Evolving retail conduct risks

The new reality publication series

August 2021

kpmg.com/regulatorychallenges

New publication series

KPMG's EMA FS Regulatory Insight Centre (RIC) is pleased to publish the eighth and last paper in its thought leadership series ***Financial Services: regulating the new reality***.

As the focus of government and businesses moves from initial response to the COVID-19 pandemic, through resilience concerns, to recovery and the new reality, financial services regulators are moving into a new phase of adjustment and challenge.

In this paper we consider the new or heightened retail conduct risks that should be identified, mitigated and managed effectively by firms so that they continue to deliver good customer outcomes in the new reality of increased digitalisation, changing customer expectations and hybrid working.

Financial services: regulating the new reality

Remote governance and controls

Delivering sustainable finance

Ensuring stable capital markets

Financial resilience in banking: a balancing act

Accelerating digital finance

Redefining operational resilience

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Introduction

Changing investor demands and behaviours, the need to finance economic recovery, increasing digitalisation and the move to hybrid working models are giving rise to new or heightened retail conduct risks. These risks should be identified, mitigated and managed effectively by financial services firms to ensure delivery of good customer outcomes.

Regulators are attuned to both the benefits and evolving risks to consumers of new products, distribution models and marketing methods. Firms should review their overall culture and their treatment of both customers and staff. Firms should also review their products and services to ensure they are fit for purpose and do not over-promise on environmental and social issues.

The COVID-19 pandemic has led to significant – and potentially permanent – shifts in consumers' financial circumstances and lifestyles. In turn, what consumers need and expect of financial services and products, and how they wish to interact with financial service providers, is evolving. Customers are likely to want to continue to interact in a more digital manner, but still wish to speak with a human being on occasion. They are seeking flexibility in service channels, innovative product choices to reflect changing lifestyles, and alignment with environmental and social considerations. They are demanding greater transparency about how firms treat their customers.

During the pandemic, customers have suffered from a degree of vulnerability. When consumers are vulnerable in any sense, it can adversely impact the way they engage and the decisions they make. In an increasingly digital world, individuals and companies are more likely to be victims of financial crime as criminals develop increasingly sophisticated approaches.

To aid economic recovery, policymakers are seeking to encourage individuals to move from savings to investments, and are reducing current restrictions for sophisticated retail investors. These actions could herald new risks to consumers and therefore for firms. Retail consumers may need additional help to understand the differences between bank deposits and investments, and firms should ensure that product disclosures are clear.

Regulators are concerned about the wave of new types of digital finance, including crypto-assets and trading apps, and the risks to consumers. They are monitoring distribution channels and firms' use of technology, such as artificial intelligence (AI). A broader approach to operational resilience, including the wider ICT[1] risk environment, is expected in order to minimise disruption and detriment to consumers. Regulators now expect firms to consider not only what would happen if they were to experience disruption, but how they will respond when it does.

Actions firms should take

Governance arrangements, controls and resilience should be reinforced and enhanced for the new reality of increased digitalisation, hybrid working and evolving consumer demands. Firms should also review their overall culture and their treatment of both customers and staff. Regulators and customers expect firms to ask themselves not "Can we?" but "Should we?".

Long-established governance arrangements and controls, many of which are based on the presumption that activities predominantly take place within the office, should be reviewed. Hybrid working will enable some oversight to be performed in the office but it will likely require greater co-ordination than with office-only working.

1 Information and communication technology

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Firms should adopt an holistic approach to identifying retail conduct risks, so those risks can be consistently and robustly addressed, and so the firm can deliver better customer outcomes.

Firms will likely continue to be more reliant on the individual and unobserved conduct of employees. This may require a replacement of narrow controls with a greater emphasis on culture, behaviours and outcomes. New ways should be deployed to ensure individuals understand the firm's culture and that their behaviours are aligned with it. Upskilling will be required, and customer service staff may require specific consideration.

Firms should embed customer-centricity throughout their operations. In particular, they should seek to identify and treat vulnerable customers in every department and activity of the firm and at all stages of the customer journey. Existing data and MI should be reconfigured to ensure that firms can evidence appropriate consideration and treatment of customers.

The possibility of multiple concurrent disruptions and the emergence of new threats and vulnerabilities should be factored into resilience strategies. Important business services should be identified and impact tolerances set. From a retail conduct perspective, there is a risk of customer detriment if a firm is not sufficiently customer-centric in this analysis.

There are challenges in collating, storing and analysing data. The transfer of customer data between firms and across borders is being encouraged via "open finance" initiatives but is subject to data protection requirements, and regulators are concerned about the ethical use of data.

Firms should reassess whether their products and services are still aligned to changing customer demand and needs, and whether their product governance framework remains fit for purpose. Consumer outcomes should always be at the heart of product design. Assessment of value requires routine, robust and objective engagement with end-customers.

In conclusion

Retail conduct risks are not linear and discrete. They are inherently interconnected and cannot be mitigated in a standalone or separate fashion. Firms should ensure they operate an holistic approach to addressing retail conduct risks, to deliver good customer outcomes in the new reality and beyond.

A firm's culture can set the ethos and drive the manner in which it seeks to address risks. Its overarching governance, oversight and controls framework sets the mechanism, appetite, rigour and degree of objective challenge to which risks are subject.

Key messages for CEOs

— Are our governance and oversight arrangements effective regardless of the location where they are performed? Are our risk management framework and controls fit-for-purpose with a hybrid working model? Are we identifying, measuring and managing risks arising from new technologies and increased digitalisation? Are we using technology effectively to enhance client services and run our business more efficiently?

— Do we regularly and objectively assess the firm's culture, including leadership, approach to rewarding and managing people, and diversity and inclusion? Are we empowering and upskilling our employees or still reliant on office-based controls?

— Can we evidence a client-centric approach throughout our business? Do we consider the customer in every department and activity of the firm? How do we identify and treat customers that exhibit signs of vulnerability, whether permanent or temporary?

— Have we assessed the changing needs of customers for both digital and human communication? Do we empower employees to support customers to ensure we deliver good outcomes? Is our approach consistent irrespective of whether the customer service function is conducted remotely or in office? Is there regular flow of MI and customer insights with the product governance function?

— Are we considering not only what would happen if we were to experience disruption, but how we will respond when it does? Have we identified critical business services and potential impacts on our customers, as well as on the firm and other stakeholders? How do we ensure that customer data are held securely and used ethically, and how do we deal with privacy breaches?

— Are our product governance arrangements subject to robust and objective challenge, and delivering good customer outcomes? Do we have the correct framework in place to ensure products and services continue to be fit for purpose and deliver good customer outcomes? Are we actively monitoring how customer demands and needs are evolving?

— Can we evidence consideration of value through the eyes of the customer? Do we put consumer outcomes at the heart of product design? Are our product disclosures clear and understandable? How do we minimise the risk of over-promising on environmental or social considerations?

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01. Changing customer profiles and demands

The pandemic has led to significant – and potentially permanent – shifts in consumers' financial circumstances and lifestyles. In turn, what consumers need and expect of financial services and products, and how they wish to interact with financial service providers, is evolving. Digital expectations and demands for sustainable finance have accelerated, bringing new risks such as "greenwashing".

Customers experienced a similar **technological journey** to firms: a rapid switch to online methods of transacting and communicating. Looking forward, customers are likely to want to continue to interact in a more digital manner, and their needs and wants are also changing. They are seeking flexibility in service channels, different product choices and closer alignment to the "greater good" – environmental, social and governance considerations. The European Commission notes a visible and global trend of young savers being increasingly open to the use of new technologies and investing in assets that support the green and digital transition.

There is also increased demand to be able to speak with a human being when issues arise. Firms have seen a significant rise in volume of **customer service needs**, ranging from routine servicing requests and complaints, to refunds, cancellations and claims. As firms (and their customers) adopt hybrid working, some firms are already experiencing a long tail to servicing volumes.

Further **innovation** and development in products and services to meet the changed circumstance and needs of customers can help ensure good customer outcomes. Some traditionally held assumptions may no longer be consistently true, such as many customers travelling to their place of work, five days a week. During lockdown, car insurance immediately lost much of its utility and the normal volume of claims dropped significantly. In response, some insurers offered a refund on premiums. There has also been innovation: car insurance offered by the mile, for example.

Private medical insurance procedures fell as routine private operations were cancelled to ease critical capacity issues for hospitals. Unlike car insurance, when routine operations were allowed to recommence, insurers received a backlog of claims. Therefore, there is less of an argument that the product's utility and value diminished during lockdown. These differences led the UK Financial Conduct Authority (FCA), for instance, to state that it expected all general insurance product providers to consider "whether and how coronavirus may have materially affected the value of their insurance products".

The public is demanding greater transparency about how firms treat their customers. They expect firms to exhibit **good governance**, including a clear focus on customers, good treatment of employees, and a proactive approach to social issues, such as diversity and inclusion. Customers expect senior management to be held personally to account for their firm's actions and for regulators to enforce that accountability.

During the pandemic, customers have suffered from a degree of **vulnerability**. When consumers are vulnerable in any sense, it can adversely impact the way they engage and the decisions they make. Vulnerability is not related only to health or age factors. Other drivers include life events (e.g. bereavement), resilience (e.g. indebtedness) and capability (e.g. literacy/numeracy skills). Vulnerability can be temporary or permanent. It is a complex spectrum across independent drivers, some of which may be fleeting and require minimal change by the financial service provider, while others can be permanent and require significant intervention by the firm.

In an increasingly digital world, customers – both individuals and companies – are more likely to be victims of **financial crime** as criminals develop increasingly sophisticated approaches. Scammers tend to target people who are more vulnerable as they have a greater chance of success, which can inflict significant and irrecoverable harm. Also, some customers may be motivated to commit digital financial crime.

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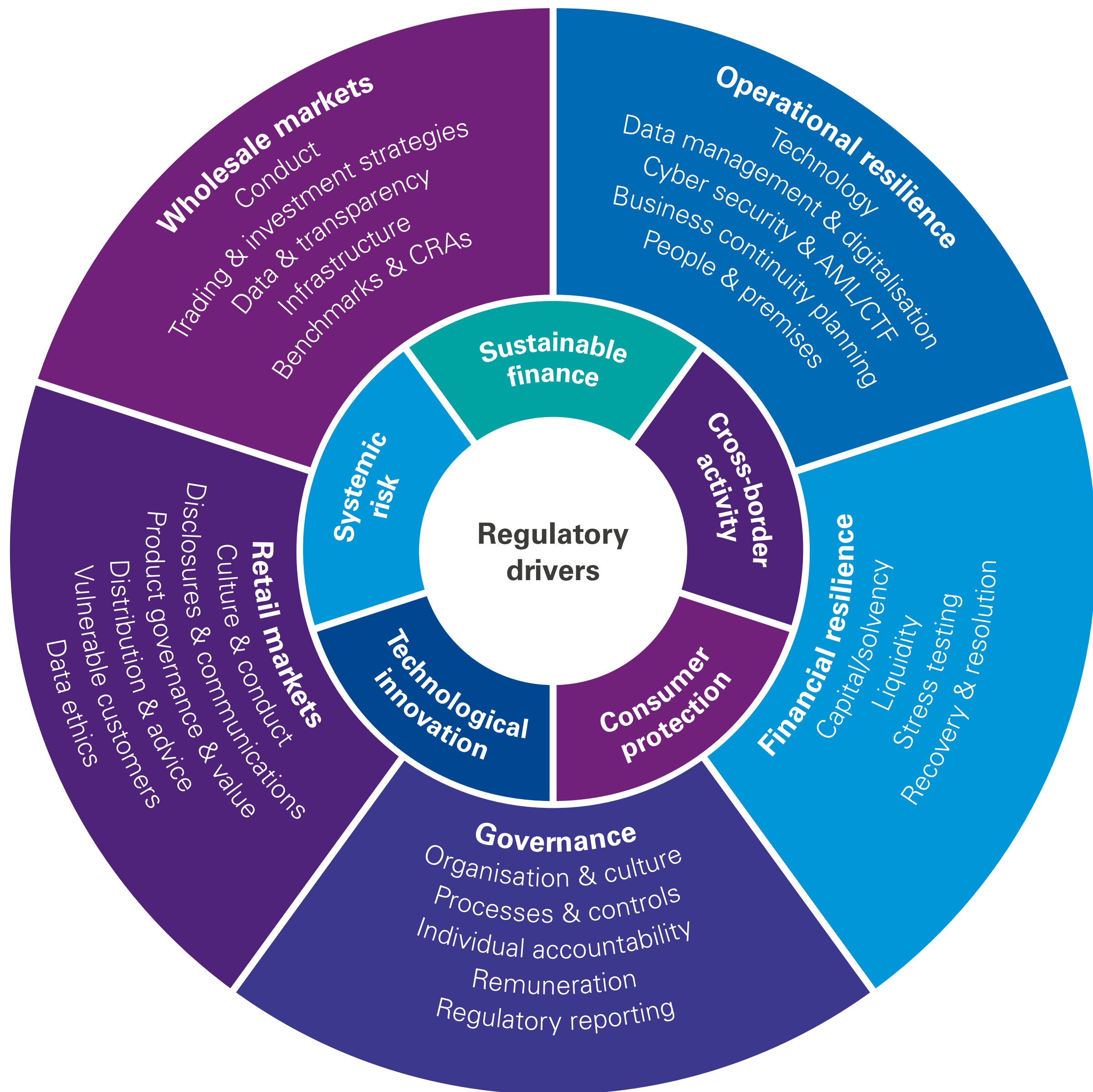
Consumer protection: a key driver influencing regulatory priorities



Five key drivers are influencing priorities in regulatory agendas. Consumer protection and financial stability are the bulwarks of much financial services regulation, but the impacts of the pandemic and lockdown measures have brought additional topics to the fore. Volatility in capital markets has led to a renewed focus on systemic risk in relation to margin, computer-led trading strategies and certain types of funds. Also, the pandemic has accelerated trends in the use of technology and demands for sustainable finance, and there are new challenges to doing business across borders. These three trends are now equally prominent drivers of regulatory priorities.

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02. Encouraging private investment

The long-term trend of diversification from government and bank funding towards the capital markets is now set against the backdrop of the impacts of the pandemic, the need to encourage greater private investment to aid economic recovery, and new technologies and increased digitalisation.

These drivers are calling into question whether consumer protection rules need to be recalibrated, to capture better the broad spectrum of consumers. Policymakers are seeking to encourage individuals to move from savings to investments, and are reducing current investment restrictions for sophisticated retail investors. These actions could herald new risks to consumers.

According to the European Commission's June 2021 Staff Working Paper on monitoring progress towards a Capital Markets Union (CMU), EU households have on average a high saving rate but barely invest directly in equity and bond markets. There are large variations across the Member States, but at aggregate level, the pandemic has resulted in a significant increase in households' deposits and to a more moderate increase in shareholdings.

It is too soon to say whether this increase is a sign of permanent shift in consumer sentiment, but the Commission notes other encouraging signs, including declining costs for individuals to invest via UCITS and the emergence of green investment vehicles and digital platforms. However, these developments bring new risks , such as "greenwashing" and highly volatile prices of certain crypto instruments, of which consumers may not be fully aware and which may discourage market participation in the longer term.

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Three areas of focus

Retail investors' participation

Money invested in market instruments and intermediaries that invest in market instruments, share of households investing

Costs of investing

Fees for using investment funds

New choices

Investing green, using new technologies to invest

One of the aims of CMU is to ensure a safer place for individuals to save and invest. The Commission's paper includes the indicators against which it will assess the success of CMU in this regard:

- Direct retail investment by households relative to cash holdings and deposits
- Investment funds, claims against insurers and pension funds of households relative to cash holdings and deposits
- Direct and intermediated retail investment by households relative to cash holdings and deposits
- Proportion of households that directly hold bonds or listed shares
- Proportion of households that hold investment funds, life insurance products or pension funds
- Total expense ratio [ongoing charges figure] of equity UCITS
- Issuance of green bonds by the private and public sector relative to total bond issuance
- Credit and equity allocated through crowdfunding relative to GDP

Revisiting categorisations

Jurisdictions around the globe are considering relaxing restrictions on sophisticated, non-professional investors. The Markets in Financial Instruments Directive (MiFID II) review, for example, could include the introduction of a new category of "semi-professional" investors who would have access to a wider set of investment products.

Policymakers are seeking to encourage investment in infrastructure, social projects and other longer-term assets by permitting existing investment funds to invest in such assets or by allowing a wider range of savers to invest in such funds. These changes are mainly targeted at qualified or semi-professional investors, but some jurisdictions are reducing restrictions on assets that can be held in pension vehicles, which will enable access by retail savers.

The FCA has consulted on a regime to enable UK-authorised open-ended funds to invest more efficiently in long-term, illiquid assets. These Long-Term Asset Funds (LTAFs) will initially be accessible only by professional or sophisticated retail investors. In the EU, the European Long-Term Investment Fund (ELTIF) Regulation is under review, with the aim of encouraging take-up of this vehicle. Issues under consideration are a widening of eligible assets, lowering the restriction on types of investors and national tax incentives.

New risks to consumers

The perennial question for regulators is how to achieve the right balance between consumer protection and wider policy objectives, including not unnecessarily restricting consumers' access to different types of investment returns. There is a need to help consumers understand the differences between bank deposits and investments, and to ensure that product disclosures are clear and not misleading. These needs are amplified where the underlying investments are not liquid securities but involve long-term project financing. Such assets have previously been the preserve of large, professional investors that have the financial capability and capacity to estimate risks, bear losses and commit to long-term funding, often via tranches spread over set periods.

> "The perennial question for regulators is how to achieve the right balance between consumer protection and wider policy objectives."

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03. Regulators respond to evolving risks

The pandemic has provided added impetus to policymakers' plans to encourage moves towards digital finance and the widening use of technology. Regulators are attuned to both the benefits and the new and evolving risks to consumers of new products, distribution models and marketing methods. They are concerned about firms' digital resilience, governance and culture, product and service value, and treatment of customers, especially the vulnerable.

Regulators are concerned about the wave of new types of digital finance, including crypto-assets and trading apps, and the risks to consumers. Several jurisdictions have issued risk warnings to the general public on crypto-assets and some have banned crypto-asset derivatives from being sold to retail consumers.

More generally, the rapid acceleration of digitalisation and use of social media have changed the way financial products are marketed and distributed, providing new opportunities for domestic and cross-border offerings, and reaching a wider audience of potential consumers.

Digitalisation facilitates access, improves transparency of markets, enables competition and helps to remove some of the obstacles for retail consumers, but there are increased risks. Younger investors are often attracted by the small deal size that is possible via digital channels, but their knowledge of investment risk may be low. Regulators are concerned about the potentially detrimental impact of online message boards and the development of investment bubbles.

The International Organization of Securities Commissions (IOSCO) is developing policy measures to mitigate the risks posed by online activities and continues to explore how AI and machine learning are being used by the industry.

Financial services firms providing or using AI tools within the EU will be subject to the proposed "AI Act", which will establish harmonised rules for a proportionate, risk-based approach to AI. The draft regulation defines AI as software that is developed with one or more machine learning, logic- and knowledge-based, and statistical approaches, and "can, for a given set of human-defined objectives, generate outputs such as content, predictions, recommendations, or decisions influencing the environments they interact with". The proposed rules include:

- Strict and mandatory requirements for "high-risk" AI, such as AI systems used to evaluate creditworthiness or establish credit scores
- Limited requirements for specific types of AI, such as chatbots
- A ban on certain uses of AI, such as AI systems that deploy subliminal techniques beyond a person's consciousness

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The European Commission has consulted on revisions to the Distance Marketing Directive to provide a "safety net" for financial services sold over the phone, on the internet or by mail. The current rules governing distance marketing of financial services are nearly 20 years old and do not provide for newer forms of digital services. In particular:

- Pre-contractual information requirements are not adapted to the digital environment
- Right of withdrawal is not fully effective
- Consumers can purchase financial services at a distance via channels or practices that are not covered by the current directive

Legislative options include clarifying existing requirements, repealing the existing directive, moving relevant parts into other legislation or undertaking a comprehensive review. Topics under consideration include personalised advertising, robo-advice and the use of digital identities.

The Commission is also consulting on the introduction of a European Digital Identity Wallet. The personal information stored in the digital ID will help firms to carry out customer checks as part of their anti-money laundering duties. Consumers will have control over their own personal data and firms will not be able to require customers to use the digital ID.

See KPMG's Accelerating digital finance for more thoughts on managing the risks arising from new technologies, digitalisation and data handling.

> "...conduct risks resulting in poor customer outcomes"

Digital resilience

Historically, the focus of regulators regarding firms' operational resilience has been on cyber and ICT security, and business continuity plans. These remain critical, but given accelerated adoption of technology and increasing sophistication of external bad actors, regulators have realised that a broader approach to operational resilience – incorporating equally important components such as people, processes, technology and information – is needed. The regulatory focus is expanding to the wider ICT risk environment: the Commission has introduced a new technology-driven definition of "digital operational resilience".

Regulators recognise that poor resilience has the potential to impact not only individual firms and wider financial stability, but to lead to conduct risks resulting in poor customer outcomes. Regulators now expect firms to consider not only what would happen *if* they were to experience disruption, but how they will respond *when* it does.

For further details, see KPMG's Redefining operational resilience, which considers how regulatory perspectives on operational resilience are developing, how the landscape has shifted as a result of COVID-19 and what firms can do now to strengthen their operational resilience through the recovery and beyond.

Product and service value

European regulators have been monitoring the level of costs and charges in products relative to their performance. The theme of value in products and services is now being viewed by both regulators and consumers against the impacts of the pandemic and digitalisation. There is a presumption that efficiencies created by greater use of technology should feed through to better services and lower product costs for consumers.

The third annual report by the European Securities and Markets Authority (ESMA) on the cost and performance of EU retail investment products found that retail fund investors continue to pay on average 40 percent more than institutional investors. Actively-managed UCITS outperformed passively-managed funds and exchange-traded funds on a gross basis, but the difference was not enough to compensate for the higher costs charged by active funds. The report also showed that actively-managed sustainable funds had lower costs than non-sustainable funds.

The European Insurance and Occupational Pensions Authority (EIOPA) is consulting on a framework to address value for money risk in the EU unit-linked insurance market. It notes that while unit-linked products offer important benefits for policyholders, costs for some products remain too high. Existing concerns have been heightened by the impacts of the pandemic: a low interest rate environment, market shocks and the risk that households will need increased access to liquidity. EIOPA considers that reliably putting consumer outcomes at the heart of product design, distribution and monitoring processes is critical for tackling value for money issues. The proposed framework is centred around the principles that:

- Value offered by unit-linked (and hybrid) products should be assessed by considering the product as a whole, as well as each product component (investment, insurance and guarantees, if any).
- When products are tested, manufacturers should assess the product features and characteristics, including costs and the reward profile of the products, vis-à-vis the target market characteristics, objectives and needs, and they should ensure that no "undue" costs are charged.
- Products that are difficult for consumers to understand should have more granular target markets and adequate measures in place to mitigate complexity related risks.

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Duty to customers

Studies on behavioural economics have increasingly been drawn upon by both regulators and firms to improve understanding of likely consumer behaviour and to design consumer engagement strategies. Regulators are concerned that such techniques should not be used for firms' commercial benefit without an appropriate balance of customer-based considerations. As the use of technology accelerates, so the level of data and MI is increasing. If firms fail to use behavioural information appropriately and fairly in their pricing decisions, it could lead to a lack of effective price competition, resulting in poor customer outcomes.

> "...putting consumer outcomes at the heart of product design"

The general instruction to act always in the customer's best interests, as enshrined in regulation, may come under renewed scrutiny as part of ongoing EU legislative reviews. And in the UK, the FCA is consulting on the introduction of a new consumer duty. The intention is to challenge a firm's purpose and its associated business models where they are not designed to deliver good customer outcomes. There will be overarching rules that seek to achieve good outcomes across the firm-customer relationship: communications, products and services, customer services, and price and value.

For more details, see KPMG's Consumer Duty – final stage of the journey.

A focus on vulnerable customers

There is a specific concern about the identification and treatment of vulnerable customers. The FCA, for example, is seeking equity for vulnerable customers such that they are consistently able to achieve outcomes that are as good as for other customers. New guidance underlines that vulnerable customers should not be considered only by the customer services function but in every department and activity of the firm and at all stages of the customer journey. The FCA expects firms:

- To understand the customer needs of their target market
- To have the right skills and capability to recognise and respond to the identified needs of vulnerable customers
- To respond to customer needs throughout product design, customer service provision and communications
- To monitor and assess whether they are meeting and responding to the needs of customers with characteristics of vulnerability, and make appropriate improvements

Open questions

There is a fundamental question whether current governance and conduct-of-business rules, which largely presume face-to-face contact, are fit for purpose in the digital age. Will virtual board meetings and AGMs (especially cross-border) be allowed to continue despite regulatory and fiscal concerns about substance?

Will policymakers and regulators enable firms to convert static paper-based disclosure documents into dynamic online presentations that enable bespoke information and promote consumer understanding and engagement?

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04. Identifying, mitigating and managing risks

The impact of lockdown measures on firms' existing governance arrangements and controls was significant. Overall, there is recognition that firms have fared reasonably well. Looking forward, governance arrangements, controls and resilience should be reinforced and enhanced for the new reality of increased digitalisation, hybrid working and evolving consumer demands.

Firms should review their overall culture and their treatment of both customers and staff. As we noted in the first publication of this series, the challenge is whether firms' pre-pandemic structures and behaviours can and should continue unchanged. Regulators and customers expect firms to ask themselves not "Can we?" but "Should we?".

Ensuring good governance

If remote or hybrid working is to remain a major factor going forward, there will need to be a wide-ranging review of long-established governance arrangements and controls, many of which are based on the presumption that activities predominantly take place within the office. This includes board meetings, customer and supplier due diligence, sign-off processes and the "three lines of defence" model.

As noted in KPMG's Remote controls and governance, key meetings may have been adversely impacted by the lack of face-to-face engagement, although many firms have also experienced positive impacts. With hybrid working, firms may want to continue to conduct meetings online where they help corporate governance mechanisms operate more efficiently and effectively. Firms should ensure that meetings with mixed attendance are as effective as face-to-face or remote-only meetings. The challenge will be to ensure there is no unfair advantage in engaging in either format.

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Hybrid working will enable some oversight to be performed in the office but will require greater co-ordination than with office-only working. The tactical risk management processes and controls developed in the immediate response to lockdown should be revisited and re-appraised to ensure that risk management is location-agnostic and allows for the frequent and seamless transition between locations. Likewise, risk identification, mitigation and monitoring will likely be impacted, requiring a different balance of where and how risk management is actioned.

> "...an holistic approach to identifying retail conduct risks"

The focus will now be on reassessing relevant risks, re-evaluating and re-calibrating the risk universe, and validating the appropriateness of associated controls, including increased use of technology and evolving working practices. This exercise will likely impact all aspects of risk management (including all three lines of defence), take the form of both top-down and bottom-up analysis, and involve both business and control functions. The outcome could be significant for some firms and could further reshape their business model or strategy.

Firms should ensure they adopt an holistic approach to identifying retail conduct risks, so those risks can be consistently and robustly addressed, and so the firm can deliver better customer outcomes.

Financial crime controls will require particular attention. Pent-up demand for consumer spending and ongoing restrictions (such as on foreign travel) could result in unpredictable spending profiles, making it harder for firms to spot unusual transactions and detect criminal activity.

Greater emphasis on a firm's culture

The pandemic has forced firms to a more mainstream realisation that culture and purpose is what can help them consistently meet regulatory obligations in relation to conduct. In some ways, large-scale remote working has helped to flatten previous hierarchies. Many of the typical barriers of office working have been removed. Access to management has become easier. However, unless there is genuine appetite and momentum for change, the transition to hybrid working may see progress stall as senior management re-embrace office working and revert to pre-pandemic approaches and practices.

Firms should continue to be more reliant on the individual and unobserved conduct of employees. This may require a replacement of narrow controls with a greater emphasis on culture, behaviours and outcomes. This, in turn, requires employees to see the value they bring to the firm and the value that the firm offers to them. Remuneration policies are important. Staff at all levels can be conflicted if they are measured and rewarded only against performance targets, risk ratings and KPIs, and feel compelled to focus on these hard metrics to the detriment of alignment with the firm's stated values.

With hybrid working, there may be a less regular requirement to attend the office. Other ways should be deployed to ensure individuals understand the firm's culture and that their behaviours are aligned with it. A key challenge for firms will be not only how they develop and maintain a purposeful culture, but how they can evidence to the regulator, staff and customers that it is embedded, is authentic and genuinely drives decisions.

Beyond technical competence, softer skills have become more important as a driver of conduct risk. Employees who understand and are able to deliver in line with the firm's culture may be given latitude to operate a degree of freedom within a framework rather than following prescribed processes. This may require a degree of upskilling and working through conduct risk considerations to ensure that the firm retains a consistency of approach and that the reduced level of focus on prescribed processes does not fragment customer outcomes.

A firm's approach to diversity and inclusion are an essential indicator of its culture, and as noted in chapter 1, are part of customers' expectations. Diversity and inclusion tend to be referred to interchangeably, but they are different. Without an inclusive culture, diversity may not lead to better decision-making and firms will not be able to meet the needs of all consumers. Firms should be representative of the diverse population of customers they serve to ensure they are developing and delivering product or services that are aligned to customer demands and needs.

A healthy and inclusive culture creates an environment where employees feel safe to share issues, problems, concerns and ideas. Senior management should recognise how their behaviour and actions can influence and support a collaborative and supportive culture. They should encourage staff to speak up and listen when they do.

A customer-centric approach

The pandemic has generated new or heightened conduct risks that have placed a strain on firms when seeking to ensure that they have fairly considered the implications on their end customers.

Regulators have communicated the importance of balancing consideration of customers with firms' own commercial interests. Firms that, prior to the pandemic, had embedded customer-centricity throughout their operations were generally able to identify emerging conduct risks, understand them from a customer perspective and know how to mitigate them.

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It is not only factors that have a direct financial impact on the firm (e.g. forbearance, payment holidays or waiving premiums) that need to be considered. By pre-empting, reacting to and proactively considering similar challenges customers might face, firms have made significant advancements in better meeting their customers' information needs by communicating more clearly and concisely. In particular, firms should seek to identify and treat vulnerable customers in every department and activity of the firm and at all stages of the customer journey.

To make customer-centric decisions, firms should upskill and empower employees, and embed a healthy culture. Also, existing data and MI should be reconfigured to enable firms to evidence appropriate consideration and treatment of customers. Firms should consciously seek to understand (and document) a customer's specific circumstances in order to improve the quality of the treatment strategy and, ultimately, the outcome generated. There will be consequential risks to consider, such as data protection. Where data are related to health or medical information, for example, they could constitute a "special category" for data protection purposes.

Customer service

During remote working, firms may have experienced challenges in meeting customers' expectations while also meeting internal KPIs. Customer service functions have experienced a significant increase in requests for support, which is expected to continue as customers continue to face challenges. Firms should develop additional engagement and communication channels to meet these expectations on an ongoing basis.

Customer service has traditionally been operated in a relatively standard format, utilising a hierarchical command and control structure. Front-line employees are overseen by team leaders who report into higher layers of management up to the Operations Director/Chief Operating Officer. This structure has been robust in managing the unique array of customer queries and requests with a high degree of certainty on service levels, call durations and expected KPIs, but it will need to be reviewed with the move to hybrid working. There will be both systems challenges and the potential for a two-tier customer experience, depending whether the servicing is provided from the office or an employee's home. Manual workarounds could increase the potential for error and customer detriment.

Customer service staff have been under considerable pressure for a prolonged period of time, like other employees, but they have also been dealing directly with vulnerable customers at their lowest ebb, financially or emotionally. Staff may have been less able to benefit from natural breaks in their call handling or the ability to de-compress after a particular difficult interaction. Rotation of activities can help, but the ability of a team leader to spot indicators of stress and intervene is reduced with remote or hybrid working. Well-being issues could increase the potential for conduct risk.

There is also a risk to the firm that the practice of granting concessions to customers during the pandemic – partly in response to pressure from regulators – may continue where the request appears to fit a priori fact patterns. As criminals find more sophisticated ways of exploiting firms, some are mimicking vulnerable customers' situations to obtain debt forbearance and other benefits. Customer service staff may have adopted a trusting approach during the pandemic and may require re-training.

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Working under pressure, with incomplete access to systems supported by manual workarounds, will inevitably have impacted the efficiency and effectiveness of customer service. A move to hybrid working may help mitigate these risks but will likely create additional complexity. Staff may be required to operate separate processes and procedures depending on the location from which they are working. This can increase the risk of errors and customer detriment.

Digital resilience

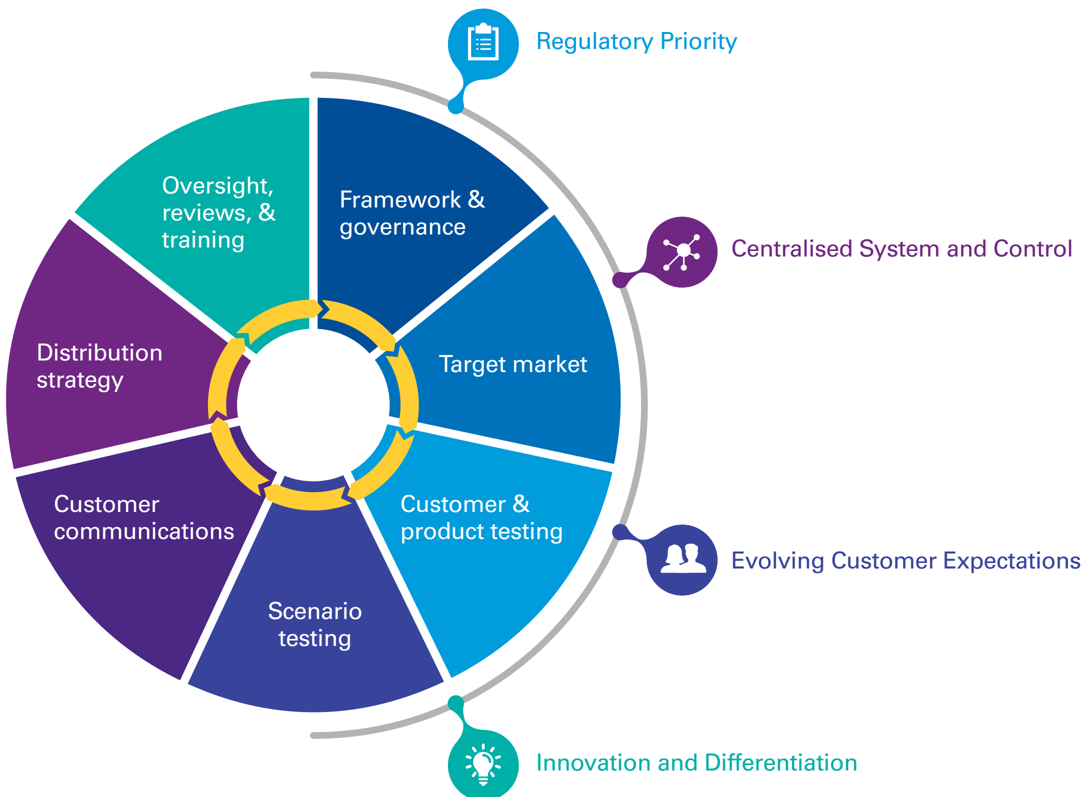
A broader consideration of a firm's systems is necessary to improve resilience. Robust operational resilience strategies should reflect the accelerated adoption of technology, the increasing sophistication of external bad actors, the interconnectedness of the financial system, and firms' dependencies on third parties and people. Firms should consider the possibility of multiple concurrent disruptions and the emergence of new threats and vulnerabilities. Important business services should be identified and impact tolerances set. Boards and senior management should ensure they have a clear understanding of the level of service disruption that could cause intolerable levels of harm.

From a retail conduct perspective, there is a risk of customer detriment if a firm is not sufficiently customer-centric in this analysis. It requires a shift from thinking about the resilience of individual systems and resources to considering the ways in which customers use and view the firm's services. Even if only a small number of customers would be affected by a particular type of disruption, the firm may identify that service to be important. The relative importance and impacts of business services may change over time and should be kept under review. For example, access to mobile or online banking may not have been viewed as an important business service when it was used only by a small minority of customers.

Increased regulatory expectations around the treatment of customers when disruptions occur will drive the need for robust internal and external communication plans, with an emphasis on ensuring the timeliness and accuracy of information provided. If these are not appropriately implemented, customers may be unable to make informed decisions, understand the prognosis, or progress/plan for resolving issues, all of which could lead to customer detriment.

Firms face challenges in the collation, storing, analysis and transfer of data, especially customer data, including reliance on third parties. The transfer of customer data between firms and across borders is being encouraged via "open finance" initiatives, but has been the subject of recent legal opinions on data protection, in part due to the new EU-UK border, but more generally around the globe. And the ethical use of data is being defined by regulators. See KPMG's Accelerating digital finance for more thoughts on this topic.

Product governance framework



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Product governance

In addition to reviewing customer services, firms should reassess whether their products are still aligned to customer demand and needs, and whether their product governance framework remains fit for purpose. The principal driver of product governance rules is to ensure products are developed, not just to meet the firm's own commercial interests and/or to generate shareholder value. A firm should objectively and robustly consider the customer at every stage of a product's design, manufacture, distribution and maintenance, and ensure that good customer outcomes are generated.

Product governance acts as a centralised system and control. It is a framework that, by design, cuts across different business areas. Where a firm's product governance arrangements are effective, they will have enabled the firm to respond appropriately to impacts of the pandemic and other external events. However, COVID-19 impacts will have strained firms' product governance arrangements in some way. New conduct risks, which would not have been considered in the design or review phases, have arisen and should be factored in more formally going forward, especially in relation to stress and scenario testing. Further, firms may have identified that their product governance framework did not operate as efficiently as it could have done, as they tried to respond with agility to a constantly evolving landscape.

Firms should be able to demonstrate that product development and distribution are genuinely aligned to the customer's best interest. Firms should manage the entire product lifecycle from a customer's perspective in order to generate good outcomes. They should focus on the specific new or heightened retail conduct risks that should be identified, mitigated and managed effectively. This may require changes in mindset, resourcing, training and employee empowerment.

> "...genuinely aligned to the customer's best interest"

The quality of inputs into the process may also need to be refined to ensure there is a genuine assessment of outcomes rather than proxies. For example, whilst complaint data and net promoter score results may indicate customer satisfaction, this may not automatically equate to good customer outcomes being delivered. A customer may, unknowingly, have the wrong product, albeit they are pleased with it and/or do not understand its salient aspects. Greater customer engagement may be needed. The more data and insights a firm gathers, the more likely it is able to identify new innovative solutions to address emerging customer needs and thereby differentiate itself.

Assessment of value

A core aspect of the governance of products or services is consideration of value for the customer. As noted in chapter 1, the pandemic has had an adverse impact on some products' or services' utility and therefore on their value. Customers are the ultimate arbiters of value. Firms should engage with end customers routinely, robustly and objectively in order to assess true value.

In well-functioning markets, with engaged and appropriately knowledgeable consumers, firms can compete on features and benefits of their product or services, as well as the associated costs and charges. In the retail markets, this is highly unlikely to be the case given asymmetries between firms and consumers as regards both information and understanding. These asymmetries may be exacerbated when customers are vulnerable, whether temporarily or permanently.

Where prices in a particular financial sub-sector are known to be relatively inelastic, the exercise of rebalancing value may, in the short term, have a negligible impact on a firm's revenue. Therefore, there is no first-mover advantage in redressing any value imbalance. Firms should instead consider first-mover disadvantage. Further, when determining value, firms may need to consider conceptual questions such as when a charge becomes a penalty – at what point does the charge stop being the cost of administration to complete the request versus a punitive penalty designed to dissuade that decision?

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