the mortgage-lending strategy is supported by adequate training and guidance?
- How do you seek assurance that any third parties that are used to outsource delivery are competent?
- How does your firm monitor the effectiveness of its reward policies/strategies?
- How does your firm evidence that customers have been considered when implementing a lending strategy?

Assurance

- How does your firm provide assurance that the mortgage-lending strategy is not delivering poor outcomes for customers?
- How do you ensure that you have the right people/processes to measure and provide assurance with respect to the impact of the lending strategy on customer outcomes?
- Who is ultimately responsible for reviewing the assurance that conduct risks identified have been mitigated?
- How do you evidence that the three lines of defence model is at work, ie, are first lines of defence supported and monitored by second and third lines?
- How does the management information (MI) cover conduct risks in key customer risk areas? For example, operations, sales, errors, complaints, claims, arrears and customer queries. Will it identify worsening trends?
- Does the MI include appropriate qualitative/quantitative data and is it provided on a timely basis enabling proactive decision making?
- How can your assurance measures adequately address the risks to customer outcomes highlighted in the approval and development phases?
- How does the MI monitor the risks identified throughout the process?

3. Next steps

We encourage firms operating in the market to consider the key areas we have outlined in this report. Firms should satisfy themselves that they have appropriate controls in place to prevent customer harm and damage to the market. Firms should adopt an approach suitable to their business to produce good outcomes for customers.

Financial Conduct Authority



PUB REF: 005015

© Financial Conduct Authority 2015
25 The North Colonnade Canary Wharf
London E14 5HS
Telephone: +44 (0)20 7066 1000
Website: www.fca.org.uk
All right reserved