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Management Information for
Conduct Risk

Underpinning better decision-making



Executive summary

The concept of “conduct risk” has risen to the top of firms’ and regulators’ agendas in recent years. In the UK, the FCA expects conduct risk management to be embedded into firms’ risk management frameworks, supported by appropriate management information (MI).

The upcoming Senior Managers Regime (SMR) and Senior Insurance Managers Regime (SIMR) will amplify the focus on personal accountability, and the right MI will help Senior Managers discharge their responsibilities. Conduct risk and MI are also increasingly in focus in the EU and internationally. Effectively managing conduct risk is not only a regulatory imperative but also brings business benefits. It can help to avoid potential conduct costs such as fines, redress, legal fees, or reputational damage, as seen in recent mis-selling and benchmark manipulation scandals. Furthermore, effective MI can help senior management to understand client needs and behaviours, driving commercial benefits as well as building trust.

It is important that individual firms have a consistent understanding of conduct risk and what conduct risk MI is intended to deliver within their organisation. Conduct risk MI should bring together a series of indicators, specific to the organisation, covering operational technology, market propositions, conduct, behaviour, culture, breaches of policies or regulations, as well as the effectiveness of conduct risk mitigants and controls.

Both retail and wholesale firms across the financial services sector have made progress in embedding conduct risk within their risk management frameworks, and have sought to improve associated MI. However, there are still several areas where firms can continue to make improvements. Building on current regulatory and supervisory expectations and our experience of what works well in practice at firms, we have identified 10 principles of strong conduct risk MI (see pages 6-7). Whilst the precise way that firms achieve strong conduct risk MI is unique to them, we believe that the 10 principles serve as a sound foundation for conduct risk MI across all financial services firms.

The principles should be underpinned by robust and clearly articulated governance, culture, and capabilities. Firms should ensure that there is a documented governance framework for conduct risk MI and the Board and senior management should seek to instil a culture where conduct risk is given the same prominence as other risks. Staff need to have the right skillset and firms need to ensure that the processes by which they source data and information are as streamlined as possible. Investing in technology can enable increased automation to report, govern and aggregate conduct risks on both a periodic and ad hoc basis. Analytics, when used effectively, can also be a powerful tool to highlight risks often obscured by large data volumes.

In putting the principles into practice, there are a number of steps that firms can take to get started. They can establish a governance framework and conduct a stock-take of existing MI governance arrangements and the data and information collected to populate MI, using our 10 principles as a guide to identify areas of weakness in conduct risk MI. They need to review and determine conduct risk appetite, key risk indicators, metrics and thresholds and establish a consequences framework for when MI thresholds are triggered. Sourcing the data and information needed to populate MI and deciding on the process for analysing and presenting MI is important. Finally, firms need to continue to work on effective conduct risk MI, as they are unlikely to get it right first time.

In this paper, we provide an overview of the expectations and advantages of conduct risk MI; discuss the progress the industry has made on developing it; set out our 10 principles for achieving strong conduct risk MI and the governance, culture and capabilities that underpin them; and then put the principles into practice. This paper is relevant for firms across all sectors in the financial services market and for both retail and wholesale activities.

Both retail and wholesale firms across the financial services sector have made progress in embedding conduct risk within their risk management frameworks, and have sought to improve associated MI. However, there are still several areas where firms can continue to make improvements.

Expectations and advantages

In the UK, the effective management of conduct risk is central to the FCA's supervisory approach. The FCA expects conduct risk management to be embedded into firms' risk management frameworks, supported by appropriate MI.

The SMR and SIMR will increase personal accountability in banks and insurers, making it even more important that MI provides Senior Managers with sufficient comfort that they have discharged their duties effectively. Conduct risk and MI are also increasingly in focus in the EU and globally, with Australia and South Africa, among other countries, looking to developments in the UK when setting their local agendas. Figure 1 provides an overview of regulatory and supervisory expectations in relation to conduct risk MI.

Effectively managing conduct risk is not only a regulatory imperative but also brings business benefits.

Effective MI empowers firms to allocate resources appropriately to address and quickly resolve emerging and crystallised conduct risk and to help avoid potential conduct costs such as fines, redress, legal fees, or reputational damage, as seen in recent mis-selling and benchmark manipulation scandals. Responding quickly to conduct risks allows firms to demonstrate that good client outcomes and market integrity are at the heart of their business. This is now an expectation of both regulators and clients. Furthermore, effective conduct risk MI provides senior management with a clearer view of what clients want and need, so that they can respond better to issues, helping to restore and build trust. All this underpins a firm's competitive advantage in the marketplace.



Figure 1

Regulatory and supervisory expectations in relation to conduct risk MI

UK

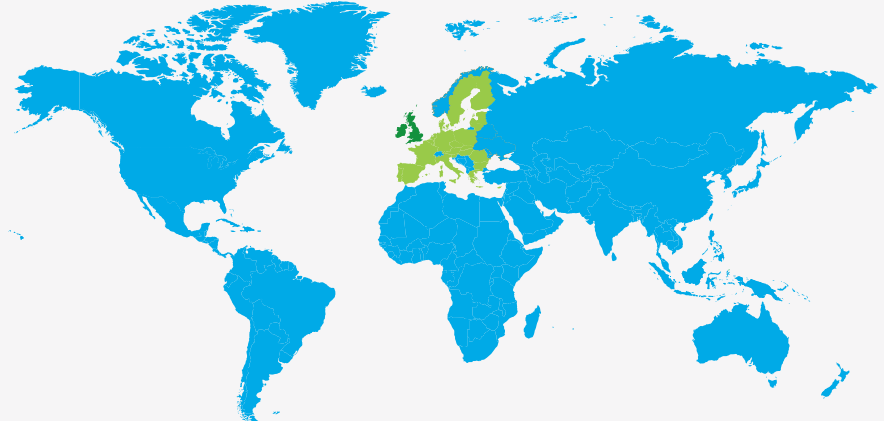
- FCA requirements in relation to MI and conduct risk MI stem from the FCA's Senior Management Arrangements, Systems and Controls (SYSC) Sourcebook: "a firm's arrangements should be such as to furnish its governing body with the information it needs to play its part in identifying, measuring, managing and controlling risks of regulatory concern", which include "those risks which relate to the fair treatment of the firm's customers, to the protection of consumers, to effective competition and to the integrity of the UK financial system"¹.
- The Financial Services Authority's (FSA) 2007 Treating Customers Fairly – guide to management information² remains relevant and sets out examples of good and poor MI. For example, "TCF MI should generally focus on how far a firm is delivering the TCF consumer outcomes rather than measuring processes" and "MI on customer satisfaction may be indicative of fairness. However it does not demonstrate fairness" as "customers can be satisfied with unfair treatment and dissatisfied with fair treatment".
- While the published rules and guidance have not changed significantly in recent years, firms have been made aware of the FCA's expectations in relation to conduct risk MI through their supervisory interactions e.g. through supervision via the Firm Systematic Framework or thematic reviews. Conduct risk management is central to the FCA's supervisory approach. However, this supervisory shift from the TCF regime to conduct risk more broadly may be less apparent to smaller firms who have relatively less interaction with the FCA.
- The upcoming transition to the SMR³ and the SIMR⁴ from the current Approved Persons Regime (APER) will increase personal accountability at banks and insurers respectively. Those in Senior Management Functions will be assigned specific responsibilities and, as a result, we expect Senior Managers to seek increased comfort, including through high quality MI, that they are effectively discharging their duties and can demonstrate that they have taken "reasonable steps" to do so.

EU

- While the UK has so far led the way on conduct risk, changes being introduced at the EU level will make conduct risk MI a more familiar and important concept across Europe.
- The revision to the Markets in Financial Instruments Directive (MiFID II) will strengthen governance requirements for investment firms and require that "members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making"⁵.
- Product governance rules and guidance are being introduced across sectors that stress the importance of ensuring that products are sold to their target market. The European Securities and Markets Authority (ESMA) set out in product governance advice in MiFID II that information about the products a firm manufactures and its distribution strategy should be systematically included in compliance reports to the management body⁶.
- Principle 7 of the European Supervisory Authorities' (ESA) joint position on manufacturers' product oversight and governance processes stated that "the manufacturer should monitor periodically the functioning and operation of the product to ensure that it continues to meet the objectives and interests of the target market and should, where appropriate, review the product to ensure compliance"⁷.

Global

- At the international level, the FSB has set out expectations in relation to conduct risk in its work on risk culture⁸. Further, in its peer review report on risk governance, the FSB identified business conduct as a new risk category⁹ and the FSB's principles for risk appetite frameworks stated that risk appetite statements should "address more difficult to quantify risks such as reputation and conduct risks"¹⁰.
- The South African Financial Services Board has implemented a 'Treating Customers Fairly' regime. As part of this, firms are required "not only [to] have effective MI in place, but also to show that they have analysed the MI they have gathered to identify TCF risks and areas for improvement and acted upon these findings to enhance their customers' experience". Firms should respond to "changes in the broader environment" and "proactively identify conduct risks and pre-empt possible unfair outcomes, or at least respond promptly where adverse customer impacts arise"¹¹.
- The Australian Securities and Investments Commission (ASIC) published a Risk Outlook¹² and Strategic Outlook¹³, highlighting concerns in relation to conduct risk, such as weak compliance systems, poor cultures, unsustainable business models and conflicted distribution resulting in poor advice, mis-selling and investor loss.



What is conduct risk MI?

The FCA has deliberately not set out a “master definition of conduct risk”, stating that “a firm’s conduct risk profile will be unique... there is no one-size-fits-all framework that can be put in place to assess it”.¹⁴

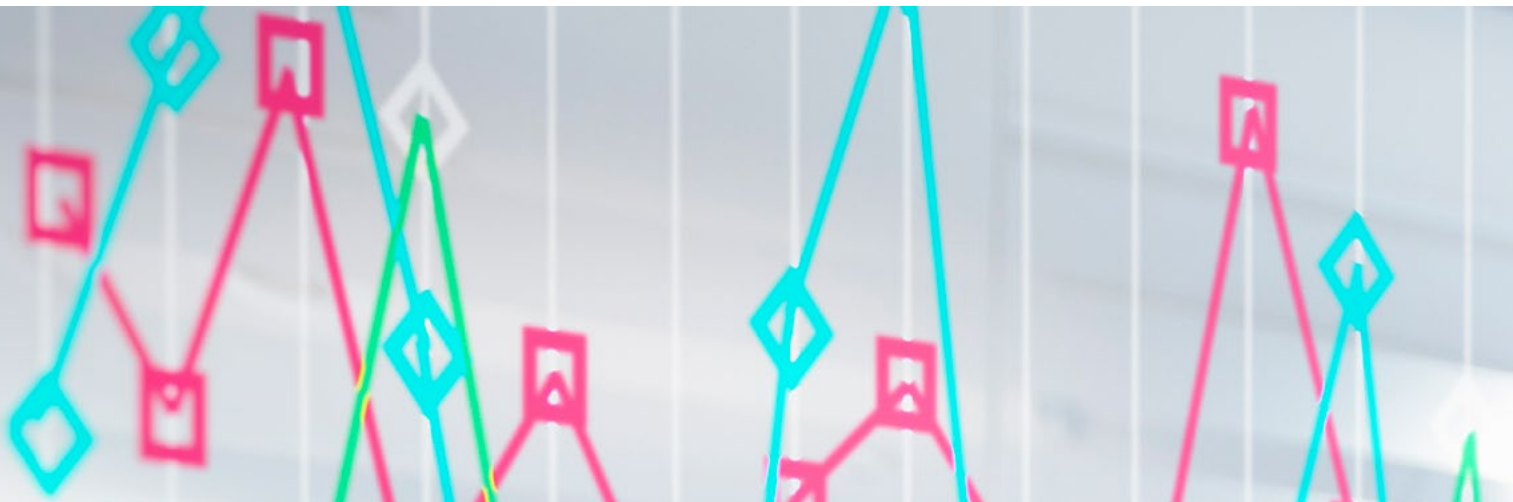
This policy is intended to allow firms the flexibility to articulate what conduct risk means to them and produce MI which is relevant for their own business models and the inherent risks that arise from them. It is important that individual firms have a consistent understanding of conduct risk and what conduct risk MI is intended to deliver within their organisation, although this can be particularly challenging where firms operate a number of distinct business units across different jurisdictions.

Conduct risk is broader than ‘Treating Customers Fairly’, since it focuses on risks to market integrity and to client outcomes in both the retail and wholesale sectors, and should go beyond measuring compliance with conduct of business requirements.

It should also not be confused with reputational or operational risk, which measure potential damage to the firm, rather than potential damage to the client or market integrity. Conduct risks arise across business and operating models and are strategic (e.g. reliance on cross sales), financial (e.g. dependency on high margin products), infrastructural (e.g. risks from outsourcing or IT) or behavioural (e.g. poor incentives) in nature.

Reflecting this, conduct risk MI should cover operational technology, market propositions, conduct, behaviour, culture, breaches of policies or regulations, as well as the effectiveness of conduct risk mitigants and controls. While conduct risk itself cannot be priced and hedged in the same way as other risks, such as market or credit risk, firms can determine a set of key conduct risk indicators and underlying metrics, specific to their organisation, which can be quantified and measured.

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State of the industry

Both retail and wholesale firms across the financial services sector have made progress in embedding conduct risk within their risk management frameworks, and have sought to improve associated MI. However, there are still several areas where firms can continue to make improvements.

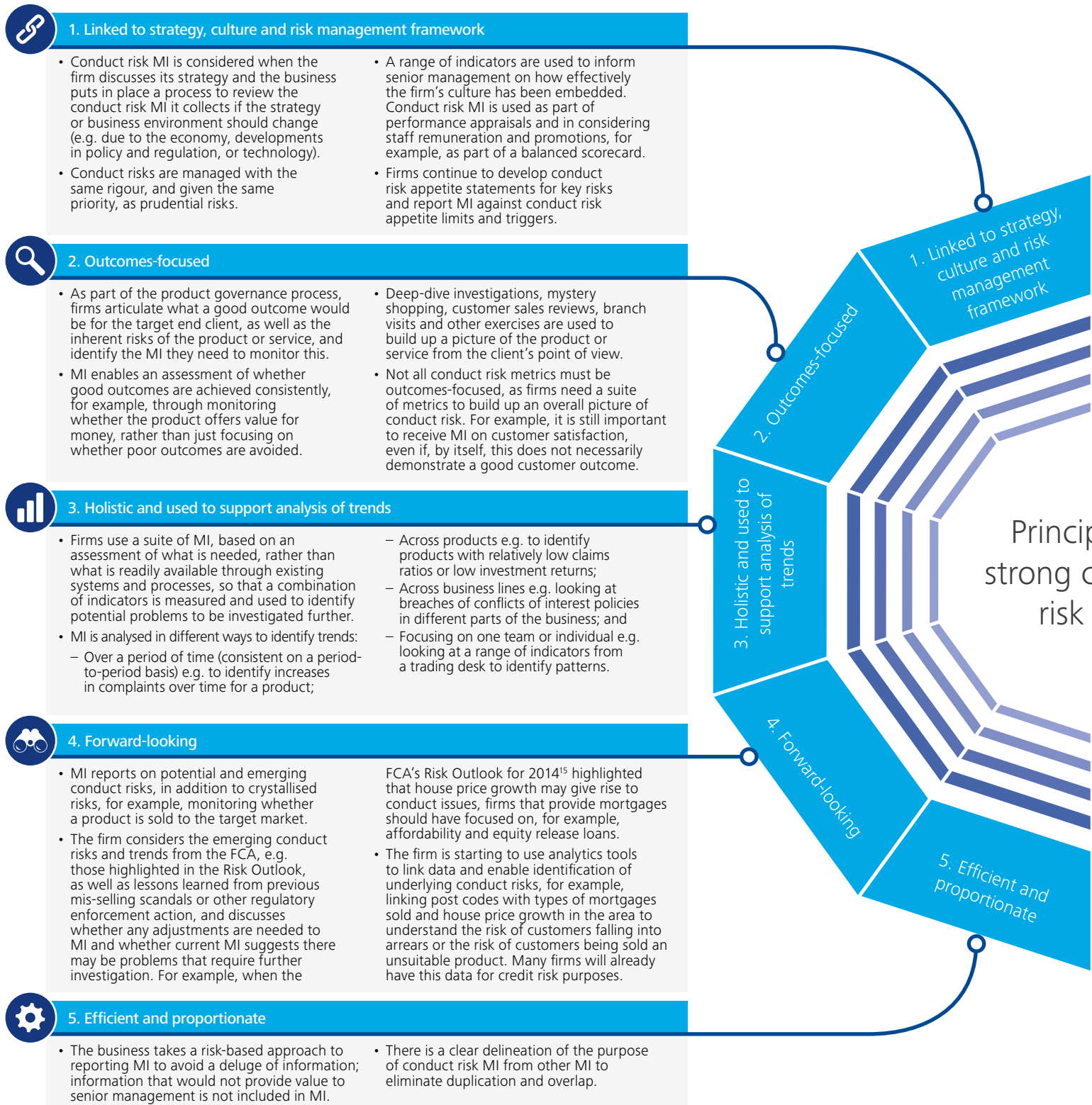
- **Tone from the top.** Senior management often perceives an inherent conflict between commercial drivers and achieving good outcomes for clients. Such a trade-off is much less likely in the medium-term, and it is important to consider conduct risk MI without being influenced by short-term commercial or profit and loss considerations.
- **Deluge of detail.** Typically, firms' senior management receives large MI packs containing a multitude of documents and data from which key conduct risks are not readily discernible. This makes it difficult for Senior Managers to identify key issues and take meaningful action.
- **Reporting against conduct risk appetite.** For conduct risk MI to be relevant and meaningful for senior management, it should be reported against the firm's conduct risk appetite in a systematic and measurable way. However, many firms are still struggling to articulate what their conduct risk appetite is and how they can measure it.
- **Achieving outcomes-focused and forward-looking MI.** Firms often package up data and information that is readily available, for example on complaints or sales, as conduct risk MI. However, strong conduct risk MI should provide evidence of good client outcomes and identify potential and emerging conduct risks. Such data may not have been provided already for other purposes.
- **Business buy-in.** There is often confusion within firms about who owns conduct risk MI, making it harder to engage business lines sufficiently on conduct risk. First line business units should be responsible for MI in relation to the risks they manage with their clients, with oversight and challenge from the Risk and/or Compliance Functions.
- **Technology.** In many instances, firms are drawing on multiple legacy systems to pull together conduct risk MI, which is often a very resource hungry and manual process, with many firms reluctant to make investment in systems. However, firms can reap significant benefits from simpler IT architectures, making it easier to extract MI and make future changes to systems as required due to regulatory change.



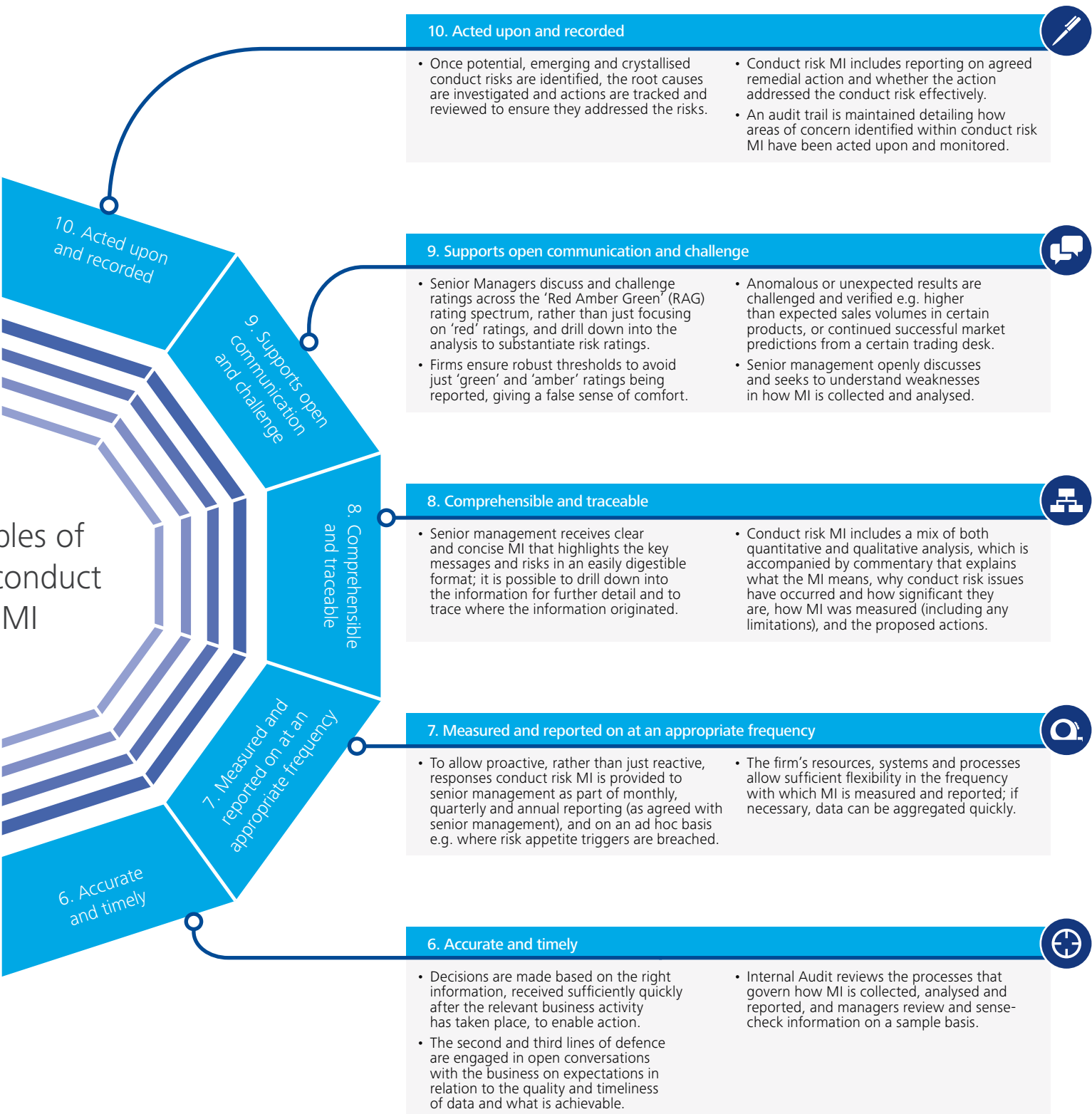
What firms should be doing – our 10 principles of strong conduct risk MI

Building on current regulatory and supervisory expectations and our experience of what works well in practice at firms, we have identified 10 principles of strong conduct risk MI. Whilst the precise way that firms achieve strong conduct risk MI is unique to them, we believe that the 10 principles serve as a sound foundation for conduct risk MI across all financial services firms.

Figure 2. What strong conduct risk MI looks like: examples of good practice against the 10 principles



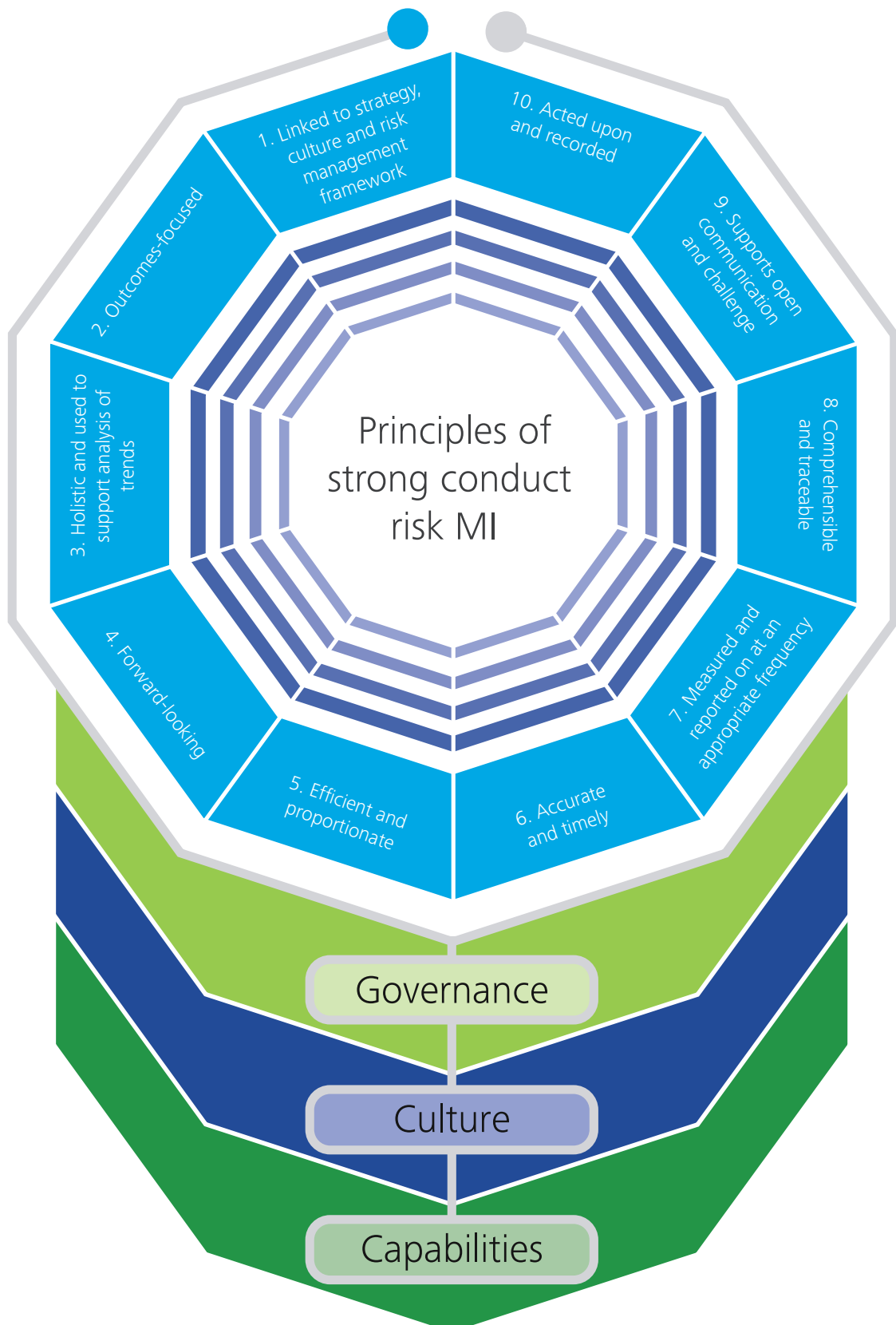
Principles of Conduct MI



Governance, culture and capabilities

The foundation upon which strong conduct risk MI is built

Figure 3



In order to achieve strong conduct risk MI, firms need the right governance, culture and capabilities in place.

Governance

Firms should ensure that there is a documented governance framework setting out clear roles and responsibilities with respect to conduct risk MI. This should include a consequences framework, which documents the actions that should be taken when risk appetite limits or other thresholds are triggered.

The business should be responsible for reporting on the conduct risks generated by its activities, while the Risk (including Compliance) Function should be responsible for reporting on MI related to their activities, for example, the effectiveness of conduct risk controls or adherence to policies.

The Risk Function should monitor and oversee the MI process. Both the business and the Risk Function should feed into the process of defining risk appetite, key conduct risks and metrics, as well as analysing, prioritising and providing commentary on MI before it goes to the Board, for example, through a joint committee. The business should lead this process. However, in the initial phase of setting up a conduct risk framework, it is common for Risk and Compliance to lead the way, and then hand over the ongoing identification and monitoring of conduct risk to the business as part of implementation.

Internal Audit should undertake periodic reviews to ensure that the governance process is documented, and that there is an audit trail demonstrating sufficient challenge and analysis by the business and the Risk Function, with evidence of completed actions that have addressed the root causes of any crystallised conduct risks.

Culture

The Board and senior management need to instil a culture which gives conduct risk the same prominence as other risks, and which emphasises the importance of medium-to-long-term profitability, taking into account the possible impact of conduct risk. This culture should be embedded throughout the organisation. Conduct risk MI should support this by reporting on the extent to which a culture that supports good client outcomes and market integrity has been embedded within the firm. Tone from the top needs to lead to actions elsewhere in the organisation.

Staff in the business need to take ownership of and responsibility for conduct risk management and for delivering strong MI. This cultural shift can be achieved through increasing personal accountability across the firm, and through linking remuneration and incentives to the management of conduct risk. One way to do this is through considering MI on performance alongside conduct risk MI as part of a balanced scorecard, something many firms are already doing.



Capabilities

Firms must consider the people, processes and systems that are required to deliver strong conduct risk MI. First, staff need to have the right skillset. Those in the Risk and Compliance Functions need to have an understanding of the business environment and commercial drivers to effectively support and challenge the business. Those in the business need to be trained on and understand conduct risk and regulatory expectations. To understand the risks being measured and to challenge internal assessments as needed, the team preparing and collating MI requires a balanced skillset of data and analytical skills in addition to operational knowledge of front to back processes. This involves commitment by firms to train both those contributing directly to conduct risk MI and those who pose the highest level of conduct risk, usually front-office staff and/or those in client facing roles.

Once firms have decided on the key conduct risks which should be monitored and the appropriate metrics, they should focus on trying to ensure the processes by which they source data and information are as streamlined as possible to improve accuracy, consistency and timeliness. Many firms operate numerous legacy systems with piecemeal IT solutions inconsistently implemented across

business lines, which makes this particularly challenging. Investing in technology can enable increased automation to report, govern and aggregate conduct risks on both a periodic and ad hoc basis. This allows focus to shift from the sourcing and manual collection of data to the analysis of results and root causes, enabling more forward-looking conduct risk MI. It also enables improved conduct risk surveillance, for example, of behaviour, communications or trading, as well as increased use of risk assessment tools and product approval workflows with in-built system controls.

Analytic tools use a range of data-driven approaches that, when combined with deep business and sector knowledge, can highlight risks often obscured by large data volumes. The analysis draws on a range of data sources within the firm and potentially from external sources to establish insights that provide a comprehensive assessment of conduct risk. Using these tools supports Senior Managers in identifying key issues, assessing how material each one is and focusing time and attention accordingly. They can also drill down for further detail, trace where the information originated, the risk owner, and the steps it went through before it reached senior management.



The following outlines examples of poor MI that the FCA found with respect to payment protection insurance (PPI) mis-selling and best execution respectively.

Figure 4

PPI mis-selling

As at Q4 2014, the amount paid out in redress to customers with respect to PPI since January 2011 was £18bn.¹⁶ As early as 2005, the former regulator, the FSA, stated in the context of PPI that “the extent and use of management information to identify potential systems and controls problems varied greatly in large firms and was generally poor or non-existent in medium-sized and smaller firms...”¹⁷ It highlighted the following issues with respect to MI:

- Focus by Boards on sales figures rather than MI on the quality of the sale
- MI collected on an ad hoc and reactive basis, responding to problems only when they had crystallised
- Even where MI was collected, some firms did not use it to identify compliance issues
- Firms did not fully exploit their IT resources to validate compliance e.g. not building in eligibility checks for PPI into systems so that customers that would be unable to claim under the policies would be automatically rejected.

According to the FCA, firms could have improved their MI by contacting customers to find out why they had cancelled PPI policies and using this information to improve products or processes where necessary, and through root cause analysis of cancellations and complaints.

While a number of factors contributed to PPI mis-selling, strong conduct risk MI could have highlighted issues before they had crystallised. Firms could have been more proactive in their analysis of conduct risk MI, for example, looking at the value for money of PPI. Questions should have been asked about a product that resulted in significant reported profit and had a low claims ratio. MI would need to have been supported by the right governance, culture, and capabilities. For example, one of the issues regarding PPI was mindset. Firms were not used to looking at customer treatment through the lens of seeking to ensure good customer outcomes, and when problems did emerge many firms sought to “paper over the cracks”, trying to justify the sales, rather than ending them quickly. Staff were also incentivised on sales volumes, rather than fair customer outcomes.

Best execution

A FCA thematic review on best execution and payment for order flow¹⁸, published in July 2014, identified a “significant risk that best execution is not being delivered to all clients on a consistent basis”. As part of this, the FCA found that most firms lacked effective monitoring capability and “it was often unclear how monitoring was captured in management information and used to inform action to correct any deficiencies observed by firms”. In most firms, MI did not evidence how real-time monitoring of execution effectively supported the delivery of best execution and, even where MI did exist, firms were generally unable to demonstrate the escalation of best execution issues arising from real-time monitoring or how real-time monitoring may have improved execution quality for clients.

Best execution continues to be a supervisory priority, both in the UK and the EU, particularly as firms begin to implement strengthened best execution rules under MiFID II. Getting MI right on best execution is important for firms in evidencing that they are meeting regulatory requirements and client expectations.

Putting our 10 principles into practice

We have set out our 10 principles of strong conduct risk MI and the governance, culture and capabilities that should underpin them, but how can firms start to put these principles into practice?

Typically, firms need to identify their key conduct risks and articulate their conduct risk appetite against these risks. They also need to identify underlying metrics for each key

conduct risk and set thresholds, which will trigger escalation when breached. For example, a firm may decide that two of its key conduct risks are value for money and conflicts of interest. The table below illustrates examples of metrics to consider.

Figure 5

Example key conduct risk	Example metrics
Value for money for customers	<ul style="list-style-type: none"> • Percentage of successful claims on insurance products • Percentage of cancelled products • Usage of product • Investment return post costs and charges
Conflicts management	<ul style="list-style-type: none"> • Number of breaches of conflicts of interest policies • Percentage of near misses on breaches • Percentage of late reporting of conflicts of interest • Number of new conflicts identified • Number of whistleblowing reports



There is no one right approach for determining a firm's conduct risk appetite, key conduct risks, metrics and thresholds. Some firms prefer to take a top-down approach, starting with high-level conduct risk appetite statements, while others prefer to take a bottom-up approach, starting with the key conduct risks and metrics for individual products. Firms will need input from across the firm, from senior management, to front-line business staff, to those in Risk and Compliance. Firms are unlikely to get their MI right first time and may need a number of iterations to determine what should be measured and to calibrate triggers and thresholds.

How MI is presented depends upon the audience. Dashboards that set out current and past performance of metrics against thresholds across key conduct risks, alongside commentary, are a useful way of displaying information. Scorecards that combine metrics across key risk indicators for a particular team or individual are also useful in providing a holistic picture of conduct risks. In practice, firms should not always stick rigidly to one way of presenting information, but consider how best to present it once the information has been analysed. For example, senior management may be unclear about what decisions they should make if they are presented with a dashboard where the majority of metrics have received an 'amber' RAG rating, which could easily happen in large organisations where lots of information is aggregated. It could be helpful to cut the information in different ways (e.g. by country, branch, or product) and to supplement it with commentary. It is also important for the producers and users of the data to communicate effectively, so that the former are clear about what the users are looking for, and the latter understand some of the limitations of the data with which they are provided.

Below we set out some steps that firms can take to get started in achieving strong conduct risk MI.

Figure 6

1	Establish an overall project plan and governance framework
2	Conduct a stock-take of existing MI governance arrangements and the data and information collected to populate MI
3	Use our 10 principles as a guide to identify areas of weakness in conduct risk MI
4	Review and determine conduct risk appetite, key risk indicators, metrics and thresholds
5	Establish a consequences framework for when MI thresholds are triggered
6	Source the data and information needed to populate MI, focusing on improving processes and leveraging technology
7	Decide on the process for analysing MI and the presentation of MI; firms should consider the role of analytics in helping to determine the root causes of identified issues
8	Embed effective conduct risk MI, focusing on firm culture and staff capabilities

Firms are unlikely to get their MI right first time and may need a number of iterations to determine what should be measured and to calibrate triggers and thresholds.

Conclusion

UK, EU and global regulators and other stakeholders are placing increasing emphasis on the management of conduct risk within financial services firms. Central to this is that the right MI is reported to firms' senior management so that they can ensure and evidence the effective management of their firm.

The upcoming SMR and SIMR are likely to change the mindset of senior individuals within firms. There will be a greater focus on individual accountability of Senior Managers if things go wrong and strong conduct risk MI will help individuals to demonstrate that they have taken reasonable steps to understand conduct risks and that they have put in place proportionate controls to mitigate the risks. Firms need to review their MI to ensure that the right information is captured and escalated to senior management and the appropriate governance committees.

It is therefore essential that firms consider the current state of their conduct risk MI arrangements. Based on our experience of working with firms from across the industry, we are aware that many firms still face a number of challenges in achieving strong conduct risk MI. The 10 principles that we set out in this paper are intended to guide firms as they continue to embed conduct risk into their risk management frameworks. Whilst the precise way that firms achieve strong conduct risk MI will be unique to them, we believe that the 10 principles serve as a sound foundation for conduct risk MI across all financial services firms.

We also suggest three areas in which firms should start to seek investment and take practical steps to implement our principles: in their governance, culture and capabilities. Whilst we recognise that improvements will take time to implement, regulators already expect to see strong conduct risk MI in firms, and therefore firms cannot afford to delay. Senior Managers who fail to make progress in achieving strong conduct risk MI will ultimately fail in arming themselves with evidence of 'having done the right thing' in a world where they face increased personal accountability for issues taking place within their firms. More importantly, however, conduct risk MI is essential for better decision-making in advance of any problems. By getting this right, improvements in governance and culture will translate into better outcomes for clients, and for the firms themselves in the long-run.

Endnotes

- 1 [FCA/PRA Handbook, SYSC 3.2](#)
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