Conduct Risk - Regulatory Developments and Best Practices for UK Life Insurers

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Introduction

Conduct risk can be described as the risk to consumers, insurers and the insurance market as a whole that a firm's behaviours will result in poor outcomes for customers. Although few would debate the importance of recognising and addressing conduct risk, the recent increased attention it has received within the financial services industry has been largely driven by ever-strengthening conduct of business supervision.

The introduction of Solvency II has marked a clear departure from compliance-driven approaches towards an approach that is led from the top, embedded in the frontline and driven by judgement. With the ultimate objective of a prudential framework such as Solvency II being the protection of policyholders, there is a clear link between conduct and prudential issues. Indeed, conduct incidents such as the Payment Protection Insurance mis-selling scandal in the UK have demonstrated that conduct issues are not only harmful to consumers but can also have a wider prudential impact.

This paper covers recent regulatory developments in the UK in relation to conduct risk, and our observations of best practice for robust conduct risk management frameworks.

Regulatory conduct risk objectives and initiatives

The responsibility for the regulation of insurance companies in the UK has been split between the Prudential Regulation Authority ('**PRA**') and the Financial Conduct Authority ('**FCA**') since 2013, with the PRA focusing on the financial soundness of insurers and the FCA focusing on conduct issues.

The FCA has a single strategic objective, to ensure that relevant markets function well, and three operational objectives:

1. To secure appropriate protection for consumers;
2. To protect and enhance the integrity of the UK financial system; and
3. To promote effective competition in consumers' interests.

Since its formation in 2013, the FCA has placed considerable emphasis on, and has taken a proactive approach to, promoting good conduct. This is evidenced by its recent research, thematic reviews and market studies that inform best practice, some of which are discussed below.

FAIR TREATMENT OF LONG-STANDING CUSTOMERS IN THE LIFE INSURANCE SECTOR

The FCA has stressed that good service and fair outcomes should be provided to all customers of life insurance firms, and not just to those who have recently taken out a new product. As a means to address its concerns that firms are not actively monitoring and maintaining good outcomes for closed-book customers, on 9 December 2016 the FCA published finalised guidance[1], which sets out actions that firms should consider taking to treat these customers fairly.

REVIEW OF PART VII INSURANCE BUSINESS TRANSFERS

On 5 May 2017, the FCA published a guidance consultation paper on its approach to the review of insurance business transfers under Part VII of the Financial Services and Markets Act 2000. In this paper, the FCA states that it will consider the experience of the prospective Independent Expert ('**IE**') in relation to conduct risk issues arising from a particular transfer when it is reviewing the appointment of the IE. The FCA also stresses that it expects conduct issues to be considered explicitly by the IE when assessing the transfer and that both the firm and the IE should have conduct considerations at the forefront when designing and assessing a policyholder communications plan.

In December 2017, Milliman published a summary[2] highlighting the key points of the FCA's approach alongside insight from our experience of Part VII transfers and our response to the consultation paper.

ASSET MANAGEMENT MARKET STUDY

On 28 June 2017, the FCA published a report setting out the final findings of its Asset Management Market Study, which includes proposals to drive competitive pressure on asset managers, increase value for money for investors and improve the effectiveness of intermediaries. Alongside this report, the FCA published a consultation paper for the first set of proposed remedies, which focus on the duties of fund managers as the agents of investors in their funds, and asked for stakeholders' views on whether its governance proposals should be extended

[1] FG16/8 - Fair treatment of long-standing customers in the life insurance sector

[2] Milliman Briefing - Part VII transfers and the FCA's approach to the review

to unit-linked and with-profits insurance products.

In September 2017, Milliman produced a summary[3] highlighting the key outcomes of the FCA's report alongside our own views on the potential implications for UK life insurers.

A policy statement[4] for the first set of remedies and a consultation paper[5] for the second set of remedies, which focus on improving the information available to investors, were released on 5 April 2018. Although the FCA has not extended its proposals to unit-linked and with-profits insurance products at this time, it is currently undertaking diagnostic work to assess any harm that exists in these markets and expects to reach a view on whether further intervention is required in the first half of 2019.

This investment-oriented initiative represents an expansion of the FCA's life insurance focus, which has up to now mainly been on conduct issues relating to protection and with-profits business.

SENIOR MANAGERS AND CERTIFICATION REGIME

On 26 July 2017, the FCA published a consultation paper outlining proposals to extend its Senior Managers and Certification Regime ('**SM&CR**') to insurers, of which Milliman published a summary[6] in October 2017.

The FCA published two further consultation papers on this subject on 13 December 2017. The first of these[7] sets out proposals to move insurers and individuals to the new regime, while the second paper[8] discusses the FCA's plans to apply the 'Duty of Responsibility'[9] to insurers once the SM&CR is extended.

The aim of the SM&CR is to reduce harm to consumers and strengthen market integrity by making individuals more accountable for their conduct and competence. This is likely to be a driver of cultural change within firms. In the past the onus has largely been on the collective firm to ensure good conduct, and the move to individual accountability should force management to think carefully about what their duty is to customers and ensure their day-to-day decisions and actions, and those of the individuals and teams they are responsible for, are in accordance with this duty.

VULNERABLE CUSTOMERS

The FCA's 'Ageing Population and Financial Services' occasional paper[10], 'Financial Lives Survey'[11] and 'Approach to Consumers' consultation[12], published in September, October and November 2017 respectively, evidence its recent focus on the needs of vulnerable customers, who it broadly defines as "people who can readily be identified as significantly less able to engage with the market, and / or people who would suffer disproportionately if things go wrong". In these publications, the FCA discusses the challenges facing vulnerable and excluded customers, including older consumers, and its strategy for helping and protecting them, which involves collaborating with other organisations to improve outcomes for vulnerable consumers and focusing on the most vulnerable and least financially resilient consumer groups. The FCA expects firms to be able to demonstrate that they taking steps to address this issue, at a minimum paying attention to indicators of vulnerability and establishing policies to deal with consumers who may be at greater risk of harm.

PENSION TRANSFER ADVICE

Another area that is being prioritised by the FCA is the advice given to consumers in respect of Defined Benefit ('**DB**') pension scheme transfers.

Following a review of 88 recommended DB transfers between October 2015 and October 2017, the FCA found that only 47% of customers should have been advised to give up their DB pensions, and that the products and funds recommended for those who transferred were suitable in only 35% of cases. The FCA said that four firms "chose" to stop advising on DB transfers a result of these assessments. Furthermore, in light of the recent scandal surrounding ill-advised DB transfers from the British Steel Pension Scheme ('**BSPS**'), the FCA has contacted and requested information from financial advice firms conducting BSPS transfers, and a number of these firms have since agreed to cease their DB transfer business.

On 16 January 2018, the FCA wrote a letter[13] stating its intention to collect data from all firms with permission to advise on pension transfers during 2018. In this letter, the FCA reminded firms that

[3] Please contact us if you would like to receive a copy of this summary
[4] PS18/8 - Implementing asset management market study remedies and changes to our Handbook
[5] CP18/9: Second consultation on remedies following the asset management market study
[6] Milliman Update - Extension of the Senior Managers and Certification Regime to insurers
[7] CP17/41 – Individual Accountability: Transitioning insurers and individuals to the Senior Managers & Certification Regime
[8] CP17/42 - The Duty of Responsibility for insurers and FCA solo-regulated firms
[9] Under the Duty of Responsibility, the UK regulators can take action against Senior Managers where an activity in their firm for which they are responsible contravenes a regulatory requirement and they do not take reasonable steps to avoid the contravention occurring
[10] Occasional Paper – Ageing population and financial services
[11] Understanding the Financial Lives of UK Adults – Findings from the FCA's Financial Lives Survey 2017
[12] FCA Mission - Our Future Approach to Consumers
[13] FCA pension transfer advice letter

advice on pension transfers is a "key areas of focus" and expressed its concerns over recommendations that are based on generic assumptions, which do not fully reflect individual circumstances.

On 21 June 2017, the FCA published a consultation paper with proposals to improve the quality of advice on pension transfers. This was followed by a policy statement[14] on 26 March 2018, in which the FCA summarises the feedback it received during the consultation process and sets out final rules and guidance, which include:

- maintaining the starting assumption that a DB pension transfer will be unsuitable;
- requiring transfer advice to be provided as a personal recommendation that takes account of a client's individual circumstances; and
- replacing the current transfer value analysis with a requirement to undertake a personalised analysis of the client's options and a comparison to show the value of the benefits being given up.

Alongside the policy statement, further proposed changes were published in a second consultation paper[15]. These include:

- raising qualification levels for pension transfer advisors;
- guidance on assessing clients' attitudes to transfer risk;
- guidance on the advice boundary when providing 'triage'[16] services; and
- a requirement for firms to provide a suitability report regardless of the outcome of advice.

The FCA is also seeking views on whether it should intervene in relation to advice charging structures.

INSURANCE DISTRIBUTION DIRECTIVE

On 19 January 2018, the FCA published a policy statement[17] setting out near-final rules for the implementation of the Insurance Distribution Directive ('**IDD**'), which is due to replace the current rules governing the sale of insurance products in the EU (the Insurance Mediation Directive or '**IMD**').

Though an EU-wide initiative, the IDD is worth mentioning in the context of UK conduct of business supervision. Historically the FCA has taken a 'gold plated' approach to IMD implementation and as a result the IDD will have relatively less impact for UK firms because it replicates many provisions that are already in force in the UK. However, there are a number of areas where the IDD goes beyond the current FCA rules and in turn the FCA has proposed certain changes that exceed IDD minimum requirements. UK insurers will therefore need to conduct gap analyses and identify necessary changes to their business models and practices to comply with the new regime.

The IDD introduces general principles that apply to insurance distributors, including insurers that sell directly to consumers, namely to act honestly, fairly and professionally in the best interests of customers. A number of new requirements are set out in respect of pre-contract disclosures and the IDD makes it clear that firms must take an active role in ensuring that any contracts offered are in line with customers' demands and needs. Where an insurance policy is sold as part of a package with a non-insurance product or service, and insurance is the primary product, information must be given on whether different components of the package can be bought separately. Where insurance is an ancillary part of the package, the customer must be able to buy the primary product or service without the insurance.

The IDD sets out minimum knowledge and ability requirements, dependant on the type of insurance sold, with 15 hours per annum of continuing professional development ('**CPD**') covering these requirements specified for relevant employees. The FCA intends to introduce these rules for firms that are not subject to its existing Training and Competence sourcebook, under which employees who advise on certain insurance products must complete 35 hours of CPD.

Where appropriate, the FCA has decided to broadly align the IDD requirements for firms selling investment-based insurance products ('**IBIPs**') with the MiFID II requirements for investment products. For example, certain MiFID II rules relating to inducements (commissions, fees and non-monetary benefits), which are above IDD minimum standards, will apply to IBIPs. In turn, the FCA will introduce elements of the IDD which are supplementary to, or more specific than, its current rules, including MiFID II - for example, additional requirements for suitability or appropriateness assessments for advised and non-advised sales of IBIPs respectively.

Under the IDD, conflicts of interest management will be subject to higher standards. The FCA proposes to introduce rules which require insurers to establish a conflicts of interest policy for their distribution activities, disclose information on conflicts of interest to customers where these cannot be sufficiently managed and maintain a record of the situations in which a conflict of interest has arisen.

The IDD also includes a number of provisions in relation to

[14] PS18/16 – Advising on Pension Transfers
[15] CP18/7 – Improving the quality of pension transfer advice
[16] Triage is an initial conversation to give the customer sufficient information to enable them to make a decision about whether to take pensions transfer advice
[17] PS18/1 - Insurance Distribution Directive implementation

product oversight and governance ('**POG**'), which apply to both manufacturers and distributors of insurance products. The FCA considers that its current guidance on firms' obligations in 'Responsibilities of Providers and Distributors for the Fair Treatment of Customers' ('**RPPD**') broadly covers the POG provisions and therefore this aspect of IDD should not have a significant impact on UK firms. It proposes to implement these provisions, but also to align the rules with additional MiFID II product governance requirements.

Originally scheduled for 23 February 2018, the application date for the IDD has recently been pushed back, with EU Member States now required to finalise their local rules by 1 July 2018 and comply with the new requirements by 1 October 2018. As a result of this delay, the FCA has included a transitional provision in its near-final rules so that firms may adopt some or all of the new requirements early if they so choose.

CULTURE AND CONDUCT

The FCA has identified "a clear link between poor culture and poor conduct" and has stressed the need for firms to establish the right culture in numerous publications over the last few years, for example in its recent business plans[18] and in speeches given by FCA staff[19].

On 12 March 2018, the FCA published a discussion paper[20] to generate debate on transforming culture in the financial services sector, with the four main themes being:

- what a good culture might look like;
- the role of regulation in managing culture;
- the role of reward, capabilities, and environment in driving behaviours; and
- how firms can lead culture change.

In this paper, the FCA states that there is no 'one size fits all' or 'right' culture for firms, but that its aim is to promote a healthy culture with characteristics that reduce harm. It sets out two fundamental concepts that underpin its thinking about culture and regulation:

1. Regulation has to hold the individual as well as the firm to account; and
2. Leaders can manage culture even if they cannot measure it very well, as they can measure and take account of their own behaviour and the behaviour of those in their area of responsibility.

Both of these concepts are deeply embedded in the SM&CR.

Rather than attempting to measure a firm's culture by assessing behaviours directly, the FCA states that it will focus on four main drivers of behaviour, which can be more easily identified and managed: a firm's purpose, leadership, approach to rewarding and managing people, and governance arrangements.

Turning to the question of what firms can do to achieve cultural change, the paper offers a number of insights which include:

- using behavioural science to guide incentives and cultural change;
- looking beyond the role of leadership in effecting change;
- applying strategic focus to the continuous process for adapting culture;
- fostering environments of trust to encourage openness and learning; and
- applying a systems perspective in assessing both internal culture and external influencers.

Further discussion on the increasing influence of culture on conduct risk management and examples of the changes we have seen firms making to establish a healthy culture and promote appropriate behaviors are provided later in this paper.

Practical aspects of conduct risk management

Milliman's experience of working with life insurers on a wide range of conduct risk matters has allowed us to identify best practices and important considerations for firms in relation to the design and implementation of an effective conduct risk management framework. Some specific examples of the practical steps firms are taking, or should consider taking, are set out below.

CONDUCT ACROSS THE PRODUCT LIFE CYCLE

Traditional approaches to conduct risk management focused on the point of sale, for example disclosure and selling practices. However, conduct risks are present through all stages of the product life cycle and therefore a good conduct risk

[18] 2016/2017 Business Plan; 2017/18 Business Plan; 2018/19 Business Plan

[19] Getting culture and conduct right – the role of the regulator; Culture in financial institutions: it's everywhere and nowhere; Culture and conduct – extending the accountability regime

[20] DP18/2 – Transforming culture in financial services

management framework should also cover activities such as:

- post-sale correspondence and information;
- monitoring ongoing product suitability and customer value;
- policy closure or switching;
- claims handling; and
- complaints management.

The FCA's recent guidance on the fair treatment of long-standing customers in the life insurance sector, mentioned earlier in this paper, supports this concept.

ARTICULATING CONDUCT RISK

As a first step, most insurers define conduct risk, which should help to promote consistency in how these risks are understood and treated across the business. However, there is a challenge in doing so – firms' conduct risk profiles are unique and there is no 'one-size-fits-all' definition.

Whilst definitions vary amongst firms, as a starting point they should focus on the customer and not on damage to the firm. For example, most refer to "treating customers fairly" and "delivery of good consumer outcomes". Some also refer to actions that are detrimental to consumers or cause reputational damage to firms, and to the FCA's market integrity and competition objectives.

Firms will need to consider the risk classification used, to ensure this provides adequate coverage of conduct risks. For example, conduct risks can be linked to operational, strategic, reputational, legal or regulatory matters, each of which have different sources of risk and for which firms have different risk appetites and management techniques.

Insurers should define a conduct risk appetite statement to articulate the types of conduct of business failures that must be avoided. These statements are usually set and communicated by firms' boards, and should be integrated with their existing risk appetite and reflect the business strategy and objectives. The concept of 'risk appetite' in the context of conduct of business can be difficult to visualise, however. Whilst most firms wish to avoid or minimise conduct risks insofar as possible, they generally acknowledge that 'low' tolerance is more realistic than 'zero' tolerance, given the wide-range and nature of conduct issues. For this reason, it may be more meaningful to express conduct risk appetite in terms of good behaviours and customer outcomes.

IDENTIFCATION AND ASSESSMENT TECHNIQUES

It is fair to say that conduct risks may vary considerably across firms, depending on a variety of factors including their size, business model and geographical reach. However, despite these differences, most conduct risks are driven by:

- aspects of the nature of insurance business, for example product complexity, information asymmetries and customer behaviour;
- aspects of an insurer's own governance models or business processes, for example product design, data quality and complaints handling;
- factors relating to the external environment in which an insurer operates, for example the level of competition and market performance.

Reviewing past misconduct events and applying root cause analysis has proved a good way of identifying likely sources of conduct risk for most firms. Rather than dealing solely with known problems, however, emerging opportunities and risks should also be identified, for example by considering trends and developments in the business and external environment and their potential impact. One such area is the advance of technology and 'Big Data', which has allowed firms to obtain information on customers without their explicit consent. Where this information improves customer outcomes its use may be justified but conversely it could have a negative impact on customers, for example resulting in false conclusions, inequalities and privacy concerns.

For most of a firm's risks, the 'severity' rating, for example Low / Medium / High, would reflect the expected loss to the firm on event occurrence. Given the nature of conduct risks, however, it is more appropriate for them to be ranked according to customer detriment, considering for example the expected number of customers affected and total loss to customers.

CONDUCT RISK MANAGEMENT, MONITORING AND REPORTING

Conduct risk appetite statements should be translated into specific risk policies that set constraints on the business model. For example, 'safer' business models from a conduct risk perspective might be ones that:

- have a lower cost base, so that there is less pressure to press for marginal income growth;
- don't overly rely on profits from back book customers to subsidise new customers;
- don't have high degrees of cross-subsidisation between products; and
- don't rely on products that are highly profitable.

Defining a control framework for conduct risk is useful in ensuring alignment with risk policies, with different types of controls operated across the product life cycle. Important controls include human resources ('**HR**') policies such as remuneration, specific consumer protection policies and procedures such as claims handling, and governance structures (some examples of which are provided later in this paper). Although conduct risks are often viewed as qualitative, we are aware that some firms also hold capital to address these risks, the level of which might be estimated by considering projected losses under adverse Own Risk and Solvency Assessment ('**ORSA**') scenarios.

In terms of monitoring conduct risk exposures, risk metrics should be tailored to the customer outcomes firms wish to achieve and would therefore be expected to comprise measurements relating to customer experience and employee behaviour. For example, they might include policy cancellation rates, scores for customer satisfaction surveys, incidences of missed staff training, and other incidences of conduct policy breaches.

The collection of conduct risk management information ('**MI**') should reflect typical characteristics of conduct risk drivers, for example:

- the time lag between misconduct and detriment emerging;
- the scale of detriment can depend on other factors, for example market movements; and
- the impact of a given monetary loss varies for different customers.

Conduct risk MI should also be meaningful and actionable – given the wide-ranging nature of conduct risks, a challenge is making sense of the volume of data that can be generated.

Culture and conduct

It would be remiss to talk about the practical aspects of conduct risk management without also talking about culture, as it is now believed that establishing the right culture lies at the heart of designing and implementing a suitable conduct risk management framework.

CHANGE IN APPROACH TO CONDUCT RISK MANAGEMENT

The former Financial Supervisory Authority ('**FSA**'), which was the single UK financial regulator before the introduction of dual-regulation by the PRA and FCA, was criticised for taking a tick-box supervisory approach to conduct risk. This resulted in firms focusing on achieving minimum regulatory compliance, rather than fully considering customer outcomes across their business and ensuring that a culture of 'fair treatment' was embedded.

In recent years, however, and as described earlier in this paper, the FCA has identified a clear link between poor culture and poor conduct. This has led to a change in firms' approaches such that firms are now focusing on establishing a culture of doing the right thing and demonstrating their commitment to positive customer outcomes - they are evolving their business models into ones that are safer from a conduct perspective, and are embedding good behaviours into business practices and at all critical points of engagement with the customer. In this way, the emphasis is now on how the business is run, and less on how it is controlled.

EXAMPLES OF CULTURE IMPROVEMENTS

Culture is the product of a number of different drivers within a firm, for example leadership, strategies, incentive structures, and the effectiveness of management and governance.

Insurers are increasingly aware of the importance of establishing the right 'tone from the top', with firms' boards and senior management providing guidance and leadership regarding which values and behaviours are rewarded or discouraged. We increasingly see boards being prominently involved in supporting the status and visibility of long-term conduct risk initiatives, for example by organising video messages, poster campaigns and conduct events. To encourage understanding and engagement of all staff, boards are setting clearly defined goals for these initiatives and are working to embed them into business as usual processes, risk management frameworks and strategic frameworks.

Tone from top is not enough in isolation, however. Everyone in the business influences the culture and, because of this, individual engagement and accountability has become an emerging theme (as embodied by the SM&CR). When conduct incidents happen, firms are increasingly considering not just the individuals directly involved, but also the role of control functions, senior managers, business unit managers and by-standers. In this way, accountability within firms is becoming more widespread, with the onus on everyone to proactively behave in the best interest of customers.

Firms' overall business plan and strategy should be aligned with good conduct. To promote this ambition for good conduct, many firms have set policies, principles, codes of conduct and service standards, which all employees must understand and comply with, and the outcomes of which are regularly monitored to ensure that everyone is working towards the same goal.

We have seen that staff recruitment, performance management and remuneration are increasingly being linked to conduct and culture objectives. This should help to mitigate unintended consequences and inappropriate behaviours which are detrimental to customer outcomes. Examples of successful approaches include:

- training for small groups, perhaps targeted at specific business functions or levels of seniority;
- lessons learned from case studies of past conduct incidents;
- gathering feedback on people's conduct and behaviour and

communicating this to staff;
- rewarding excellent conduct by public acknowledgement or staff rewards;
- focusing the linkage between conduct and remuneration on more senior and risk-taking staff; and
- conducting employee surveys, to better understand their values and what influences their behaviours.

We have observed that strict governance processes are adhered to at all stages of the product life cycle, with review, challenge and approval required for all decisions and actions that affect consumer outcomes. As part of the first line, some larger firms have established a dedicated steering group to assist with managing conduct risks. Such structures can help in particular to:

- co-ordinate different business units in relation to conduct matters;
- collate information on conduct risk exposures;
- investigate misconduct incidents in detail, to help understand and manage their drivers;
- consider legal and regulatory developments and industry events, to generate thought on emerging conduct risks; and
- develop, prioritise and close actions in response to issues identified by the second or third lines.

As part of the second line, some firms have also created specific risk committees to focus on conduct risk. Their role would be expected to include oversight of conduct over the product life cycle, as well as the achievement of an appropriate conduct-focused culture.

Conclusion

Rather than provide an exhaustive list of all UK regulatory developments in relation to conduct risk, our intention for this paper was to highlight some of the broad themes, in terms of both firms' activities and different groups of customers, which the FCA has recently focused on. Even from the subset of topics we've covered, it is clear that the scope and depth of conduct of business supervision have both increased significantly following the introduction of dual-regulation and the move to a risk-based solvency regime. As a result, there is now increased pressure on insurers to prioritise the welfare of all current and potential future customers in everything they do, regardless of customers' personal circumstances, the products and services they buy, or the maturity of their policies.

We hope this paper will help firms to generate ideas and discussion as to what steps could be taken to more effectively tackle conduct risk. With the heightened regulatory focus it has received, we would of course expect firms to place more emphasis on conduct going forwards. However, regulation alone isn't enough – as the FCA itself has stated, change needs to be "chosen rather than imposed". We believe that demonstrating commitment to positive customer outcomes is in the economic self-interest of firms – it should build customer trust and loyalty and help firms to avoid costs such as fines, redress payments or reputational damage. Hopefully this belief will be shared by the industry and encourage everyone to take personal responsibility for good conduct.

Milliman has considerable experience of working with clients on wide-ranging conduct matters. If you have any questions or comments on this paper, or any other aspect of conduct risk, please contact either of the consultants below or your usual Milliman consultant.

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