Conduct Risk – Lessons from UK

Don Johnstone

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Agenda

1. What is conduct risk?
2. Why is conduct in the spotlight?
3. What can go wrong?
4. What are firms doing about conduct?
5. How can actuaries get involved?

Conduct risk – what is it?

Conduct risk for your organisation

To be addressed effectively, conduct risk needs to be specifically defined for your organisation, taking into account activities, staff and customers

Conduct risk generally

Conduct risk is the risk of not meeting expectations that customers' interests come first

- Expectations can be regulatory, societal and/or contractual
  - Typically covers market integrity as well as investor/customer protection

New or old?

- Covers existing expectations
- Regulatory, societal and/or contractual expectations may not have previously been brought together
- Intensity of focus is new

Why is conduct in the spotlight?

High-profile misconduct

Financial System Inquiry

Off-shore focus (e.g. FCA)

Fines and enforcement

Senate Inquiry into the Scrutiny of Financial Advice

Changing ideas of investor capability

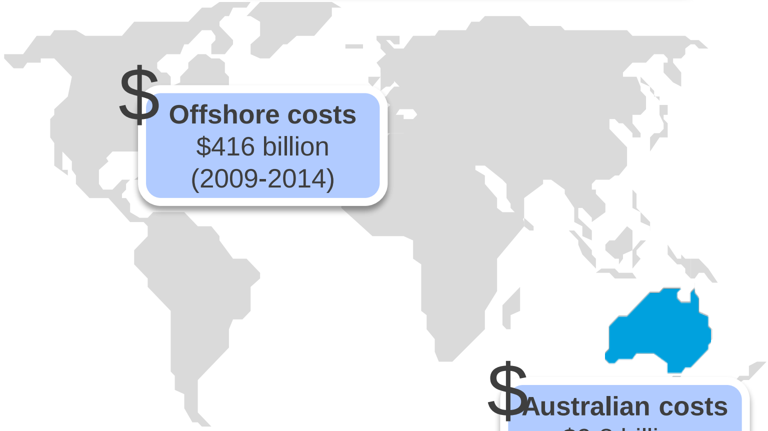
APRA focus on culture, governance and incentives

Changing regulatory toolkit including more use of data analytics

ASIC Thematic Focus

- Interest Only Loans
- Advice
- Product value to customer
- Life insurance claims

Media scrutiny and coverage



$ **Offshore costs**
$416 billion
(2009-2014)

$ **Australian costs**
$9.8 billion
(2009-2014)

Costs source: CCP Research Foundation, Conduct Cost Project; http://conductcosts.ccpresearchfoundation.com/index

What can go wrong?

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Someone at some point decided to do the wrong thing for their customers, often because they were incentivised to do the wrong thing and put personal / shareholder interests ahead of those of customers

MIS-ALIGNED INCENTIVE STRUCTURES

ASIC remains concerned about the incentive structures financial institutions use. A key theme of the big scandals in the UK around the mis-selling of add-on insurance has been incentive schemes where staff were incentivised for sales volume rather than fair customer outcomes.

INAPPROPRIATE PRODUCTS

ASIC has long been concerned about products that perform poorly. Collapsed managed investment schemes and share investment arrangements, coupled with innovative and complex products like contracts-for-difference, have caught the attention of the regulator; so too in recent months life insurance policy and claim definitions.

DISPROPORTIONATE REVENUE

The unfair fees class actions are among the biggest in Australian history. These focus on fees that are disproportionate to actual costs for minor transgressions by customers. 30,000 customers could share in up to $40million compensation.

ASIC also investigated consumer credit and add-on insurance in part due to the low loss ratios.

Subsequent, less obvious issues that are not usually the initial cause of a customer complaint, but get discovered during the remediation process.

- Poor internal management of responsibilities
- Particular advisers exhibiting bias and lack of proper training

Drivers of poor conduct – insurance

Examples of poor conduct in insurance have been highlighted by the following issues:

Suitability

Lack of customer understanding

- Customer is sold a product they do not fully understand
- Bundling (e.g. with banking / credit products)
- Lack of clarity on cover, claims handling etc…
- Don't meet needs and demands

Customer is sold an unsuitable product

- Oversight/ management of distribution channels
- Ability to evidence customer needs and ascertain eligibility
- Cross coverage sales (e.g. mobile phone insurance, travel insurance etc.)

Premiums and fees

Fair value exchange

- Firm is unable to justify the premiums and/or fees charged
- Pricing and ability to evidence a fair value exchange (e.g. for inexpensive insurance products with low claims rates)

Disclosures

Terms and conditions

- Product sold does not match T&Cs description
- Various issues around renewal restrictions (e.g. pet insurance)
- Customers fail to understand what they are buying and whether it is suitable for them

Process

Systems & Controls

- Failure in systems and controls to ensure that risks of customer detriment are measured and monitored and issues are identified and resolved
- Organisational culture not consistent with desired conduct
- Staff incentivised on sales volumes rather than fair customer outcomes

Emerging conduct issues

As expectations are changing there are emerging themes that need to be considered and addressed by all providers of financial products and services.

Good customer outcomes	Value for money	Equality	Customer data
Focus on good customer outcomes	**Demonstrate value for money of products**	**Ensure universal access to insurance**	**Protection of customer data**
A focus on good customer outcomes, rather than on actions taken by regulated entities to influence those outcomes. Following the rules is not enough.	Defining and proving the value for money of products. Both price and value need to stand up to intense public scrutiny.	Pressure to ensure greater equality. This would involve managing the trade-off between individual underwriting and pooling of risks to ensure universal access to insurance, and reducing discrimination between groups or types of customers	Setting the boundaries for the use and management of customer data to ensure that technological progress does not outstrip regulators' and customers' appetite for intrusion

Responding – redesigning products that are unsuitable for most customers

PAYMENT PROTECTION INSURANCE (PPI)

Payment protection insurance is in itself a useful product that meets a genuine need, but in the UK the premiums for this product were routinely far more expensive (around 5 times more) than they should have been.

This product requires a pricing redesign.

HEALTH INSURANCE

Customers obtain separate cover for a wide array of particular illnesses or circumstances, e.g. if they are injured at home, or at work, or have a specific type of heart attack, but not if they get injured doing a particular activity.

The products are designed more around funding mechanisms rather than customer needs.

DIGITAL SWAPS

A significant source of complaints in the UK, with very complex and costly remediation, generating huge costs for the industry.

Effectively a gambling tool that provides a type of protection virtually no-one actually needs.

Responding – product governance

	PRE-SALE	POINT OF SALE	POST SALE
PEOPLE	Who participates in the design of products?	What training or product knowledge do you provide to sales staff?	What training or product knowledge do you provide to claims staff?
PRODUCTS	How are customer needs identified? Does the design process include stress testing and modelling for performance?	How do you ensure the right products reach the right customers?	How is the performance of products monitored after issuance? Is this fed back into the product creation process?
PROCESSES	What kind of new product approvals process do you have in place, and how effective is it?	How do you monitor for alignment between customer and product?	What kind of procedures do you have for keeping customers informed and ensuring the advice and products remain relevant?
CULTURE	How do you ensure that your staff appreciate their role is to facilitate the meeting of peoples' financial needs and are aware of and consider risks in their daily operation?		

Responding – conduct risk framework

There are a number of key steps required to achieve a fit-for-purpose framework that manages conduct risk...

Steps to building a fit-for-purpose conduct risk framework

Define conduct risk

1. Define what conduct risk means in the context of the business
2. Identify conduct risk points throughout the organisation and across value chain

Assess

3. Identify gaps in current arrangements to highlight areas where current practices are not in line with the direction of the firm

Respond

4. Consider and prioritise remediation or enhancement of key focus areas identified in the gap analysis
   - Use behavioural economics to shape the right decisions
   - Create the right organisational culture
   - Use compliance rules focused on what must go right

Implement and Monitor

5. Develop and implement roadmap of actions to achieve desired outcomes
6. Measure, monitor and evidence the embedding and effectiveness of activities undertaken

   &

   Continually reassess and refine current arrangements

Conduct risk framework – challenges and considerations

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Steps to building a fit-for-purpose conduct risk framework

1 2 — **Define conduct risk**

- How broad or narrow should the definition of conduct risk be?
  - Conduct risk is harder to manage if broadly defined.
- The link between conduct risk and potential losses needs to be clearly communicated and appreciated by staff. Conflicting messages can cause confusion and an inability to buy-in.

3 — **Assess**

4 — **Respond**

- Balancing the need for incentives that encourage productivity and profitability but which do not drive the wrong conduct behaviour.
- Difficult to keep up with regulatory change and embed regulatory change cost effectively.
- Solutions can be complex and poorly received. Staff may exhibit inertia to redesign processes. Culture is embedded and difficult to change.

5 6 — **Implement and Monitor**

- Is conduct risk a new risk category and, if so, who is the owner of the risk?
- How do you measure and monitor good outcomes for your customers and know the framework you have in place is working?
- How do you use internal and external data to understand and analyse your conduct risk?
- How do you get a holistic view of conduct risk across the organisation?

Responding – remediation process

Customers identified and remediation principles/governance process drafted

Payment Protection Insurance (PPI)	Interest Rate Derivatives (IRDs)
• Scenario identification • Design specification of calculator • Calculator built • Calculator validation • Redress quantification	• Sophistication assessments • Customers invited to join review • Customers opt in • File review • Redress compliance determination • Redress quantification • Consequential loss assessment

Redress determination letters sent and offers accepted

- PPI: simple remediation process which can be “industrialised”.
- IRDs: complicated, tailored approach (case by case). Every case is overseen and verified by an independent reviewer. Consequential losses are a resource-intensive feature of IRD remediation.

Opportunities for actuarial involvement

Observation: UK financial institutions have paid far more in remediation to customers and invested far more in fixing conduct risk frameworks than in Australia.

Question: Is Australia squeaky clean or is our focus on conduct risk lagging?

Opportunities for actuarial involvement:

- Determining high risk areas to be the focus of reviews
- Providing balanced, objective challenge from a customer's perspective
- Designing products that meet customer needs and expectations
- Building & validating calculators for industrialised remediation
- Reviewing evidence surrounding point of sale for complex financial instruments
- Data analysis to identify level of sophistication of customers
- Data analysis of customer behaviours to validate assumptions around what would have happened if poor advice had not been given or a product been mis-sold
- Articulating or challenging remediation principles
- Quantifying impact of past and future conduct risk events

Contact details
Don Johnstone
djohnstone@deloitte.com.au
0447 127 571