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ROBUST PRODUCT GOVERNANCE

A key priority for financial services firms

The mis-selling scandals over the last few decades have prompted regulators to demand better product governance from financial services firms. At the same time customers have become more demanding as they look for products they can rely on to meet their increasingly diverse needs.

Yet many firms still fail to create products that are transparent and appropriate to their target market. So how do you create a robust product governance framework?

Robust product governance: What you should do now

Put customers at the heart of the product lifecycle

Make a review of product governance a high priority

Active involvement by senior management and the Board in product development

Mis-sold payment protection insurance (PPI), interest rate hedging products, packaged bank accounts and structured products – the consequences of poor product governance have severely damaged public trust in the financial services sector. These products were not inherently bad but the governance under which they were created was poor which meant that faults were not identified until customers began to suffer and express concerns.

They all demonstrate the vital importance of having an efficient, well documented and robust product governance structure in place, something that is becoming ever more essential as regulatory pressure increases.

A robust product governance framework is relevant to all products, not just new ones, and the financial services sector faces a particular challenge. Increased competition, in part required by the regulator, as well as technological innovation and demographic changes are creating a demand for new product offerings.

Innovative products are emerging to address issues such as pension reform, the future trading of annuities, lifetime mortgages for consumers trapped in interest-only mortgages, the new Help to Buy ISAs and the expanding army of disruptors such as peer to peer (P2P) lending, including P2P ISAs.

However, growing concern about exposing themselves to new risk is discouraging some firms from creating innovative new products. Additionally the challenge of creating new products to meet a rapidly changing market, while at the same time ensuring that the risks associated with such innovation is managed effectively, underlines the increasing importance of good product governance. Firms need to have in place effective, holistic governance processes in order to manage not only their existing but also their new products.

As well as being a challenge this trend also presents an opportunity. The financial services industry can regain the trust of consumers if it demonstrates a strong commitment to good product and governance. Indeed, if it can become more proactive and take the initiative, rather than simply complying with the demands of the regulators, it can restore confidence and improve its reputation more quickly. Individual firms that can demonstrate excellent product governance and show that they are more transparent with issues such as risk and pricing can differentiate themselves from the competition.

What does a good product governance framework look like?

Clearly the structure of a firm's product approval process will depend on its size and type of business but it will ideally involve: Distribution, Operations, Technology, Legal, Risk, Compliance, Manufacturing, Marketing and Governance. Senior management should take an active role in product development, challenging proposed products when potential conduct risks are identified. These challenges should be documented with an audit trail of discussions referring to potential conduct issues - if it is not documented then it never happened.



Changing customer demographics require a new range of products and, while public distrust of financial services providers is still running high, good product governance can minimise the risk of customers suffering. But this can only happen if firms focus on customers throughout the product lifecycle.



Senior managers should also regularly review new products to ensure that they are still appropriate for the firm and the customers to whom they are being marketed. The Board must also be involved, ensuring that products fall within the firm's strategy and risk appetite and checking product performance data and review results.

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To ensure customers are at the centre of the product development process, firms should ask the following questions:

- How do we assess the needs of our customers?
- How do we manufacture and distribute products? How do we control these activities?
- Which customer segments are our products designed for? Which channels will they be sold through?
- What visibility do the Board and senior executives have of new products launches?
- Which stakeholders are involved in the process and at what stage?
- Who signs off new products? Who has the ultimate decision to 'go'?
- How will staff be incentivised so that what they offer to customers is appropriate?
- How will new products be monitored? Are results that are greater or less than those expected calibrated?
- How are vulnerable customers' interests taken into account during product design?
- How often will product reviews be performed? Who will own that responsibility? What role do the second and third lines of defence play?
- What documentation exists to support product governance? What evidence is there of policies, procedures and education?
- What evidence is maintained and can be easily provided to demonstrate the governance programme and the reasons for specific product or client decisions?

Know your customers

A key FCA requirement is for firms to identify clearly the customer target market(s) and the most appropriate distribution channels when they are designing products. Firms cannot simply continue with creating a product and then deciding who it might right for. Instead, they need to take customers' needs into account during the design stage. This means considering the customer's financial knowledge and sophistication and whether the product should be sold through an advisor or not. The recent FCA Occasional Paper Number 8 on Consumer Vulnerability reminded the industry to consider a broad range of client needs and situations when designing and delivering products.

Considering how to handle customers should be a priority. Firms need to look at:

- complaints procedures
- sales incentives
- distribution model
- pricing
- marketing/promotions
- staff education
- product monitoring processes and related management information

In summary, firms should be evaluating products from the customer's point of view.

The dangers of product creep

In its Thematic Review of Product Development and Governance into Structured Products, the FCA recently warned of “product creep”. This occurs, for example, where the re-pricing of a structured product, savings bond or credit card interest rate may effectively create a new product. According to the FCA, firms should have a review mechanism to prevent “product creep” and to monitor associated customer risks.

Firms must consider at what point making changes to an existing product turns it into a new product. This is a challenging question and the more specific a firm can be to customers and the regulators, the better. Operations and Technology teams can play a key role here, as they are already often involved in tweaking products. When firms are writing new product policies they should include examples of new and existing products to illustrate their points.

Firms need to have in place systems and controls to identify “product creep”, and those that are approaching the limit of the firm's stated risk appetite must be identified and subjected to increased oversight.

Take action now

Firms of all sizes, servicing all market sectors, should make reviewing their product governance processes and controls a high priority. This includes looking at their product development and governance from the customers' point of view. Firms should ensure that the customer needs are at the heart of their products, particularly as they design new ones. As the FCA's former director of supervision, Clive Adamson, noted in a speech in 2014, while firms are in the business of business, customer needs rather than profitability should drive the new product design process.

Firms should ensure their product governance framework has the following components as a minimum:

- A clearly defined business strategy and risk appetite established by the Board with Management Information to monitor compliance.
- A senior executive responsible for new product governance – with sufficient gravitas to hold all of those involved to account for their actions.
- Clearly documented Product Approval Policies and Procedures, made available to all staff.
- Documented discussions involving senior management about new and existing products.
- Procedures for Distribution, Risk and Operations, Legal, Operational Risk, Compliance, Manufacturing, Marketing and Governance teams to sign off products before they are launched.
- Demonstrable evidence that the customers' needs have been considered throughout the process.
- The capability to stress test products to establish how they work in different economic conditions.
- Post-launch product monitoring against predefined benchmarks and thresholds.
- Long-term product reviews and lessons learnt built into the approval process to improve overall governance of new products

Summary

In order to succeed today companies in the financial services sector need a strong product approval and monitoring structure. Poor product guidance can lead to regulatory fines, remediation and additional reputational risks. All of this can be avoided when firms put suitable processes and controls in place.

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